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4 October 2012

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Dear John

AEMC Draft Determination on the economic regulation of network services

United Energy and Multinet Gas welcome the opportunity to lodge this submission in response to the Commission's draft Rule determination on the economic regulation of network services. In addition, United Energy and Multinet Gas wish to draw the Commission's attention to the submission lodged by the Energy Networks Association (ENA), which we fully support. We note that the ENA submission includes detailed drafting suggestions for the Commission's consideration.

The Commission's determination is one of the most important that it has undertaken, given its potential impact on investment and network prices. It is essential for the Commission to ensure that the overall effect of its proposed changes is to promote investor confidence. If investor confidence diminishes, regulated companies will face increasing difficulties in attracting the capital to fund the investment needed to ensure the on-going provision of reliable network services over the longer term.

It is also important to remember that the existing Rules were developed over an extended period, taking account of numerous expert reports and operational experience of how regulation has worked in practice. Regulation will always be an imperfect substitute for market competition. It is not possible to develop 'perfect' regulatory arrangements, and the existing Rules should not be judged against an unattainable standard of perfect regulation.

These observations suggest that the Commission should be seeking incremental change, not radical reform of the existing Rules. To a large extent, the draft determination achieves reasonably well-balanced, incremental reform. As noted below and in the accompanying

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attachment, however, United Energy and Multinet Gas do not support all aspects of the Commission's proposals.

The Commission's proposals cover the following areas:

- Rate of return (electricity and gas)
- Capital expenditure incentives (electricity)
- Capital expenditure and operating expenditure allowances (electricity); and
- Regulatory process (electricity).

In relation to the rate of return, United Energy and Multinet Gas support the Commission's development of a common rate of return framework for all energy networks. We also support the Commission's view that the National Gas Rules provides an appropriate starting point to develop this framework because of its relative flexibility.

However, the draft Rules leave 'too many dots to be joined' by the AER. For example, the draft Rules are sufficiently broad to accommodate the AER's current approach of mechanistically applying the CAPM, even though the draft determination concludes that this approach is not consistent with the NGO or NEO. In our view, the Rules must provide sufficient guidance to the AER to ensure that the Commission's preferred approach to the cost of capital is adopted by the AER.

The draft Rules in relation to the cost of capital should also be amended to give effect to the following regulatory principles:

- Regulation should not distort the investment and financing decisions that would be made in the absence of regulation.

- Financing costs must be benchmarked, where benchmarks are set with reference to competitive markets.

- Market evidence should be given substantial weight in regulatory determinations.

- Regulators must be accountable for their decisions.

Although these principles are wholly consistent with the NEO and NGO, they are not fully reflected in the draft Rules. In section 2.2 of the attachment to this letter, we suggest some drafting changes that would assist in giving effect to these principles.

United Energy and Multinet Gas are also concerned that the Commission places too little weight on regulatory precedent and the 'inertia principle'. Regulatory precedent - so long as it is soundly based - will promote the NEO and NGO by providing the regulatory stability that is necessary to foster investor confidence.

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In relation to the capital expenditure incentives in National Electricity Rules, the draft determination provides for capital expenditure sharing schemes and ex post prudency reviews. The Commission's intention is to provide incentives for network companies to invest capital efficiently.

From our perspective, the Commission's objectives are well intentioned and should be supported by all stakeholders. United Energy and Multinet Gas are concerned, however, that unintended consequences may arise if these arrangements were to be implemented. For example, earlier experience in the electricity transmission sector prompted the AER to note in a submission made to the Commission in January of this year that "an ex post review may be an intrusive and resource intensive process"[1].

More importantly, the application of regulatory discretion in ex-post capital expenditure reviews represents a tangible threat of stranded asset risk (that is, destruction of capital). For instance, in its review of Western Power's 2009-12 access arrangement, the Economic Regulation Authority removed approximately $250 million from the company's regulatory asset base (RAB) following an ex-post expenditure review. This experience highlights the magnitude of the threat of capital loss when regulators:

- apply inappropriate standards - after the event, and with the benefit of hindsight - to judge the efficiency of capital expenditure that has already been incurred; and
- turn the onus of proof on the service provider to demonstrate that actual investment is efficient.

In our view, the Commission should not entertain ex post reviews of any kind. However, if the proposed arrangements for ex-post review of capital expenditure are retained, the regulators must bear the burden of proof. It would be totally unacceptable if the AER could simply declare that it was 'not persuaded' that actual capital expenditure is efficient and therefore exclude that expenditure from the RAB. Such an approach would drive investment from the sector as investors, quite reasonably, seek to minimise their exposure to regulatory risk and capital loss.

The capital expenditure sharing scheme has the potential to strengthen the incentives for achievement of capital expenditure efficiencies. This is to be welcomed. However, the Commission has proposed that the Rules would not define efficient and inefficient capital expenditure. Under this approach, the outcomes provided by the scheme would be subject to considerable uncertainty, which will weaken its incentive properties. Depending on how the AER applies the provisions, the scheme may not provide the stronger incentives that the Commission intends.

In relation to the capital expenditure and operating expenditure allowances, the Commission provides some helpful clarification regarding the AER's ability to review and amend the

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[1] See http://www.aemc.gov.au/Media/docs/Australian%20Energy%20Regulator%20120125-b7191eee-5364-4fc4-ab44-c8e51ca3bcd1-0.PDF

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expenditure proposals submitted by network service providers. In addition, the Commission has strengthened the role of benchmarking by requiring the AER to publish annual benchmarking reports, which would analyse the relative efficiencies of network businesses. United Energy and Multinet Gas support these changes.

However, United Energy and Multinet Gas cannot support the Commission's view that the regulator should determine an expenditure forecasting methodology for network companies. Incentive regulation is predicated on a view that companies, not regulators, are responsible for expenditure decisions.

Under the arrangements proposed by the Commission, the AER's role of reviewer would be expanded to the point where the regulator is, in effect, assuming an operational role. The Commission's approach invites the regulator to adopt the perspective of a central planner, under which a 'one-size-fits-all' forecasting methodology would be rolled out across all network companies. It is an approach that will create many more problems than it resolves.

United Energy and Multinet Gas are also concerned that the Commission proposes to remove the reference to the "circumstances of the network service provider" from the expenditure criteria. From our perspective, it is only reasonable that the AER should consider the company's specific circumstances in making its determination. We note that Professor Stephen Littlechild also expressed concern on this issue in his advice to the Commission on the AER's proposed Rule change in February 2012.

The attachment sets out our views on these matters in further detail. As noted at the outset, United Energy and Multinet Gas also support the submission lodged by the Energy Networks Association, which includes detailed drafting suggestions for the Commission's consideration.

Given the importance of this Rule change, United Energy and Multinet Gas would welcome further discussion with the Commission as it addresses the issues raised by stakeholders. In the meantime, should you or your staff have any queries regarding this submission, please contact me directly on (03) 8846 9860.

Yours sincerely

Andrew Schille
General Manager Regulation

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ATTACHMENT

United Energy and Multinet Gas Submission to the AEMC's draft Rule change on the economic regulation of network services

1. Introduction

United Energy and Multinet Gas welcome the opportunity to lodge this submission on the Commission's draft determination and the accompanying draft Rules. United Energy and Multinet Gas are privatised Victorian electricity and gas distributors with considerable experience of regulation.

Although incentive-based regulation is comparatively new to Australia compared to the UK, it has already been through a major reform with the establishment of the current national legislative framework. The current Rules were settled only 6 years ago, and the regulated energy networks sector therefore remains in a bedding-in phase. It is essential, therefore, that further changes to the Rules are focused on delivering incremental improvements rather than major reform.

In many respects, United Energy and Multinet Gas welcome and concur with the approach adopted by the Commission. In particular, the Commission is right to resist the AER's preference for locking-in cost of capital parameters based on a narrow application of the Capital Asset Pricing Model. In addition, the Commission has recognised the importance of benchmarking and the need to provide incentives to network service providers to deliver better outcomes for customers.

In our view, however, there are some respects where the Commission's draft Rules could be further improved. In some cases, our concerns relate primarily to drafting. Specifically, the Commission has allowed too much scope for different interpretations of the Rules, with the risk that the Commission's intentions will not be implemented. These concerns relate primarily to the cost of capital provisions.

In other instances, United Energy and Multinet Gas disagree with the Commission's position. For example, United Energy and Multinet Gas cannot support the proposal that the regulator should play a role in establishing the expenditure forecasting methodology. This attachment explains that such an approach blurs operational responsibility between the company – which is best placed to evaluate expenditure decisions - and the independent regulator. The regulator's role is to provide incentives for the company to deliver more efficient outcomes, but the regulator should not play a role in delivering those outcomes.

The remainder of this attachment is structured as follows:

- Section 2 comments on the Commission's proposed approach to the cost of capital;
- Section 3 responds to the Commission's proposed approach to setting the expenditure allowances; and

- Section 4 discusses the Commission's proposed changes to the capital expenditure incentives.

2. Cost of capital

2.1 Introduction

United Energy and Multinet Gas agree with the Commission's approach to the cost of capital. Specifically, the Commission is right to focus on the problems that can arise – and indeed have already arisen – if an overly mechanistic approach is applied to estimating the cost of capital.

This Section 2 explains that improvements can be made to the draft Rules to ensure that they give effect to the reasoning and positions set out in the Commission's draft determination. In addition, it is important that the draft Rules appropriately balance flexibility and regulatory accountability. At present, the balance has swung too far towards flexibility. The remainder of this section is structured as follows:

- Section 2.2 discusses the rate of return objective;
- Section 2.3 addresses the cost of debt provisions; and
- Section 2.4 discusses the importance of investor confidence in the context of the cost of capital guidelines.

2.2 Rate of return objective and the cost of equity

Clause 6.5.2(b) defines the allowed rate of return objective as follows:

> "The allowed rate of return for a Distribution Network Service Provider must correspond to the efficient financing costs of a benchmark efficient entity with a similar nature and degree of risk as that which applies to the Distribution Network Service Provider in respect of the provision of standard control services."

The Commission argues that[2]:

> "The draft rule gives primacy to an overall rate of return objective. This objective is directly linked to the NGO (or NEO) by focussing on estimating a rate of return required by a benchmark efficient entity."

While United Energy and Multinet Gas agree that the rate of return objective should be directly linked to the NEO and NGO, in our view further drafting improvements can be made to give effect to these objectives. In particular, the competitive market paradigm is

[2] AEMC, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Draft Rule Determinations, 23 August 2012, page 17.

embedded in the NGO and NEO through the concepts of efficiency and promoting efficient investment. The NGO (and NEO) state that:

> "The objective of this Law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas."

In our view, competitive markets provide a first-best mechanism for delivering efficient outcomes. However, the rate of return objective does not make any mention of competitive markets. Instead, the drafting is rather abstract because it focuses on benchmarking, without any reference to competitive markets. This is not conducive to satisfying the NGO or NEO.

In addition, the rate of return objective should be consistent with the Revenue and Pricing Principles. In particular, the following Revenue and Pricing Principles in the National Gas Law[3] have important implications for setting the rate of return:

- Section 24(2) requires that a gas service provider should be provided with a reasonable opportunity to recover at least its efficient costs.
- Section 24(3) requires that a gas service provider should be provided with effective incentives to promote economic efficiency in investment in, and the operation and use of, the pipeline for the provision of pipeline services.
- Section 24(5) requires that the reference tariffs provide a return commensurate with the regulatory and commercial risks.
- Section 24(6) requires the regulator to have to the economic costs and risks of the potential for under- and over-investment by a gas service provider in a pipeline that is used to provide pipeline services.

These principles are also focused on the practical issues of attracting funding to finance efficient investment. It is important, therefore, that the rate of return objective reflects these concepts, albeit in broad terms.

United Energy and Multinet Gas concur with the Commission's view that the benchmark efficient entity is an important concept in setting the cost of capital. It is standard regulatory practice to abstract from the company's own financial structure in order to provide incentives for each company to minimise its own cost of capital.

The benchmarking concept also captures an important goal that should guide all regulatory decisions – regulation should not affect the investment and financing decisions that a company would make in the absence of regulation. In other words, as the Commission has recognised, regulation should not affect the efficient investment and financing decisions that would be made in a competitive market. It would be helpful, therefore, if the reference to

3 Equivalent provisions are set out in section 7A of the National Electricity Law.

"benchmark efficient entity" in the rate of return objective clarified that the benchmark should refer to competitive markets.

The draft rate of return objective (as set out in the mark-up of the proposed changes to Chapter 6 of the Electricity Rules, and in the draft Gas Rule) is confusing in that it requires the benchmark to be set with reference to an efficient entity which is similar in terms of risk and nature to the service provider[4]. The fundamental feature of a benchmark is that it must abstract from the service provider because it is intended to provide an independent point of reference. However, if the 'nature of the service provider' is regarded as unique, the benchmark concept may be misinterpreted and misapplied.

In light of the above comments, United Energy and Multinet Gas propose the following drafting changes for the rate of return objective:

> "The allowed rate of return is to be the best estimate of the cost of capital that ~~The allowed rate of return for a Distribution Network Service Provider~~ corresponds to the efficient financing costs of a benchmark efficient entity in a workably competitive market, assuming ~~with~~ a similar ~~nature and~~ degree of risk as that which applies to the Distribution Network Service Provider in respect of the provision of standard control services."

In addition, the cost of equity provisions must also recognise the importance of prevailing conditions in the market. At present, the drafting relegates this information to a factor that the AER must 'take into account'. As funding must be raised in capital markets, market information must be given the highest weighting by the regulator. The current drafting does not achieve that outcome.

United Energy and Multinet Gas therefore propose that the Rules should require the estimated cost of equity to be commensurate with the prevailing conditions in the market for funds. This will ensure that the estimated cost of equity takes proper account of the available market evidence and data. In a similar vein, where the cost of debt benchmark is to be set with reference to prevailing market conditions, there should be provisions requiring the estimated cost of debt to be commensurate with the prevailing conditions in the market for funds.

2.3 Cost of debt

The draft Rule sets out the following provisions in relation to the cost of debt:

> "The return on debt for a *regulatory year* must be estimated:
>
> (1) in a way that is consistent with the *allowed rate of return objective*; and
>
> (2) using a methodology under which:
>
> (i) the return on debt for each *regulatory year* in the *regulatory control period* is the

[4] It is noted that the drafting of clause 6.5.2(b) in the marked-up version of chapter 6 published by the Commission differs from that presented in the Commission's Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012.

same; or;

(ii) the return on debt for a *regulatory year* (other than the first *regulatory year* in the *regulatory control period*) is estimated using a methodology which complies with paragraph (i)."

United Energy and Multinet Gas strongly agree with the Commission's view that[5]:

> "As the return on debt is part of the overall allowed rate of return, the Commission considers that the best way to meet the NEO, the NGO and the RPP for estimating the return on debt is the same as that discussed in the rate of return framework chapter. That is, the return on debt estimate should reflect the efficient financing costs of a benchmark efficient service provider. It should try to create an incentive for service providers to adopt efficient financing practices and minimise the risk of creating distortions in the service provider's investment decisions. If a service provider is run inefficiently then its shareholders, and not its customers, should bear the financial consequences of inefficient financing practices."

However, United Energy and Multinet Gas are concerned that the draft Rules in relation to the cost of debt do not adequately capture the concepts set out by the Commission. Our proposed changes to the rate of return objective (set out in section 2.2 above) will assist in addressing these concerns by making it clear that the benchmark is a competitive market concept, not a concept focused on the specific costs incurred by the service provider.

United Energy and Multinet Gas also consider that improvements can be made to the draft Rules to ensure that the Commission's proposed approach to the cost of debt – which we support – is reflected in the drafting. In this regard, United Energy and Multinet Gas rely on the submission of the Energy Networks Association, which proposes a number of drafting improvements.

In relation to the methodology used to derive a cost of debt benchmark, United Energy and Multinet Gas note that if there is a move to use trailing averages, then there will be a need for appropriate transitional provisions to be included in the Rules. There will also be a need for the Rules to recognise that transitional provisions will differ across companies depending on the characteristics of their debt portfolios.

United Energy and Multinet Gas regard it as essential that the regulated company (and not the AER) should have the discretion to adopt a trailing average approach. We note that if the AER were to have this discretion, then companies that have established efficient debt portfolios and hedging strategies in response to the incentives provided by the current Rules would face potentially significant losses simply as a result of the migration to a new methodology for setting the benchmark cost of debt. By allowing network companies to decide whether to adopt the trailing average approach, this potential exposure will be effectively managed.

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5 AEMC, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Draft Rule Determinations, 23 August 2012, page 64.

2.4 Cost of capital guidelines and regulatory precedent

In developing its Rule change determination, it is important for the Commission to have regard to the history of regulatory development in Australia, which differs markedly from the experience in the UK. In Australia, the greater discretion afforded to the ACCC in the early years of regulation did not produce acceptable outcomes. Today's Rules are, therefore, not an accident of history. The Rules reflect a conscious decision by policy makers to ensure that regulatory discretion is "guided".

The Commission's proposal that the cost of capital guidelines should be non-binding, and that the Rules should provide little guidance on the scope of the guidelines themselves, is therefore at odds with regulatory experience in Australia. The Commission's role as Rule-maker specifically recognises that the regulator must apply the Rules, not set them. In drafting Rules that require the regulator to publish guidelines, but which do not provide constraints or direction in relation to the content of the guidelines, the Commission is, in effect, returning the role of Rule-maker to the regulators.

The distinction between Rule-maker and Rule-enforcer is not purely conceptual – it also has practical implications. In relation to the cost of capital, by setting Rules the Commission can ensure that the regulators implement its preferred approach to estimating the cost of capital. In the absence of Rules that mandate the Commission's preferred approach, the regulator is free to side-step the Commission's determination.

There are a number of aspects of the Rules in relation to the cost of capital guidelines where the Commission's preferred approach may be side-stepped. Specifically, United Energy and Multinet Gas agree with the Commission that the regulators should weigh up a range of estimation methods, financial models, market data and other evidence to determine the cost of capital. However, the draft Rules do not preclude the cost of capital guidelines from specifying the CAPM as the preferred estimation method, providing that the regulator has considered other estimation methods in making its decision.

The draft Rules could be improved by requiring the cost of capital guidelines to satisfy a number of principles that reflect the Commission's determination. This approach is consistent with other guidelines in the Rules, such as the cost allocation guidelines.

Given the importance of the cost of capital to all stakeholders, the cost of capital guidelines should also be subject to merits review. The regulators should be bound to follow the cost of capital guidelines unless the rate of return objective would be better achieved by a change in approach. The ability to hold the regulator to account if its approach is unreasonable or inconsistent with the Rules is an essential safeguard. Experience tells us that decisions are less likely to be optimal if the decision maker is not accountable.

The draft Rules provide little comfort that cost of capital determinations will be reasonably stable and predictable. The regulator has no formal requirements to have regard to previous regulatory decisions and no formal requirements to adhere to the WACC guidelines. This approach – whilst maximising flexibility – provides little comfort to investors that the regime

will be stable and predictable. The Commission has given too little weight to the value of regulatory precedents and the 'inertia principle' in promoting investor confidence.

Investor confidence is a fragile commodity, and perceptions of risk and uncertainty will be formed on the basis of the Commission's Rule determination. Investors will not wait to see how regulators conduct themselves before assessing their exposure to regulatory risk. If safeguards are removed and regulatory discretion broadened, investors will draw their own conclusions. It is ironic that if the Rules are amended to increase the regulator's discretion to set even lower rates of return, perceptions of regulatory risk will increase, and therefore so will the return required by investors. Such an outcome would be contrary to the NEO and NGO.

United Energy and Multinet Gas note that the Energy Networks Association has proposed drafting changes to enhance the Rules relating the cost of capital guidelines. We consider that these changes will go some way to maintaining the important principle of regulatory stability, which is essential in order to promote the NEO and NGO. As already noted, United Energy and Multinet Gas support the Energy Networks Association's submission.

3. Expenditure allowances

3.1 Introduction

United Energy and Multinet Gas agree with the Commission's view that the existing provisions in the NER generally provide the AER with appropriate discretion to set expenditure allowances at an efficient level, assuming the AER has adequate information and uses appropriate analytical techniques[6]. We also accept that benchmarking is a tool that has been under-utilised by the AER. United Energy and Multinet Gas support the Commission's view that the AER should be required to undertake annual benchmarking of network service providers.

United Energy and Multinet Gas also agree with the Commission's view that the NSP is best placed to develop the expenditure proposals[7]:

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

Given the Commission's observation that the regulated company has the most experience in how a network should be run, as well as holding all of the data on past performance of its network, it is very surprising that the Commission proposes that the AER should establish the expenditure forecasting methodology. United Energy and Multinet Gas is also concerned

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6 Ibid, page 94

7 Ibid, page 102.

that the Commission proposes to remove the reference to the "circumstances of the network service provider" from the expenditure criteria.

Each of these matters is discussed in turn.

3.2 Forecasting methodology

The Commission explains its draft Rule in relation to forecasting methodologies in the following terms[8]:

> "The draft rule requires the AER to develop a standard methodology for preparing expenditure forecasts. This overall methodology may be comprised a number of approaches. For example, it may include the "repex" model that the AER used in the recent Victorian distribution regulatory determinations for replacement capex, and a different approach for augmentation capex. NSPs would have the chance to make submissions on this model when the AER consults on it. There is no obligation that the same standard methodology be used for transmission and distribution, but given the similarities between TNSPs and DNSPs it seems likely this would be the same. There may, however, be specific NSPs for whom the standard model is not appropriate, perhaps due to size or location. The AER would have the ability in its framework and approach paper, which is also consulted on, to identify if the NSP is required to use the standard methodology, or if not, what alternative methodology should be used. In preparing its proposal, the NSP could use different methodologies but at least one of these would have to be the methodology specified in the framework and approach paper."

From United Energy and Multinet Gas's perspectives, the AER's development of the repex model provides a good example of why the AER is not best placed to develop expenditure forecasts. The AER relied on the repex model in its Draft Decision for the Victorian distributors. However, there were serious deficiencies with the repex model, which led the AER not to rely on the model in its Final Decision, and instead to focus on the distributors' forecasting methodologies and models. The AER commented as follows[9]:

> "After reviewing the Victorian DNSPs' initial and revised regulatory proposals, the AER's detailed review placed particular emphasis on:
>
> - the Victorian DNSPs' forecasting methodology – their forecasting models, the inputs and assumptions of these models and the application of these data to form their forecast
> - the drivers for capex (such as asset age, risk profiles and asset condition), examining whether the drivers were appropriate, whether the drivers have changed and whether the timing of the expenditure was appropriate
> - the outcomes delivered by the Victorian DNSPs in the 2006-10 regulatory period and the potential benefits of the Victorian DNSPs' proposed increase in capex."

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8 Ibid, page 112.

9 AER, Victorian Electricity Distribution Network Service Providers Distribution determination 2011–2015, Final Decision, October 2010, page 427.

However, there is a more fundamental concern with the Commission's proposal that the AER should establish the expenditure forecasts - it is that the AER is not best placed to determine the forecasting methodology. The network companies have the expertise to determine the optimal forecasting methodology. The AER should review these methodologies, but should not be responsible for developing them.

Incentive regulation is predicted on the view that privatised or corporatised companies are more likely to deliver efficiency improvements than centrally planned, nationalised industries. The Commission's proposal, however, is more aligned with a view that central planning is likely to deliver the best outcome. Specifically, the AER would develop a forecasting approach that is not informed by each company's operational experience, but is centrally planned and applied consistently across all companies irrespective of their particular circumstances. As such, it is an approach that is highly unlikely to yield appropriate forecasting approaches and it will not further the NEO.

3.3 Forecasting methodology

The Commission is proposing to amend the wording of the capital and operating expenditure criteria so that the requirement for the AER to consider 'the costs that a prudent operator would require to achieve the capital expenditure objectives', no longer includes a reference to 'in the circumstances of the relevant DNSP'.

The Commission explains its reasoning as follows[10]:

> "…the reference to "circumstances of the relevant NSP" should be removed from the capex and opex criteria. There appears to be little doubt about how the AER should undertake a benchmarking exercise, including the circumstances that should be taken into account, and the reference to individual circumstances is likely to constrain the AER in an inappropriate way. Given the importance of benchmarking in determining the capex or opex allowance, any inappropriate constraints on the AER under the NER in undertaking a benchmarking exercise should be removed."

United Energy and Multinet Gas disagree with the Commission's reasoning. The reference to 'the circumstances of the relevant NSP' is included in the expenditure criteria, which relate to the 'costs of a prudent operator'. As a practical matter, an assessment of prudence requires a consideration of the particular circumstances of the network service provider. Prudence is not a concept that can reasonably ignore the actual circumstances of the company concerned.

It is also worth recalling the submission made by Professor Stephen Littlechild on this issue. Professor Littlechild was critical of the AER's suggestion that the reference to "in the circumstances" should be removed[11]:

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[10] AEMC, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Draft Rule Determinations, 23 August 2012, page 106.

[11] Professor Stephen Littlechild, Advice to the AEMC on Rule Changes, 11 February 2012, page 16.

> "AER's argument here is less persuasive than elsewhere. AER suggests that it would not be appropriate to consider the particular circumstances of a network. But in the abstract, it is difficult to argue ex ante that any particular circumstances could not or should not be taken into account."

United Energy and Multinet Gas agree with Professor Littlechild's comments. It is always better to consider the particular circumstances of the network service provider, as opposed to ignoring them. The Commission's proposal to remove the reference would be a retrograde step. Not only is it inconsistent with the concept of prudence, but it also sends a signal to the AER that the particular circumstances of the network service provider should be ignored. Such an outcome would be contrary to Professor Littlechild's advice.

4. Capital expenditure incentives

4.1 Introduction

United Energy and Multinet Gas welcome the Commission's conclusion that the current NER does not provide incentives for network service providers to spend more than their capital expenditure allowance. We also welcome the Commission's finding that the AER should be provided with a number of "tools" to ensure that network companies have adequate incentives to spend capital efficiently.

However, there are two aspects of the Commission's proposals that need further careful consideration:

- The Commission's proposed capex sharing scheme; and
- The Commission's proposal that the AER should be able to exclude inefficient expenditure from the regulated asset base.

Each of these matters is addressed in turn below.

4.2 Capex sharing schemes

The purpose of a capex sharing scheme is to encourage network companies to seek out and achieve efficiency improvements in capital expenditure. The scheme provides a mechanism for sharing these efficiency improvements between the company and its customers. The effectiveness of such schemes depends on balancing the following competing objectives:

1. Maximising the achieved efficiencies, which means maximising "the size of the pie";
2. Minimising costs to customers, which means maximising "customers' share of the pie"; and
3. Improving service performance, where it is efficient to do so.

There is a natural tension between the first two objectives. Maximising the size of the pie is achieved by allowing network service providers to retain a greater share of the benefits.

However, the second objective is to deliver benefits to customers, which will naturally reduce incentives to deliver efficiency improvements.

The third objective recognises that reducing capital expenditure may have implications for service performance. It is important that the incentive schemes are not focused exclusively on cost minimisation, because this may lead to deteriorating service performance.

These issues have been very extensively examined in Victoria through successive price reviews, commencing with the first electricity distribution determination in 2000. This review implemented the first S-factor scheme and efficiency carryover mechanisms. A number of the findings in that determination are relevant to the Commission's proposed capex sharing scheme.

In its final determination, the Office of the Regulator-General commented on the difficulty in attempting to distinguish between management-induced efficiencies and windfall efficiency gains as follows[12]:

> "The Office does not believe that the requirement to have regard to a fair sharing of the benefit from efficiency gains necessitates a full audit of the actual efficiency gains made. As the Office noted in its Draft Decision, an audit of actual efficiency gains within a regulatory period would necessitate a forensic assessment and would be extremely difficult and costly. Such a forensic analysis would be subject to many of the criticisms made by the distributors and other parties in responses to the Office's earlier proposal to distinguish between management-induced and windfall efficiency gains."

Consequently, the Office adopted an approach that relied on a simple 'rule of thumb' that efficiency is the difference between the actual and allowed expenditure.

The Office also highlighted that incentives will be weaker if there is uncertainty regarding the operation of the scheme[13]:

> "The Office recognises that to the extent there is uncertainty regarding the adoption of the post-2001 incentive mechanism outlined in this Determination, the incentive properties of the mechanism will be reduced. For this reason, the Office is now setting out in some detail what it considers to be the appropriate mechanics for applying the long-term carryover mechanism. This is intended to provide a clear and stable framework within which the distributors can make future expenditure decisions. The long-term carryover mechanism has been designed with the objective of making it transparent, easy to administer and replicable from one regulatory period to the next. These features enhance the credibility of the Office's commitment to implementing the mechanism in the future."

United Energy and Multinet Gas consider that the Office's assessment of these issues remain valid. Furthermore, the Office's findings contrast sharply with the Commission's draft determination[14]:

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[12] Office of the Regulator-General, Electricity Distribution Price Determination 2001-2005, Volume 1 Statement of Purpose and Reasons, September 2000, page 86.

[13] Ibid, page 87.

> "It should be noted that the use of the terms 'efficiency' and 'inefficiency' are not intended to define any amount above or below the allowance. Specifically, it will be for the AER to define efficient and inefficient expenditure, as well as the relevant benchmark. The purpose of not defining such terms in the draft rule is to give the AER the flexibility to interpret and apply as it sees most appropriate."

In our view, the absence of a definition of "efficient" and "inefficient" capital expenditure will re-open a debate that was resolved by the Office in September 2000. While there is no particular harm in revisiting issues again, it is also important to build on previous experience. Specifically, it will be a wasted effort if the AER embarks on a forensic examination of whether capital expenditure savings are "efficient"; "inefficient" or "windfalls".

United Energy and Multinet Gas recommend that the Commission revert to the approach that has been adopted in successive reviews following the Office's deliberations in the 2001-2005 electricity distribution determination, as noted above.

4.3 Efficiency reviews and exclusion of investment from the regulated asset base

The Commission proposes that actual capital expenditure should be subject to an ex post review. The Commission appears to be concerned that the current arrangements fail to ensure that inefficient capital expenditure *never* takes place[15]:

> "Reviews of the efficiency of past capex would, as described above, provide scrutiny of capex that has been undertaken. This risk of an inability to recover for inefficient expenditure would therefore provide an incentive for NSPs to avoid inefficient capex as this may result in allowances being exceeded. Ex ante incentives, while effective, do not ensure that NSPs never undertake inefficient capex. A further check that what is rolled into the RAB is efficient is therefore in the long term interests of consumers."

It is important to remember that regulation is an imperfect substitute for competition. Moreover, even in the most competitive markets there is no mechanism to ensure that companies *never* undertake inefficient capital expenditure. In fact, competitive markets provide reasonable rates of return to companies with average efficiency, which is bound to include some level of 'inefficient' expenditure. The Commission is therefore applying an efficiency standard for regulated companies that exceeds the standard of competitive markets.

The Commission also comments that[16]:

> "To mitigate any potential for an increase in regulatory risk, the draft rule is that the amount of capex that may be precluded from being rolled into the RAB will be limited to the extent of any over expenditure of the capex allowance for the relevant period. If the NSP does not overspend, no reduction will be possible."

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14 AEMC, Draft Determination, page 133.

15 Ibid, page 136.

16 Ibid, page 137.

United Energy and Multinet Gas agree with the Commission that regulatory risk is a major concern with ex post reviews. However, the solution proposed in the draft Rule would have the effect of providing a very strong incentive not to exceed the capital expenditure allowance. If the capital expenditure allowance is exceeded, presumably the AER will need to conduct a review of the total capital expenditure incurred. This may prove to be an extensive exercise.

It must be remembered that conducting an ex post review will only deliver an efficiency benefit if it improves the network company's investment decisions. The ex ante capital expenditure allowance will already provide incentives for the company to develop investment appraisal processes that are focused on delivering efficient investment. In our view, the Commission's proposal for ex post efficiency reviews is unlikely to promote the achievement of the NEO. Our conclusion is further supported by the negative experience with ex post reviews when these applied to electricity transmission networks only a few years ago, as recognised by the Commission in its 2006 Rule determination on the electricity transmission Rules[17]:

> "In general the criticism of the proposed ex post prudency review was that it undermined the incentives of the ex ante cap and contributed to the investment uncertainty that the remainder of the package sought to overcome. Submissions also raised the legitimate concern that ex post prudency reviews are, by their very nature, an intrusive form of regulation. An ex post review effectively requires the regulator to put itself in the position of a TNSP at the time that they were undertaking a particular project to determine if the project was undertaken efficiently. Previously, this process has been the subject of controversy when it has been applied to network businesses. For these reasons, the Commission has removed the arrangements for ex post reviews and instead focused more on improving ex ante incentives."

If the Commission retains its proposed approach of potentially excluding actual capital expenditure from the RAB, the burden of proof must fall on the AER to prove that the investment is inefficient. The AER cannot have the discretion simply to conclude that 'it is not persuaded' that the expenditure is efficient. Such an approach will greatly diminish the incentives to invest as companies, quite reasonably, seek to avoid stranded asset risk.

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[17] AEMC, Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, Rule Determination, 16 November 2006, page 98.