

20 December 2011

Mr John Pierce  
Chairman  
Australian Energy Market Commission  
Level 5, 201 Elizabeth Street  
Sydney NSW 2000

Via website: [www.aemc.gov.au](http://www.aemc.gov.au)

Dear John

**Consolidated Rule Request – National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011**

Grid Australia made a submission to the Australian Energy Market Commission on 8 December 2011 in response to the above Rule change proposals submitted by the Australian Energy Regulator (AER) and the Energy Users Rule Change Committee (EURCC).

This supplementary submission provides advice to the Commission that Grid Australia has subsequently obtained from Cameron A. Moore SC and Ruth C. A. Higgins in relation to:

- first, whether Chapter 6A of the NER is drafted in a manner that gives rise to a susceptibility to systemic bias in making distribution and transmission determinations (being the first question addressed in the Lloyd Opinion supporting the AER's Proposed Rule Change); and
- secondly, the correct characterisation of the nature of the power that would be conferred on the AER if the rules for WACC and forecast opex and capex included within the AER Proposed Rule Change were to be adopted.

In summary the Joint Opinion finds that in relation to the first question, insofar as it deals with the opex and capex criteria, Chapter 6A does not give rise to systemic bias in making distribution and transmission determinations.

In relation to the second question the Joint Opinion finds:

- The proposed amendments permit the AER, in its assessment of costs, to abstract from the particular circumstances of the TNSP. There is tension between this proposal and s 7A of the NEL, which must permit a particular TNSP to recover at least its efficient costs.

- The amendments represents an important change in emphasis, and one which confers greater latitude on the AER in exercising its discretion by reference to benchmarks, as opposed to idiosyncrasies of the TNSP under consideration.
- Further, the sheer latitude of the AER's discretions, and the removal of parameters and prescription in respect of its powers, could be productive of regulatory uncertainty.

As noted in its previous submission, Grid Australia considers the following are important contextual matters that are relevant to the AEMC's assessment of the Proposed Rule Changes:

- The current Rules were intended to enhance regulatory certainty;
- The current Rules are achieving their intended outcomes; and
- The need for a stable, transparent and certain environment for major investment in network infrastructure has not diminished.

Grid Australia looks forward to continuing to work with the AEMC and stakeholders through the Rule change process. If you require any further information, please do not hesitate to contact me on (08) 8404 7983.

Yours sincerely



Rainer Korte  
**Chairman**  
**Grid Australia Regulatory Managers Group**

**GRID AUSTRALIA**  
**IN THE MATTER OF AER RULE CHANGE PROPOSAL**

**JOINT OPINION**

**A INTRODUCTION**

1. Our instructing solicitors, Blake Dawson, act for Grid Australia, which represents the owners of electricity transmission networks operating within the National Electricity Market (NEM), and the network located within Western Australia.
2. The members of Grid Australia are:
  - (a) ElectraNet Pty Ltd (South Australia);
  - (b) Powerlink Queensland (Queensland);
  - (c) SP AusNet (Victoria);
  - (d) Transend Networks Pty Ltd (Tasmania);
  - (e) TransGrid (New South Wales); and
  - (f) Western Power (Western Australia).
3. Each of these members is the owner and operator of a transmission network located in each designated State or Territory, by and through which it provides transmission network services. Each of these members, with the exception of Western Power, is registered as a transmission network service provider (TNSP) under clause 2.5.1 of the National Electricity Rules (the **NER**).
4. The **NER** are a statutory instrument made pursuant to the National Electricity Law (the **NEL**)<sup>1</sup> which have the force of law in each of the participating jurisdictions (s 9 **NEL**). Version 45 of the **NER** is currently in effect. The **NEL**, in turn, is a schedule to the *National Electricity (South Australia) Act 1996* (SA) (the **1996 Act**) which is applied by local statute in each participating jurisdiction in the NEM.

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<sup>1</sup> Cf Schedule 2, clause 41 **NEL**

5. The NEL and Chapter 6A of the NER regulate the revenues TransGrid is permitted to derive from the provision of transmission network services.
6. On 20 October 2011, the Australian Energy Market Commission (the **AEMC**) published a consultation paper in respect of a Rule Change Proposal, *Economic Regulation of Transmission and Distribution Network Service Providers*, dated September 2011, proposed by the Australian Energy Regulator (the **AER**) (the **AER Proposed Rule Change**).
7. We have been briefed with the following materials:
  - (a) the AER Proposed Rule Change and associated materials;
  - (b) memorandum of advice of Stephen Lloyd SC, issued to the Australian Competition and Consumer Commission (**ACCC**), and dated 21 September 2011 (the **Lloyd Opinion**); and
  - (c) memorandum of advice of Neil Williams SC and Ruth Higgins, issued to the Australian Energy Market Commission (**AEMC**), and dated 24 October 2006 (the **AEMC Joint Opinion**).
8. We have been asked to advise:
  - (a) *first*, whether Chapter 6A of the NER is drafted in a manner that gives rise to a susceptibility to systemic bias in making distribution and transmission determinations (being the first question addressed in the Lloyd Opinion); and
  - (b) *secondly*, the correct characterisation of the nature of the power that would be conferred on the AER if the rules for WACC and forecast opex and capex included within the AER Proposed Rule Change were to be adopted, having regard to the discussion in the AEMC Joint Opinion.
9. In relation to the first of these questions, we have *not* been asked to advise in relation to the matter of the RAB rollover provisions, which are referred to in paragraphs 20 and 36 of the Lloyd Opinion. Our answer to the first question is therefore confined to consideration of the opex and capex criteria.

## **B SUMMARY**

### **The first question**

10. Insofar as it deals with the opex and capex criteria, Chapter 6A does not give rise to systemic bias in making distribution and transmission determinations.
11. The starting point is the National Electricity Objective (NEO).<sup>2</sup> The NEO is fundamental to the legislative and regulatory structure. The matters identified in the NEO are consumer-oriented, and are multifaceted. The NEO refers to the promotion

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<sup>2</sup> Section 7 of the NEL

of efficiency in a range of possible ways. It is in the nature of things that a particular proposed Rule might promote efficiency in one or more of those possible ways but not in others. The legislature has expressed a deliberate preference for promoting safety, reliability and security in the supply of electricity, amongst other things.

12. In light of the multifaceted NEO, to focus on price alone would involve error. The AER's approach, and the approach in the Lloyd Opinion, assumes that there is a "range" of appropriate forecasts, in which higher figures are bad and lower figures are good. That is not consistent with the legislative structure.
13. The AER's approach also fails to give proper regard to s7A(2) of the NEL and its requirement that a TNSP should be provided with a reasonable opportunity to recover *at least* the efficient costs incurred by it in providing the relevant services.
14. The structure of Chapter 6A, which requires the AER to accept an opex or capex forecast if it is satisfied that the forecast reasonably reflect efficient costs, and costs of a prudent operator, is not productive of any bias. Nor, properly applied, would it give rise to inefficient investment.
15. The approach of the AER, and the conclusion expressed in the Lloyd Opinion, is driven to a considerable extent by consideration of the requirement in Chapter 6 of the NEL that the AER's substitute amount must be determined on the basis of the current regulatory proposal and amended from that basis only to the extent necessary to enable it to be approved in accordance with the Rules. That provision is not applicable to the relevant opex and capex forecasts under Chapter 6A. The reasoning in the Lloyd Opinion is thus inapplicable to Chapter 6A.

### **The second question**

16. In respect of the *second* question, our short answer is as follows.
17. The key changes proposed by the AER Proposed Rule Changes are a proposed new clause 6A.6.6(c), new clauses 6A.6.6(d)(12) and (7)(d)(12), a new clause 6A.6.6(e)(12) and (7)(e)(12) and the deletion of clauses 6A.6.6(f) and (7)(f) and 6A.13.2(b).
18. The cumulative effect of these amendments, and other ancillary amendments, is to alter the architecture of the regulatory scheme from a "propose-respond" model to a "consider-decide" model (cf AER Rule Change Proposal at §6.2.3, page 30 and Lloyd Opinion [32]).
19. The proposed amendment to clause 6A.6.6(c) has two aspects. *First*, it confers an extremely broad discretion upon the AER, which remains confined by ss 7 and 87A of the NEL, but is otherwise ambulatory in its operation. *Secondly*, it inserts a "prudent TNSP" test to replace current clause 6A.6.6(c)(2), which speaks of "the costs that a prudent operator in the circumstances of the relevant TNSP would require to achieve" the opex objectives. The proposed test permits the AER, in its assessment of costs, to abstract from the particular circumstances of the TNSP. There is tension between this proposal and s 7A of the NEL, which must permit a particular TNSP to

recover at least its efficient costs. This amendment represents an important change in emphasis, and one which confers greater latitude on the AER in exercising its discretion by reference to benchmarks, as opposed to idiosyncrasies of the TNSP under consideration.

20. Further, the sheer latitude of the AER's discretions, and the removal of parameters and prescription in respect of its powers, could be productive of regulatory uncertainty. The other proposed amendments identified above are apt to contribute to such a result.

## **B THE STATUTORY SCHEME**

21. Before addressing the questions, it is convenient to set out relevant aspects of the statutory scheme.

### **(1) The NEO and the revenue and pricing principles**

22. The NEO, as stated at s 7 NEL, is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers with respect to:

(a) price, quality, safety, reliability and security of supply of electricity; and

(b) the reliability, safety and security of the national electricity system.

23. The NEO is inherently forward looking. In seeking to "promote" efficiency in the ways identified in s 7, it is directed to the creation of an environment that is more conducive to improving efficiency in respect of the identified matters than the environment that would otherwise exist: cf *Re Sydney Airports Corporation Ltd* (2000) 156 FLR 10; *Re Duke Eastern Gas Pipeline Pty Ltd* (2001) 162 FLR 1.

24. Section 7A of the NEL sets out the revenue and pricing principles. Section 7A(2) provides that a regulated network service provider should be provided with a reasonable opportunity to recover *at least* the efficient costs the operator incurs in:

(a) providing direct control network services; and

(b) complying with a regulatory obligation or requirement or making a regulatory payment,

25. Section 7A(3) provides that a regulated network service provider should be provided with effective incentives in order to promote economic efficiency with respect to direct control network services the operator provides, including the promotion of efficient investment.

### **(2) The AER and its functions**

26. The AER is a body corporate established by s 44AE of the *Trade Practices Act 1974* (Cth) (now the *Competition and Consumer Act 2010* (Cth)).

27. Section 15 of the NEL prescribes the functions and powers of the AER. Section 16 of the NEL provides that, in making a distribution or transmission determination, the AER must have regard to:

(a) under s 16(1), the national electricity objective (the NEO) set out in section 7 of the NEL; and

(b) under s 16(2), the revenue and pricing principles set out in s 7A of the NEL.

**(3) The AEMC and the Rule making process**

28. The AEMC is established by section 5 of the *Australian Energy Market Commission Establishment Act 2004* (SA) and has functions and powers conferred by the NEL. Relevantly, it is empowered, under s 34(1)(b) of the NEL, to make rules for the purposes of the NEL. Part 7, Division 3 (ss 91 – 106) of the NEL prescribes the process for the making of a rule by the AEMC.

29. By s 88(1) of the NEL, the AEMC may only make a proposed Rule change if it is affirmatively satisfied that the Rule will or is likely to contribute to the achievement of the national electricity objective. Likewise, s 88B requires the AEMC to take into account the revenue and pricing principles in making Rules such as those proposed by the AER.

30. In determining, under s 88(1) of the NEL, whether or not to be satisfied that a particular Rule will or is likely to contribute to the achievement of the national electricity objective as stated in s 7 of the NEL, the AEMC is necessarily engaged in looking to “hypothetical futures” with and without the proposed Rule. To adapt an explanation given by the Australian Competition Tribunal, in another but broadly analogous statutory context, the test is not to compare the present situation with the future situation were the Rule to be made (a “before and after” test) but rather to appraise the future were the Rule to be made in the light of the alternative outcome (a “future with and future without” test): *Re Medicines Australia Inc* [2000] AComp T 4 at [117]-[118].

31. The task of the AEMC under s 88(1) of the NEL is accordingly to compare the future environment for efficiency in terms of s 7 of the NEL if the proposed Rule were to be made and the future environment for efficiency in terms of s 7 of the NEL if the proposed Rule were not to be made.

32. To reach the state of satisfaction for s 88(1) to be met, the AEMC must come to the view that it is likely that the proposed Rule, if made, would make a material contribution to the creation of an environment that is on balance more conducive to improving efficiency in one or more of the different ways identified in s 7 of the NEL than would be the environment that would exist if the proposed Rule were not made.

**(3) Principles of construction of the NEL and NER**

33. The NEL prescribes the following general interpretative principles.
34. Section 3(2) of the 1996 Act provides that words and expressions used in the NEL and the 1996 Act have the same meanings in both contexts, save to the extent that the context or subject matter otherwise indicates or requires: s3(3).
35. Section 3 of the NEL provides that Schedule 2 to the NEL applies to the NEL, the Regulations and the Rules and any other statutory instrument made under the NEL.
36. Schedule 2 to the NEL contains miscellaneous provisions relating to the interpretation of the NEL. Schedule 2, clause 7 provides:
- (1) In the interpretation of a provision of this Law, the interpretation that will best achieve the purpose or object of this Law is to be preferred to any other interpretation.
- (2) Subclause (1) applies whether or not the purpose is expressly stated in this Law.

**C THE AER PROPOSED RULE CHANGE**

37. We set out below the aspects of the AER Proposed Rule Change which we consider material to the opinions we express.

**D THE FIRST QUESTION – SYSTEMIC BIAS**

38. The first question we are asked is whether the existing NER are drafted in a manner that gives rise to a susceptibility to systemic bias in making distribution and transmission determinations. It is necessary first to identify what we understand by the notion of “susceptibility to systemic bias”, and then to outline the context in which assessments of bias should occur.
- (1) Meaning of “susceptibility to systemic bias”**
39. Neither the question posed of Mr Lloyd, nor his answer, identifies what is intended to be conveyed by the phrase “systemic bias”.
40. Within the context of administrative law, “bias” denotes a pre-existing favourable or unfavourable attitude to an issue, where impartial consideration of the merits of the case is required: cf T Endicott, *Administrative Law* (2<sup>nd</sup> edition) (Oxford, Oxford University Press, 2011), pp. 155-7 and 625. It is a norm which applies to decision-makers: *Geveran Trading Co Ltd v Skejevesland* [2003] 1 WLR 912 (CA); M Aronson, B Dyer, M Groves, *Judicial Review of Administrative Action* (4<sup>th</sup> edition) (Sydney, Lawbook Co, 2009) Chapter 9.
41. The question naturally arises as to whom this bias is said to favour and whom it is said to disfavour. It is apparent that the class of persons said to be favoured is NSPs.

The persons who could be taken to be disfavoured are consumers or the AER in its capacity as regulator. At page 4 of the AER Rule Change Proposal, the AER appears to suggest that each of these is disfavoured:

At the time [2006], the AER expressed concerns with the framework that was being developed. The AER argued that the framework would not deliver effective incentives for efficient investment, would tilt the regulatory balance in favour of the NSPs and would limit the AER's capacity to respond to the individual circumstances of each NSP.

The AER has applied the framework that was developed to four transmission determinations and twelve distribution determinations. These experiences have reinforced the AER's view that the regulatory regime inappropriately favours NSPs and consumers are paying more than they should to maintain a reliable and secure power system.

42. Similarly, at page 13 of the, the AER continues:

The current framework goes beyond affording a reasonable opportunity to recover efficient costs. Indeed, it invites upwardly biased expenditure forecasts and provides the regulator with limited ability to interrogate and amend forecasts proposed by the NSPs...Even if there is a lower possible forecast that is efficient, prudent and realistic, the rules operate to exclude the AER from setting that lower forecast. In an unbiased regime, all answers that meet the requirements of the NEL could be determined. That is not the case under the current rules.

43. Finally, at page 62, the AER says this:

The proposals address the features of the current regime that lead to upwardly biased expenditure forecasts and the restriction on the AER's ability to respond to this bias.

44. Difficulties are also created by the use of the term "susceptibility to" systemic bias. This adds a further layer of ambiguity. Where delegated legislation confers some measure of discretion upon a decision-maker it is difficult to conceive how – absent a misdirection of that discretion – there would be a susceptibility to biased outcomes.
45. It appears that the term "susceptibility to systemic bias" is being used in the sense of "skewed in favour of the ultimate success of a proposal submitted by a TNSP". We shall proceed accordingly. We note that this was the language used in the AEMC Joint Opinion, at [37].
46. The AER's Rule Change Proposal also proceeds on certain factual premises. The first is that "a significant proportion of the more recent [price] rises can be attributed to increases in regulated network charges" (§2.2, page 5). This is not a matter on which we are able to advise. A second crucial motivating integer in the AER Rule Change Proposal is the assertion (§2.2, page 6) that although recent increases in network charges have been driven in part by the need for increased investment to replace ageing assets and to meet increased peak demand, growing customer connections

and higher reliability standards, “these drivers do not fully account for the level of observed increases”. This is advanced as a bald statement without any analysis. It is likely to be highly controversial. Nevertheless, it appears to underpin the AER’s Rule Change Proposal.

47. Any consideration of the AER’s Rule Change Proposal would involve ascertaining whether the AER had established these factual premises which it asserts give rise to a need for change.

**(2) Relevant Rules**

48. The key provisions within Chapter 6A said by the AER to skew decision-making in favour of NSPs under the NEL and NER are the following.

49. *First*, in respect of forecast opex, clauses 6A.6.6(a), (c), (d) and (f) which respectively provide:

- (a) A *Revenue Proposal* must include the total forecast operating expenditure for the relevant *regulatory control period* which the *Transmission Network Service Provider* considers is required in order to achieve each of the following (‘the *operating expenditure objectives*’)

(1) meet the expected demand for *prescribed transmission services* over that period;

(2) comply with all applicable *regulatory obligations or requirements* associated with the provision of *prescribed transmission services*;

(3) maintain the quality, reliability and security of supply of *prescribed transmission services*; and

(4) maintain the reliability, safety and security of the *transmission system* through the supply of *prescribed transmission services*.

- (c) The *AER* must accept the forecast of required operating expenditure of a *Transmission Network Service Provider* that is included in a *Revenue Proposal* if the *AER* is satisfied that the total of the forecast operating expenditure for the *regulatory control period* reasonably reflects:

(1) the efficient costs of achieving the *operating expenditure objectives*;

(2) the costs that a prudent operator in the circumstances of the relevant *Transmission Network Service Provider* would require to achieve the *operating expenditure objectives*; and

(3) a realistic expectation of the demand forecast and cost inputs required to achieve the *operating expenditure objectives*.

(the *operating expenditure criteria*).

- (d) If the *AER* is not satisfied as referred to in paragraph (c), it must not accept the forecast of required operating expenditure of a *Transmission Network Service Provider* that is included in a *Revenue Proposal*.
- (f) If, in its final decision on the *Revenue Proposal* under rule 6A.13, the *AER* does not accept the total of the forecast required operating expenditure for the *regulatory control period* under paragraph (d), then the *AER* must, **in accordance with clause 6A.13.2(b)**, use a substituted forecast of required operating expenditure. **[Emphasis added]**

50. Clause 6A.6.6(a) gives express effect to the NEO.

51. *Secondly*, in respect of forecast capex, the equivalent provisions of clauses 6A.6.7(a), (c), (d) and (f).

52. *Thirdly*, subclauses 6A.13.2(a) and (b) of the Rules, which, in combination with 6A.6.6(f) and 6A.6.7(f), describes the character of the AER's overarching discretion in making transmission determinations is governed by clause, which relevantly provide:

(a) If the *AER's* final decision is to refuse to approve an amount or value referred to in clause 6A.14(1) [Contents of decisions], the *AER* must include in its final decision a substitute amount or value which, except as provided in paragraph (b), is:

(1) determined on the basis of the current *Revenue Proposal*; and

(2) amended from that basis only to the extent necessary to enable it to be approved in accordance with the *Rules*.

(b) If the *AER's* final decision is to refuse to approve an amount or value referred to in clause 6A.14.1(1) for the reason that, or a reason which includes the reason that, the *AER* is not satisfied that:

(1) the total of the forecast operating expenditure for the regulatory control period reasonably reflects the operating expenditure criteria, taking into account the operating expenditure factors; or

(2) the total of the forecast capital expenditure for the regulatory control period reasonably reflects the capital expenditure criteria, taking into account the capital expenditure factors,

the *AER* must:

(3) where subparagraph (1) applies, include in its final decision (in addition to the estimate referred to in clause 6A.14.1(3)(ii)) the forecast operating expenditure for each regulatory year which the *AER* is satisfied reasonably reflects the operating expenditure criteria, taking into account the operating

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

(4) where subparagraph (2) applies, include in its final decision (in addition to the estimate referred to in clause 6A.14.1(2)(ii)) the forecast capital expenditure for each regulatory year which the AER is satisfied reasonably reflects the capital expenditure criteria, taking into account the capital expenditure factors, subject only to the requirement that the total of such forecasts must equate to the estimate referred to in clause 6A.14.1(2)(ii); and

(5) use each such amount (and its components) in place of the forecast of required operating or capital expenditure that is included in the current Revenue Proposal for the purposes of calculating the amount or value that it has refused to approve in its final decision.

53. It should be noted that Rules 6A.6.6(f) and 6A.6.7(f) refer to the application of Rule 6A.13.2(b) rather than 6A.13.2(a). Rule 6A.13.2(a) itself provides that it applies “except as provided in paragraph (b)”. Paragraph (b) makes specific provision for the forecasts for opex and capex. Thus for the purposes of forecasts for capex and opex, Chapter 6A, unlike Chapter 6, does not contain a limitation that the AER can amend the proposed amount only to the extent necessary to enable it to be approved in accordance with the Rules. Rather, once the precondition for revision by the AER is satisfied, the AER can fix any amount which it is satisfied “reasonably reflects” the operating or capital expenditure criteria.
54. This is recognised by the AER in its Rule Change Proposal, where it is observed that the limits on the regulator amending a proposed forecast only to the extent necessary to make it comply with the rules, “applies only to chapter 6” (§6.2.2).

### **(3) Preliminaries**

55. In answering the first question, regard must first be had to the structure of the NEL and NER and then to the matters regulated thereunder.
56. In respect of structure, as we have already noted above, the NER are a statutory instrument made pursuant to the NEL, and hence delegated legislation. The NEO sits at the heart of the NEL. Its stated objectives guide the economic regulatory decision-making of the AER (s 16(1)), the rule-making decision of the AEMC (s 88(1)), and the proper construction of the NEL and NER: s 3 and Schedule 2, clause 7(1) NEL.
57. While trite, it is worth emphasising that the construction of the NER (as delegated legislation) could not be inconsistent with the NEL and the 1996 Act.<sup>3</sup> In *Webster v*

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<sup>3</sup> Accordingly, certain statements by the AER within the Rule Change Proposal are concerning; for example, the statement at page 12 that: “It is the AER’s view that the current framework for setting forecasts of capex and opex is not promoting efficient outcomes in the long term interests of consumers.”

*McIntosh* (1980) 32 ALR 603 at 606. Brennan J, with whom Deane and Kelly JJ agreed, said that:

the intention of Parliament in enacting an Act is not to be ascertained by reference to the terms in which a delegated power to legislate has been exercised.

58. Similarly, in *Hunter Resources Ltd v Melville* (1987–88) 164 CLR 234 at 244, Mason CJ and Gaudron J said:

it is not permissible to interpret a statute by reference to the regulations [purportedly made under the Act].

59. The matters regulated by the combined operation of the NEL and NER are the regulatory and economic supervision of monopoly infrastructure.
60. Regulation is sustained and focussed control exercised by a public agency over activities that are valued by the community.<sup>4</sup>
61. The ultimate objective of economic regulation of monopoly infrastructure is the economic efficiency of decision-making.<sup>5</sup> More specifically, regulation attempts to preserve the production efficiencies of monopolistic supply while achieving the consumption efficiencies of competitive pricing. In this regard, regulation seeks to produce reliable and efficient service coupled with competitive pricing. In return, utilities are guaranteed a competitive or normal rate of return on investment, sufficient to attract capital for future investment, and to enable utilities to continue to fulfil any legal obligation(s) to serve. Such regulation is also consistent with the interests of ratepayers, since efficient investment optimizes the (expected) capital stock over time, thus yielding efficient future prices. For the regulated rate of return to be consistent with the interests of ratepayers, it should be earned only on costs incurred prudently. If inefficient costs were allowed into rate bases, the rates may be too high under some conditions. Accordingly, the analytic context for consideration of the questions we are asked is provided by the traditional rationale for rate-of-return regulation: simulating the constraints, pressures, and incentives, and hence the costs and output, of a competitive market. A competitive market, on this model, provides efficient incentives for cost efficiency.
62. We do not consider that Chapter 6A in its current form, when read with the NEL, is skewed in favour of the ultimate success of a proposal submitted by a TNSP.

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<sup>4</sup> P Selnizk, 'Focusing Organisational Research on Regulation' in R. Noll (ed) *Regulation Policy and the Social Sciences* (Berkeley California, 1985) 363. See also R Baldwin and M Cave, *Understanding Regulation: Theory, Strategy, and Practice* (Oxford and New York: Oxford University Press, 1999) chapter 1; A I Ogus, *Regulation: Legal Form and Economic Theory* (Oxford: Hart Publishing, 2004) chapter 1; B Morgan & K Yeung, *An Introduction to Law and Regulation: Texts and Materials* (Cambridge: Cambridge University Press, 2007) chapters 1 and 3.

<sup>5</sup> See, generally, B Zycher, "Economic Efficiency and "Prudence" Analysis of Power Plant Investment" (1998) VI (July) *Contemporary Policy Issues* 42 – 59, especially at 44; and G Yarrow, M Cave, M Pollitt and J Small, *Asset Valuation in Workably Competitive Markets: A Report to the New Zealand Commerce Commission*, May 2010.

63. This is so for various reasons, which we address in the context of the provisions identified above.

**(4) The capex and opex criteria**

64. Certain characteristics of the capex and opex provisions at clauses 6A.6.6(a), (c), (d) and (f) and 6A.6.7(a), (c), (d) and (f) are noteworthy.

65. *First*, each is a provision arising within the NEL and accordingly, must be applied, in revenue determinations, in light of and subject to the NEO (s 7 NEL) and the revenue and pricing principles (s 7A NEL). As noted above, clauses 6A.6.6(a) and 6A.6.7(a), in their express objectives, give effect to the NEO.

66. Relevantly, s 7A(2)(a) requires that a TNSP be provided with a reasonable opportunity to recover *at least* the efficient costs the operator incurs in providing direct control network services. This is a basic underpinning principle of the NEL and the NEL.

67. *Secondly*, clause 6A.6.6(c) adopts a mandatory conditional structure which turns upon an exercise of discretion by the AER. The AER must accept a proposal if satisfied of the matters identified at (1)-(3). As noted in the AEMC Joint Opinion, at [34], conferring a statutory power or duty that is made dependent upon the satisfaction or opinion of a decision-maker as to some matter “is a commonly used drafting device to ensure that judicial review is restricted”: *Jabetin Pty Ltd v Liquor Administration Board* (2005) 63 NSWLR 602 at 617 [37]-[38], per Mason P.

68. One aspect of the state of satisfaction which the AEMC must reach within clause 6A.6.6(c) is that the total of the forecast opex reasonably reflects the enumerated matters.

69. Clause 6A.6.6(d) underpins the discretion conferred on the AER by clause 6A.6.6(c), by adopting a negative mandatory conditional structure, which again turns upon an exercise of discretion of the AER in reaching a state of satisfaction about various matters.

70. Clause 6A.6.6(f) then provides for the AER to make a substitute forecast in a final decision, in accordance with clause 6A.13.2(b), where it is not satisfied in accordance with sub-clauses (c) and (d).

**(5) Reasoning**

71. The structure of the Rules is that the AER must accept an opex forecast if, *inter alia*, the forecast opex reasonably reflects the efficient costs, and the costs that a prudent operator in the circumstances of the relevant TNSP would require, in achieving the relevant objectives set out in Rule 6A.6.6(a). If a forecast reflects efficient and prudent costs meeting the objectives of the Rules, then it is entirely appropriate that the AER must accept it. It is difficult to see how this, of itself, could create any “systemic bias”

or skew the regulatory process in favour of the ultimate success of a proposal submitted by a TNSP.

72. The AER, however, contends that this does create a systemic bias. The AER contends that there is likely to be a range of forecasts which meet the criteria of a forecast which “reasonably reflects” efficient and prudent costs, and that the process permits the TNSP to advance forecasts at the upper end of the range.<sup>6</sup> There are a number of difficulties with this reasoning.
73. *First*, it mischaracterises the regulatory scheme. The costs in question are those that reasonably reflect the achievement of the various objectives. As noted above, those objectives (e.g. quality, reliability, security and price) could point in different directions. The AER’s entire approach is predicated on there being an upper value - which is bad - and a lower value - which is good - of costs that otherwise meet all objectives equally well. In both theoretical terms, and practical terms, that is unlikely to ever be the case. For example, a lower value might produce a lower price for consumers but less reliability, and so on. The approach of the AER in this regard involves fundamental error, and is inconsistent with the statutory scheme under which the Rules are propagated.
74. It follows that there is no reasonable range of values, in which each option falling within the range is indistinguishable from other options in meeting the opex and capex criteria. That is, each option will be able to be assessed on its own merits, by reference to the criteria, and on that basis able to be distinguished from other possible options within that range. The starting point for the AER’s analysis is predicated on a false notion. We note that this applies equally to Chapter 6 and 6A.
75. *Secondly*, the AER’s approach fails to give proper weight to the requirement that the relevant costs be efficient costs. For example, the stated mischief which the AER’s Rule Change Proposal is said to address is the issue of:
- whether the current framework is meeting the NEO in ‘promoting efficient investment’ or whether it is stimulating investment above efficient levels.<sup>7</sup>
76. The stimulation of investment above efficient levels cannot be the outcome of a requirement, properly applied, that the AER accept forecasts of efficient costs.
77. *Thirdly*, the AER’s approach fails to give proper regard to s7A(2) of the NEL and its requirement that a TNSP should be provided with a reasonable opportunity to recover *at least* the efficient costs incurred by it in providing the relevant services. The rationale for the AER’s Rule Change Proposal in this regard is that there is a range of “efficient costs”, and the AER wants to flexibility and power to set revenue at a rate less than certain efficient costs. Such an approach is at odds with s7A.

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<sup>6</sup> AER Rule Change Proposal, page 13

<sup>7</sup> AER Rule Change Proposal, page 8 (top of page)

78. *Fourthly*, the AER's approach misunderstands the incentives facing a TNSP under Chapter 6A. Even assuming there was such a thing as a "reasonable range", the TNSP is unlikely to propound forecasts which are aimed at the top of the range, because it then runs the significant risk that the AER will reject the forecast and substitute its own value. In this regard, the only constraint facing the AER under Chapter 6A is that the substituted value must reasonably reflect the criteria. If there is such a thing as a "reasonable range" then the AER can substitute a figure at the bottom of this range. (This would be of a particular concern to a TNSP in circumstances where the AER appears to be focussed on price at the expense of the other statutory criteria). In these circumstances, the TNSP has an incentive to adopt a conservative and realistic approach.
79. We note in this regard the discussion at [67] of the AEMC Joint Opinion. We agree with this analysis of the rational incentives likely to bear upon a TNSP under the current regulatory structure.
80. The reasoning in the Lloyd Opinion in relation to opex and capex forecasts is not based merely on perceived difficulties with the scheme of the Rules discussed above, but rather appears to be driven by considerations relevant only to Chapter 6 of the Rules. The relevant passages of the Lloyd Opinion in relation to opex and capex are as follows:
19. The AER identifies in particular the existence of aspects that create a systemic upwards bias. One is that it is required to accept a forecast that "reasonably reflects" efficient costs **and, if not satisfied, can reduce the forecast only to the extent necessary to ensure that the forecast does reasonably reflect such costs.** There tends to be a margin of appreciation in the motion of "reasonably reflects". The result is that the network service providers are encouraged to provide inflated forecasts **knowing that they can be reduced only to the top of the range of forecasts that reasonably reflects efficient costs.** This is an example of how the framework creates an upwards bias in charges.
33. The principal change of to remove the process according to which the NSP is to provide a forecast of open and capex and the AER is required to accept the forecasts if the *reasonable reflect* efficient costs. In its place, the AER is (after receiving the NSPs forecasts) to determine what it considers to be forecasts of capex and opex of efficient costs for a prudent operator. This removes the innate upwards bias in the language of the previous system, **especially where it was coupled with a limitation on the AER to reduce the NSP's forecast only to the extent necessary to make the forecast reasonably reflective of efficient costs** (hence the top of the range of reasonable forecasts). [Emphasis added]
81. The reasoning of the Lloyd Opinion is thus inapplicable to Chapter 6A. The Lloyd Opinion does not draw any distinction between Chapters 6 and 6A, and indeed does not analyse any current rules at all. That makes it of limited utility when considering the rule change proposals for Chapter 6A.

82. In our opinion, insofar as it deals with the opex and capex criteria, Chapter 6A does not give rise to systemic bias and is not skewed in favour of the TNSPs.
83. To the extent to which the Lloyd Opinion expresses an opinion on Chapter 6A in this regard (which is doubtful), then we disagree with it.
84. Although not necessary for the purposes of providing this opinion, we note that even if Chapter 6A had a relevant limitation of the sort found in Rule 6.12.3(f) of Chapter 6, this would not change our opinion. We say this for three reasons.
85. *First*, contrary to the view expressed by the AER and in the Lloyd Opinion, Rule 6.12.3(f) does not require the AER to adopt a figure at the top of some relevant range. As discussed above, the notion of a range ignores the interplay between multifaceted objectives and criteria.
86. *Secondly*, having regard to the language of Rule 6.12.3(f), its function is to constrain the AER in its process of substituting a value or amount such that the discretion is not at large, by constraining amendments to the basis of the calculation of the amount. Pursuant to this rule, the substitution must be determined on the same basis as in the regulatory proposal, but amended “from that basis only to the extent necessary to enable it to be approved in accordance with the Rules”. The limitation appears designed to prevent the AER from starting from scratch with a different basis for calculation. It is not designed to confine the AER to the top of some range. The substitute amount must itself conform to the Rules.
87. In this regard, the statement in the Lloyd Opinion (at [19], and also [33]) that Rule 6.12.3(f) operates such that the AER “can reduce the forecast only to the extent necessary to ensure that the forecast does reasonably reflect [efficient] costs” is not an accurate description of the operation of the Rule.
88. *Thirdly*, the approach of the AER is inconsistent with s7A(2) of the NEL. As a matter of law, we consider that clause 6.12.3(f) mirrors within the NEL the discretionary power conferred on the AER by s7A(2) of the NEL. That is, the need to preserve recovery of at least efficient costs, finds its correlate in a power of correction which must be exercise to do no more than bring a proposal into conformity with the NEL.

#### **D CORRECT CHARACTERISATION OF PROPOSED NEW POWERS**

89. The second question we are asked is to identify the correct characterisation of the nature of the power that would be conferred on the AER if the rules for forecast opex and capex included within the AER Proposed Rule Change were to be adopted, having regard to the discussion in the AEMC Joint Opinion
90. The key revisions to the existing rules of Chapter 6A proposed by the AER, are as follows.

(1) **New clause 6A.6.6(c)**

91. *First*, a revision to clause 6A.6.6(c), such that the current clause is deleted and *in lieu* thereof, clause 6A.6.6(c) provides:

The AER must determine the total of the forecast of required operating expenditure of a *Transmission Network Service Provider* for the *regulatory control period*, and the forecast of the required operating expenditure for each *regulatory year* of the *regulatory control period*, that the AER considers would meet the efficient costs that a prudent *Transmission Network Service Provider* would require to achieve the *operating expenditure objectives*.

92. This provision has four key structural features. It adopts a mandatory (“must”) discretionary (“determine”; “considers”) structure, and is benchmarked to a subjunctive prudent TNSP (“would meet”; “would require to achieve”).
93. The provisions confer an extremely broad discretion upon the AER. This is underscored by the words “that the AER considers would meet the efficient costs”.
94. The inclusion of a “prudent TNSP” test in the proposed new rule adopts a different criterion of operation to current clause 6A.6.6(c)(2), which speaks of “the costs that a prudent operator in the circumstances of the relevant TNSP would require to achieve” the opex objectives. The proposed test permits the AER, in its assessment of costs, to abstract from the particular circumstances of the TNSP. There is tension between this proposed rule and s 7A of the NEL, which must permit a particular TNSP to recover at least *its* efficient costs.
95. The notion of a prudent operator has extensive lineage in the regulation of electricity and gas within Australia, which provides some assistance as to how such a provision might be applied.
96. The notion appears to originate from the “prudent investment test” contained in clause 8.16 of the National Third Party Access Code for Natural Gas. The Australian Competition and Consumer Commission (**Commission**) employed this test in respect of *ex post* assessments of the carry-over of past investment into the regulated asset base, in its *Draft Statement of Regulatory Principles for Transmission Revenue* (May 1999) (**DSRP**) (which were applied to transmission pricing by the ACCC until December 1994).
97. Within the DRSP, the ACCC noted (at p 57), that:

Under the National Gas Access Code, new facilities investment must pass a prudent investment test to be included in the capital base (clauses 8.15-8.18).

The Commission proposes that a similar test be implemented for electricity transmission assets.

98. The DRSP continued (at p 63):

S5.1 Prudent Investment

The capital base may be increased to recognise additional capital costs incurred in constructing new facilities for the provision of services.

The amount by which the capital base may be increased is the amount of the actual capital cost incurred provided that:

the amount does not exceed the amount that would be invested by a prudent TNSP acting efficiently in accordance with good industry practice and to achieve the lowest sustainable cost of delivering services;

one of the following conditions is satisfied:

the anticipated incremental revenue generated by the capital expenditure exceeds the investment cost;

the TNSP or users satisfy the Commission that the new capital expenditure exceeds the investment cost;

the new capital expenditure is necessary to maintain safety, integrity or is approved under the NEC [National Electricity Code].

Should the actual capital cost incurred be deemed excessive by the Commission then the prudent amount of expenditure will be added to the regulatory asset base. The excess amount may be recorded in the regulatory accounts and rolled forward at the regulatory rate of return for possible transfer to the regulatory asset base at a later date.

99. In the AER's *Compendium of Electricity Transmission Regulatory Guidelines*, August 2005, the AER notes at Appendix B, the following in respect of the application of the then applicable prudency test:<sup>8</sup>

First, assess whether there is a justifiable need for the investment. This stage examines whether the TNSP correctly assessed the need for investment against its statutory and NER obligations. At this stage, the assessment focuses on the need for investment, without specifically focussing on what the 'correct' investment to meet that need should be. An affirmation of the need for an investment does not imply acceptance of the specific project that was developed.

Second, assuming the need for an investment is recognised, assess whether the TNSP proposed the most efficient investment to meet that

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<sup>8</sup> Being S5.1 of the *Draft statement of principles for the regulation of transmission revenues*, May 1999, which outlined the test for prudent investment as, '...the amount that would be invested by a prudent TNSP acting efficiently in accordance with good industry practice'

need. The content of the assessment here is whether the TNSP objectively and competently analysed the investment to a standard that is consistent with 'good industry practice'.

Third, assess whether the project that was analysed to be the most efficient was indeed developed, and if not, whether the difference reflects decisions that are consistent with 'good industry practice'. The analysis in this third step examines in detail the factors that caused changes in the project design and/or delivery and assesses how the TNSP responded to those factors in comparison to what could be expected of a prudent operator.

The AER will apply the prudence test to 'non-augmentation' and 'support the business' investment by reviewing the processes conducted by the TNSP in assessing the need for investment, selecting the appropriate project and then delivering that project.

100. These expositions are illustrative of the kinds of factors relevant to an assessment of prudence, although their application is limited by the fact that the test to which they were referable was an *ex post* assessment, in contrast with the *ex ante* assessment now deployed in the Rules (and deployed by the Commission after December 2004).
101. The term "prudent" was not used within the economic regulatory provisions of the predecessor to the Rules, the National Electricity Code.
102. The term "prudent" is now used in the NEL (at s 55C), and in a number of contexts within the NER, including: Schedule 5.3; clause 6A.26 and Schedule 6.2 to Chapters 6 and 6A (viz, the "prudent and efficient value of assets").
103. In the AEMC's *Rule Determination* accompanying the enactment of clauses 6.5.6 and 6.5.7 of the Rules<sup>9</sup> the AEMC relevantly observed the following:

The Commission has sought to make improvements in this area by giving clear guidance to the regulator and the TNSP on the process and criteria for making decisions. In developing the decision criteria for expenditure forecasts the Commission sought to ensure that the assessment of forecasts encourages efficiency through least cost operations and timely and prudent investment in capital. (p. 43)

While informed opinions may differ on what are efficient costs, costs of a prudent operator or realistic expectations of forecast demand and input costs in the circumstances facing the regulated entity, those matters can be tested readily by reference to objective evidence drawn

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<sup>9</sup> Rule Determination: National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2008 No. 18, 16 November 2006

from history, the performance and experience of comparable businesses and the assessments of electricity industry experts. (p. 53)

104. In a letter dated 23 November 2001, entitled, "Tribunal Guidance on Prudency Test for Capital Expenditure by Electricity Distributors" Eric Groom, Director, Analysis and Policy Development of the Independent Pricing and Regulatory Tribunal (IPART) relevantly stated:

Prudency requires that the capital expenditure option and its timing be consistent with good industry practice given:

- current and projected capacity
- current condition of assets and renewal requirements
- alternatives of contracting for support through demand management and distributed generation (taking into account emerging trends in technology and costs)
- current safety standards for the distribution network and accepted planning standards
- current and foreseeable policies in regard to factors such as environmental requirements and contestability
- current demand and reasonable projections for demand
- analysis of the risks attached to the above elements.

105. Collecting the above principles, a "prudent operator":

- (a) replaces assets only when necessary;
- (b) is consistent in its approach to deferment;
- (c) engages external forecasters to provide independent advice;
- (d) allows others (for example, generators) to bear the cost where appropriate;
- (e) takes into account one-off items/events when using historical data to forecast; and
- (f) uses competitive tenders as the basis for forecasts.

106. As noted above, the proposed test permits the AER, in its assessment of costs, to abstract from the particular circumstances of the TNSP.

107. This amendment represents an important change in emphasis in the proposed rule, and one which confers greater latitude on the AER in exercising its discretion by reference to benchmarks as opposed to the particular circumstances of the TNSP under consideration. While the use of benchmarks is a necessary and helpful aspect

of the regulatory assessment process, its utility is limited by the extent of its similarity to the infrastructure under consideration; that is, it is useful only in so far as it permits a like for like comparison. Accordingly, in order to promote efficient and safe outcomes, any use of benchmarking must attend to the particular circumstances of the infrastructure under consideration, and whether the benchmark provides a sufficiently proximate comparison to assist analysis.

**(2) New clauses 6A.6.6(d)(12) and 6A.6.7(d)(12)**

108. *Secondly*, the introduction of new opex and capex factors, through clauses 6A.6.6(d)(12) and 6A.6.7(d)(12), in effect to provide that, in addition to the opex and capex factors enumerated at clauses 6A.6.6(d)(12) and 6A.6.7(d)(12) the AER must have regard to “any other factors the AER considers relevant”.
109. The word “must” in the chapeau of clause 6A.6.6(d) and 6A.6.7(d) is obligatory: cl 12 of Schedule 2 to the NEL. Further, it is well settled that the phrase “have regard to” requires a decision-maker to take a stated matter into account and to give weight to that matter as a fundamental element in making its determination: *R v Hunt, Ex parte Sean Investments Pty Ltd* (1979) 25 ALR 497 at 504; *Queensland Medical Laboratory and Others v Blewett and Others* (1988) 84 ALR 615. More difficult is the question of whether a decision-maker obliged to “have regard to” one or more stated matters is confined to those matters, or may take other matters into account in making its determination. The answer has been seen to vary with the legislative context.
110. The insertion of new clause 6A.6.6(d)(12) resolves this difficulty by expanding the AER’s discretion. That is, should the AER form a view that it considers that any other matter to be relevant in assessing opex and capex, it is obliged to take that matter into account; however, the initial ascription of relevance lies wholly within the discretion of the AER. This again confers a very broad discretion upon the AER.

**(3) New clause 6A.6.6(e)(12) and 6A.6.7(e)(12)**

111. *Thirdly*, a revision to the opex and capex factors (currently located at clauses 6A.6.6(e)(12) and 6A.6.7(e)(12)) to provide instead (at clauses 6A.6.6(e)(9) and 6A.6.7(e)(9)), that, in respect of opex and capex, the AER must have regard (inter alia), to:

(12)(9) the extent to which ~~the Transmission Network Service Provider has considered and made provision for any~~ efficient and prudent non network alternatives may impact the forecast of required operating expenditure

112. This amendment appears, like proposed new 6A.6.6(c), to direct the AER’s attention away from the particular circumstances of a TNSP to an objective benchmarking standard.

**(4) Deletion of clauses 6A.6.6(f), 6A.6.7(f) and 6A.13.2(b)**

113. *Fourthly*, current clause 6A.6.6(f) and 6A.6.7(f) are deleted, along with current clause 6A.13.2(b), each of which is extracted above.
114. The effect of these amendments, coupled with those identified above, and other ancillary amendments, is to alter the architecture of the regulatory scheme from a “propose-respond” model to a “consider-decide” model (cf AER Rule Change Proposal at §6.2.3, page 30 and Lloyd Opinion [32]).
115. The Lloyd Opinion refers (at [32]) to the bias of the existing framework “especially in light of the information asymmetry... in favour of ever increasing capex and opex forecasts”. The “information asymmetry” is not identified or discussed. The AER enjoys extensive information gathering powers pursuant to Part 3, Division 3 of the NEL. In the event of any perceived informational shortage, the AER can exercise its powers under s 28 and obtain identified data from a TNSP. Moreover, a perceived information shortage is no reason for the proposed amendments: the combination of a broad discretion and insufficient information is not a recipe for good decision-making.



Cameron A. Moore SC



Ruth C. A. Higgins

Chambers

19 December 2011

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**IN THE MATTER OF GRID AUSTRALIA  
REGARDING AER RULE CHANGE  
PROPOSAL**

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**JOINT OPINION**

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