

ELECTRICITY TRANSMISSION NETWORK owners forum

26 October 2006

John Tamblyn
Chairman
Australian Energy Market Commission
PO Box H166
Australia Square, NSW 1215

By email: john.tamblyn@aemc.gov.au

Dear John,

Re: Counsel Opinion in relation to Commission's call of 12 October 2006 for further input on the draft Chapter 6 Rules

We wrote to you on 19 October 2006 and subsequently lodged a submission on 20 October 2006 in response to the Commission inviting further submissions and comments concerning the treatment of forecast capital and operating expenditure in the draft Chapter 6 of the National Electricity Rules.

ETNOF has now also obtained advice from Stephen Gageler SC in relation to the following questions:

- (1) How is the AER to determine under cl 6A.6.6(b)(2) or cl 6A.6.7(b)(3) of the Draft Rule whether the total of the forecast of operating expenditure or capital expenditure included by a TNSP in a Revenue Proposal is a "reasonable estimate"?
- (2) In particular, without limiting the generality of (1): (a) what is the measure of "reasonableness"? (b) is the AER required to determine a range of estimates that are reasonable and then to determine whether the total of the forecast included by the TNSP falls within that range?
- (3) To what extent is a determination of the AER under cl 6A.6.6(b)(2) or cl 6A.6.7(b)(3) of the Draft Rule subject to merits review?
- (4) In particular, without limiting the generality of (3), is the standard of merits review applicable to a determination that a forecast is a reasonable estimate the same as that applicable to a determination that a forecast is not a reasonable estimate?
- (5) How would the role of the AER be different if the AER were required to determine instead whether the total of the forecast of operating expenditure or capital expenditure included by a TNSP in a revenue proposal was the "best estimate that is reasonably possible in the circumstances"?

- (6) How would the role of the AER be different if the AER were given a residual discretion to substitute its own reasonable estimate in circumstances where the total of the forecast of operating expenditure or capital expenditure included by a TNSP in a revenue proposal is also a reasonable estimate?
- (7) Would either of the alternative formulations of a decision rule for the AER discussed in questions (5) and (6) provide more symmetrical avenues for merits review for users and TNSPs than the formulation set out in the AEMC's draft Chapter 6?

The advice is submitted with this letter as further input to the Commission's final determination. The advice supports the ETNOF submission of 20 October 2006 and includes the following key findings:

- The Draft Rule requires the AER to ensure that the TNSP's proposal is one based on sound judgement and it is neither necessary nor appropriate for the AER to formulate a range of estimates and ask whether the TNSP's proposal falls within this range.
- Both of the alternative formulations; i.e. "best estimate that is reasonably possible" and "residual discretion" are essentially the same and would, in effect, mean that the AER is empowered to simply make its own estimate.
- The standard of merits review applicable to a determination that a forecast is a reasonable estimate is identical to that applicable to a determination that a forecast is not a reasonable estimate. The rights of review as currently proposed are symmetrical and would remain symmetrical under either of the alternative formulations.

We would welcome the opportunity to discuss these findings and the advice with the Commission.

Yours sincerely,



Rainer Korte
Chair of ETNOF Regulatory Managers Committee

**IN THE MATTER OF THE DRAFT NATIONAL ELECTRICITY
AMENDMENT (ECONOMIC REGULATION OF TRANSMISSION
SERVICES) RULE 2006**

OPINION

Introduction

1. We are asked by Gilbert + Tobin to advise the Electricity Transmission Network Owners' Forum on questions concerning the draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 (**Draft Rule**). The Draft Rule is designed to give effect to the obligation of the Australian Energy Market Commission (**AEMC**) under s 35 of the National Electricity Law (**Law**) by inserting into the National Electricity Rules (**Rules**) a new Ch 6A dealing with the economic regulation of transmission services.

2. The questions relate to the role of the Australian Energy Regulator (**AER**) under the Draft Rule in considering a forecast of operating expenditure or capital expenditure included by a Transmission Network Service Provider (**TNSP**) in a

Revenue Proposal. They also relate to alternative formulations of that role referred to in a letter of advice dated 10 October 2006 from the Australian Government Solicitor to the Commonwealth Department of Industry, Tourism and Resources (**AGS Advice**) and in an invitation to make submissions published by the AEMC on its website on 12 October 2006.

Questions

3. We are asked:

- (1) How is the AER to determine under cl 6A.6.6(b)(2) or cl 6A.6.7(b)(3) of the Draft Rule whether the total of the forecast of operating expenditure or capital expenditure included by a TNSP in a Revenue Proposal is a “*reasonable estimate*”?
- (2) In particular, without limiting the generality of (1):
 - (a) what is the measure of “*reasonableness*”?
 - (b) is the AER required to determine a range of estimates that are reasonable and then to determine whether the total of the forecast included by the TNSP falls within that range?
- (3) To what extent is a determination of the AER under cl 6A.6.6(b)(2) or cl 6A.6.7(b)(3) of the Draft Rule subject to merits review?

- (4) In particular, without limiting the generality of (3), is the standard of merits review applicable to a determination that a forecast is a reasonable estimate the same as that applicable to a determination that a forecast is not a reasonable estimate?
- (5) How would the role of the AER be different if the AER were required to determine instead whether the total of the forecast of operating expenditure or capital expenditure included by a TNSP in a revenue proposal was the “*best estimate that is reasonably possible in the circumstances*”?
- (6) How would the role of the AER be different if the AER were given a residual discretion to substitute its own reasonable estimate in circumstances where the total of the forecast of operating expenditure or capital expenditure included by a TNSP in a Revenue Proposal is also a reasonable estimate?
- (7) Would either of the alternate formulations of a decision rule for the AER discussed in questions (5) and (6) provide more symmetrical avenues for merits review for users and TNSPs than the formulation set out in the AEMC's draft Ch 6?

Short Answers

4. For the reasons set out below, our short answers are as follows:

- (1) In determining under cl 6A.6.6(b)(2) and 6A.6.6(b)(3) of the Draft Rule whether or not the total of a forecast of operating expenditure or capital expenditure included by a TNSP in a Revenue Proposal is a “*reasonable estimate*”, the AER is required to evaluate whether or not the forecast is the product of sound judgment. In making that evaluation, the AER is required to give consideration to the twelve matters referred to in those clauses (according them such weight as it considers appropriate) and to make its assessment with a view to promoting efficient investment in and, efficient use of, electricity services for the long term interests of consumers of electricity.
- (2)
 - (a) The measure of reasonableness is one of sound judgment.
 - (b) It is neither necessary nor appropriate for the AER to formulate a range of reasonable estimates and to ask whether the estimate proffered by the TNSP falls within that range.
- (3) Any determination of the AER under cl 6A.6.6(b)(2) or cl 6A.6.7(b)(3) of the Draft Rule is to be subject to merits review relevantly on the basis that the determination is “*unreasonable*”.
- (4) The standard of merits review applicable to a determination that a forecast is a reasonable estimate is identical to that applicable to a determination that a forecast is not a reasonable estimate. In either case, the determination of the AER would stand unless it could be shown that the determination of the AER was itself unreasonable.

- (5) For the AER to be required to determine instead whether the total of the forecast of operating expenditure or capital expenditure included by a TNSP in a revenue proposal was the “*best estimate that is reasonably possible in the circumstances*” would be to adopt a fundamentally different model from that which is the Draft Rule. In effect, the AER would be empowered simply to make its own estimate. The AER’s estimate would then stand unless it could be demonstrated on review the estimate was unreasonable.
- (6) For the AER to be given a residual discretion to substitute its own reasonable estimate in circumstances where the total of the forecast of operating expenditure or capital expenditure included by a TNSP in a Revenue Proposal is also a reasonable estimate would produce the same effect as requiring the AER to determine whether the total of the forecast of operating expenditure or capital expenditure included by a TNSP in a revenue proposal was the “*best estimate that is reasonably possible in the circumstances*”. In effect, the AER would be empowered simply to make its own estimate. The AER’s estimate would then stand unless it could be demonstrated on review the estimate was unreasonable.
- (7) Neither of the alternative formulations of the role of the AER referred to in questions (5) and (6) would alter the nature of the rights of merits review for users and TNSPs. The rights of review as currently proposed are symmetrical and would remain symmetrical under either of the alternative formulations.

Reasons: Questions (1) and (2)

5. The use of labels such as “*propose-respond*” “*receive-decide*” and “*fit-for-purpose*” can suggest that there are a limited number of precise legal categories for regulatory decision rules which is not the case. Avoiding the use of labels which may be misleading, the scheme of cl 6A.6.6 and cl 6A.6.7 of the Draft Rule (read with cl 6A.14) is relatively straightforward.

6. A TNSP is required by cl 6A.6.6(a) and cl 6A.6.7(a) to include in a Revenue Proposal a forecast of its operating expenditure and capital expenditure. The forecast is of expenditure which the TNSP considers to be reasonably required to:
 - (1) efficiently meet expected demand;
 - (2) comply with all applicable regulatory obligations;
 - (3) maintain the quality, reliability and security of supply; and
 - (4) maintain the reliability, safety and security of the transmission system.

7. The AER is then required under a duty to determine whether or not the total of the forecast is a reasonable estimate of the TNSP’s required expenditure. The duty arises by implication from the decision-making structure: cf. *Water Conservation and Irrigation Commission (NSW) v Browning* (1947) 74 CLR 492 at 505. If the AER determines that the total of the forecast is a reasonable estimate of

the TNSP's required expenditure, the AER must accept the forecast. If the AER determines that the total of the forecast is not a reasonable estimate of the TNSP's required expenditure, the AER must go on to make an estimate of the total expenditure the AER itself considers to be reasonable.

8. In determining whether or not the total of a forecast is a reasonable estimate of the TNSP's required expenditure and (where the determination is that it is not) in going on to make an estimate of the total expenditure the AER itself considers to be reasonable, the AER is expressly required to "*take into account*" the twelve matters referred to in cl 6A.6.6(b)(2) and 6A.6.6(b)(3) of the Draft Rule. The requirement is to give those matters proper, genuine and realistic consideration. The weight to be given to any one or more of them is left to the AER.
9. The AER is also obliged by s 16(1)(a) of the Law to perform each function imposed on it by the Draft Rule in a manner that will or is likely to contribute to the national electricity market objective set out in s 7 of the Law which is:

... to promote efficient investment in and, efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.
10. That obligation imposed on the AER by s 16(1)(a) of the Law necessarily informs its assessment of the twelve matters referred to in cl 6A.6.6(b)(2) and 6A.6.6(b)(3) of the Draft Rule and necessarily informs its assessment of what is "*reasonable*". The evaluative judgment of the AER is in each case to be exercised with a view

relevantly to promoting efficient investment in and, efficient use of, electricity services for the long term interests of consumers of electricity.

11. In determining under cl 6A.6.6(b)(2) and 6A.6.6(b)(3) of the Draft Rule whether or not the total of a forecast of operating expenditure or capital expenditure included by a TNSP in a Revenue Proposal is a “*reasonable estimate*”, the AER is therefore required:

- (1) to give consideration to the twelve matters referred to in those clauses;
- (2) to accord those matters such weight as the AER considers appropriate;
and
- (3) to act with a view to promoting efficient investment in and, efficient use of, electricity services for the long term interests of consumers of electricity.

12. A “*reasonable estimate*” is nothing more than an “*estimate*” that is “*reasonable*”. Neither the word “*estimate*” nor the word “*reasonable*” has any technical legal meaning.

13. The word “*estimate*” is doubtless used in cl 6A.6.6(b)(2) and 6A.6.6(b)(3) of the Draft Rule to recognise that the nature of a “*forecast*” belies the existence of a uniquely correct or preferable or appropriate figure. Nor is there likely to be a single correct or preferable or appropriate methodology that can be used to produce a “*forecast*” either of operating expenditure or capital expenditure.

Questions of judgment and degree will be involved at various levels of analysis. The total forecast will therefore necessarily be an “*estimate*” and that estimate will necessarily be the product of a number of choices, both as to methodology and as to inputs into methodology.

14. The word “*reasonable*” is doubtless used in cl 6A.6.6(b)(2) and 6A.6.6(b)(3) of the Draft Rule to connote that which is “*agreeable to reason or sound judgment*” (Macquarie Dictionary, meaning 2) not simply to connote that which is rational or not irrational. The word has been so interpreted and applied in analogous but not identical contexts by the Australian Competition Tribunal in *Telstra Corporation Limited* [2006] ACompT 4 at [63] and in *GasNet Australia (Operations) Pty Ltd* (2004) ATPR 41 – 987 at [29]-[30] and by the Full Court of the Federal Court in *Australian Competition & Consumer Commission v Australian Competition Tribunal* [2006] FCAFC 83 at [177]-[178].
15. To describe an “*estimate*” as a “*reasonable estimate*” is in substance to express the conclusion that it is the product of sound judgment. In the precise context of cl 6A.6.6(b)(2) and 6A.6.6(b)(3) of the Draft Rule, it is the expression of the conclusion of the AER that the estimate inherent in a forecast is the product of sound choices on the part of the TNSP by which it is proffered.
16. We agree with the observation in paragraph [42] of the AGS advice that the likelihood is that “*there will be a number of total forecasts that are ‘reasonably’ open*” to a TNSP in the sense that each can be described as a “*reasonable estimate*”. If any of them is proffered by the TNSP, it would have to be accepted by the AER. That is the logical corollary of the fact that there can be no uniquely correct or

preferable or appropriate forecast and of the fact that it is for the AER in the first instance not to determine a forecast for itself but to determine whether the forecast proffered by the TNSP is the product of sound judgment. We do not see it as an invitation to exploitation. A TNSP which sought deliberately to adopt a forecast at the upper end of what it considered the AER might be prepared to accept as a “reasonable estimate” would be in breach of its obligation under cl 6A.6.6(a) or cl 6A.6.7(a) to include in a Revenue Proposal a forecast of expenditure which the TNSP genuinely considers to be reasonably required. The TNSP would also run the significant risk of overreaching and of thereby allowing the AER to make and substitute its own estimate.

17. We also agree with the additional observation in paragraph [43] of the AGS advice that:

... the concept of ‘reasonable estimate’ should not be confused with the concept of a ‘reasonable range’ of outcomes, within which a forecast must fall. The proposed Rule simply asks whether a particular total is a reasonable estimate. The proposed Rule is not as broad as the Productivity Commission’s approach of an estimate only needing to be within ‘a range of plausible outcomes’. As the proposed Rule is not based around the AER’s view of the best or most statistically probable total there will be a number of different outcomes which will be considered to be reasonable estimates. It is impossible to accurately predict, from a legal point of view, how wide that range of outcomes will be given the nature of the decisions in question.

18. In determining under cl 6A.6.6(b)(2) and 6A.6.6(b)(3) of the Draft Rule whether or not the total of a forecast of operating expenditure or capital expenditure included by a TNSP in a Revenue Proposal is a “reasonable estimate”, it is neither

necessary nor appropriate for the AER to formulate a range of reasonable estimates and to ask whether the estimate proffered by the TNSP falls within that range just as it is neither necessary nor appropriate for the AER to consider whether there is some other estimate which is more reasonable.

19. The task of the AER is rather to examine the choices that the TNSP has made in arriving at the total forecast it has proffered and to ask whether the total of the forecast resulting from those choices is the product of sound judgment.

Reasons: Questions (3) and (4)

20. We are instructed that the Ministerial Council on Energy made a decision in May 2006 (**MCE decision**) concerning the scheme for review of decision-making by the AER.

21. By the MCE decision it is proposed that reviews will be heard by the Australian Competition Tribunal and that leave be required from that Tribunal before a review can be commenced (at pg 4). Subject to the requirement for leave, it is proposed by the MCE decision (at pg 4) that the persons able to commence a review will be:

- (1) service and network providers;
- (2) users who are materially affected by the original decision; and
- (3) user and consumer groups.

22. The proposed grounds of review (at pg 6) are as follows:
- (i) that the decision-maker made an error of fact and that fact was material to the decision;
 - (ii) that the exercise of the decision-maker's discretion was incorrect having regard to all the circumstances; or
 - (iii) that the decision-maker's decision was unreasonable having regard to all the circumstances.
23. It follows from the above that a determination of the AER under cl 6A.6.6(b)(2) or cl 6A.6.7(b)(3) of the Draft Rule will be subject to review on the basis set out in these grounds.
24. We agree with the observation in the MCE decision (at pg 6) that the proposed grounds of review provide a limited merits review of a decision of the AER.
25. Adapting the recent language of the Full Federal Court in *Australian Competition & Consumer Commission v Australian Competition Tribunal* [2006] FCAFC 83 at [176]-[177]:

The Tribunal has not been given a purely substitutive function in relation to the review of the [AER's decision]. That is to say, if the [AER] has made its decision on correct principles and if the particular [decision] was open to it within the framework of the [Draft Rule], the Tribunal is not empowered to set aside that decision simply because it thinks another decision would have been preferable. This is emphasised by the provision in [(iii)] of the ground[s]

of review based on unreasonableness. The [making of a decision] is not unreasonable simply because another decision-maker would have come to a different view. On the other hand unreasonableness in [ground (iii)] is not limited to cases in which the exercise of the discretion was so unreasonable that no reasonable person could have so exercised it.

[Ground (iii)] is compatible with the wider view of ‘unreasonableness’ which would pick up logical error or irrationality in the decision. The [] submission which would limit the unreasonableness ground to so called Wednesbury unreasonableness is not accepted. (emphasis supplied)

26. Question (4) raises the issue of the standard of merits review applicable to:
- (1) a determination that a forecast is a “reasonable estimate” (for example a review of such a determination sought by a users group); and
 - (2) a determination that a forecast is not a “reasonable estimate” (for example a review of such a determination sought by a TNSP).
27. It is currently proposed by the Draft Rule that decisions of the AER be subject to the same grounds of review; namely the three grounds of review set out at paragraph 22 above. Such a review can be sought by the same classes of persons; namely, those set out at paragraph 21 above. It follows that the rights of different persons (for example users who are materially affected –v– TNSPs) to seek a review in relation to these two decisions are the same (or expressed another way, the rights of review are symmetrical).

28. In this respect we note the example considered in the AGS advice at para [60] of a challenge by a user group to a decision by the AER to accept a proposal from a TNSP as a reasonable estimate. The observations of the AGS that under the proposed grounds of review such a review would be “*difficult*” ought not in our opinion be read as suggesting that reviews sought by users are *more* difficult than reviews sought by other groups (such as by TNSPs). This is because the grounds upon which a decision of the AER can be reviewed are the same regardless of who the applicant is or which decision is sought to be reviewed. We understand the AGS advice to acknowledge this when it makes the observation that the current review framework means that a review by “*any applicant*” will be difficult.

Reasons: Question (5)

29. The reference to the possibility of the AER being required to determine whether the total forecast proffered by a TNSP is the “*best estimate that is reasonably possible in the circumstances*” appears in the last of the questions addressed in the AGS advice.
30. To require the AER to determine whether the total forecast proffered by a TNSP is the “*best estimate that is reasonably possible in the circumstances*” would be to adopt a fundamentally different model from that which currently appears in the Draft Rule. It would be to require the AER to determine whether it considered the estimate proffered to be the most preferable or appropriate and to go on to substitute its own estimate for any estimate which it considered to be less than the most preferable or appropriate.

31. The AER would no longer be asking whether the forecast proffered was the product of sound judgment but whether it was the product of a right judgment in the sense of it being a judgment which coincided precisely with its own.
32. In effect, the AER would be empowered simply to make its own estimate.
33. It would then be for the TNSP or any other person with sufficient standing to seek review to demonstrate that the estimate of the AER was unreasonable.

Reasons: Question (6)

34. The reference to the possibility of the AER being given a residual discretion to substitute its own reasonable estimate in circumstances where the total of the forecast of operating expenditure or capital expenditure included by a TNSP in a Revenue Proposal is also a reasonable estimate appears in the invitation to make submissions published by the AEMC on its website on 12 October 2006.
35. In the absence of some express limitation on the circumstances in which the discretion may be exercised, we see no difference in substance between this and the alternative of requiring the AER to determine whether the total forecast proffered by a TNSP is the "*best estimate that is reasonably possible in the circumstances*".
36. In effect, the AER would be empowered simply to make its own estimate.

37. It would then be for the TNSP or any other person with sufficient standing to seek review to demonstrate that the estimate of the AER was or perhaps that its exercise of discretion to substitute that estimate was unreasonable.

Reasons: Question (7)

38. As set out above, it is currently proposed that decisions of the AER be subject to the same grounds of review (see paragraph 22 above) where such review can be sought by the same classes of persons (see paragraph 21 above). Thus, the rights of review as currently proposed are symmetrical.
39. Neither of the alternative formulations of the role of the AER referred to in questions (5) and (6) would alter the nature of the rights of merits review for users and TNSPs. It follows that the rights of review as currently proposed would remain symmetrical under either of the alternative formulations.

25 October 2006



STEPHEN GAGELER



KATHERINE RICHARDSON

**IN THE MATTER OF THE
DRAFT NATIONAL
ELECTRICITY AMENDMENT
(ECONOMIC REGULATION OF
TRANSMISSION SERVICES)
RULE 2006**

OPINION

Gilbert + Tobin
DX 10348 SSE