# Response to Draft Determination

*Economic Regulation of Network Service Providers*

**(Reference ERC0134 & ERC0135)**

**4 October 2012**

# 1. Overview

The Energy Networks Association (ENA) welcomes the opportunity to provide a response to the Draft Rule Determination published by the Australian Energy Market Commission (the Commission) in respect of the *Economic Regulation of Network Service Providers* rule change process. The draft determination represents an important milestone in the rule change process, and the associated consultation process offers the single best opportunity for all stakeholders to provide practical guidance based on their individual experience, expertise and perspectives on how to positively achieve any required improvements to the existing energy rules framework in the areas being considered.

The ENA considers that the revised rules set out in the draft determination represent a substantial and broadly positive potential shift in network regulation. This response sets out the perspectives of the ENA's members on the major areas of change, rather than comprehensively address every proposed rule change.

## Appropriate rate of return guidance

One of the most significant areas of amendments is the implementation of a revised cost of capital assessment framework. The network sector supports the implementation of a common cost of capital estimation framework, directed by a clear objective to guide the process. While networks accept that unhelpful inflexibilities existed in the rate of return guidance under both the electricity transmission and distribution frameworks, there remains, however, a strong case to require substantive reasons and evidence to be demonstrated by the AER prior to any significant changes in regulatory practice.

The network sector considers there are a range of improvements which can build on the framework proposed by the Commission. These include ensuring the Rate of Return Guideline process, which is now potentially considering a wider range of matters than the original *Statement of Regulatory Intent (distribution) and Statement of revised WACC parameters (transmission)*, occurs over a sufficient consultation period to provide all parties with the opportunity for meaningful and iterative two-way engagement.

As a focal point for future return on capital decisions by the AER, the ENA considers there is also value in providing further guidance to the AER on the matters that should form part of the guideline. This guidance should be such that requires the AER to provide sufficient details in a guideline that would enable stakeholders to derive proxy estimates of the rate of return parameters. The ENA does not consider that the current drafting proposed by the Commission would require (or perhaps even permit) the information in the guideline to be such that proxy values for the various parameters could be derived.

## Proposed changes to the cost of debt estimation rules

The Commission has proposed wholesale revisions to how existing electricity rules guide regulatory estimates of the benchmark cost of debt. Providing investors with confidence that the regulatory process will result in a prospective return on debt which is at least sufficient to meet efficient financing costs is critical element underpinning stable access to competitively priced debt capital by network businesses. In this area, networks consider that there are significant enhancements that can be made to the guidance provided in order to provide such confidence.

As a minimum, network businesses must have confidence that efficient cost of debt approaches which form part of the regulatory proposal put forward by the business will be the firm starting point for any AER considerations on future approaches. The application of any AER-determined 'one-sized fits all' cost of debt approach which does not consider the actual financing practices of network businesses, including costs associated with the movement to any new financing practices required to reduce material risks to networks arising from the new arrangements, would be inconsistent with the National Electricity Objective (NEO) and the revenue and pricing principles.

## Operating and capital cost assessment rules

The capital and operating cost objectives and criteria are at the heart of the regulatory framework dealing with forecast operating and capital expenditure, and are key provisions in guiding regulators in their assessment of regulatory proposals. The ENA considers that the suggested changes proposed by the AER, and specifically the removal of any reference to the individual circumstances of the network firm in assessing proposed expenditure are unnecessary and risk allowing for decisions that unreasonably ignore relevant network characteristics potentially affecting forecast expenditures. In practice these clauses have not been found to be a barrier to reasonable, robust benchmarking, and their removal has the potential to lead to regulatory outcomes that are inconsistent with the revenue and pricing principles, and the national electricity objective, by potentially allowing for the setting of recoverable costs at an inadequate level.

Energy network businesses support the regulatory framework holding networks to account for commercial and planning decisions that are within their control and direction. This concept is central to the Commission's proposals around capital expenditure incentives. One element of the proposed rule that does not sit consistently with this approach is the significant scope of proposed rules relating to AER forecasting approaches. As drafted, these rules have the unintended consequence of creating a significant blurring of roles and accountabilities in the framework, without clearly meeting the intended policy goal of facilitating earlier constructive collaboration between parties to the regulatory process on the basis of provided forecasts, and how regulatory assessment tools will be applied. The ENA has made alternative suggestions in this area which will, in our view, better meet the worthwhile policy objectives sought.

## Capital expenditure incentive frameworks

The Commission has proposed in its draft rules a capital expenditure framework that is radically different to that currently operating. The Commission has not been able to identify evidence that the rules or their operation by the AER have led to inefficient capital expenditures over the initial period of the rules being in place.

Despite this, the Commission has identified a need for increased 'supervision' of capital expenditures. The network sector accepts and recognises that a lack of public confidence in the prudent and efficient expenditure of capital is undesirable, and warrants specific action by the Commission. In this respect, the network sector has closely considered the issue of providing clearer guidance for the regulator to consider in exercising functions in this area, including the power to retrospectively strand past network investment decisions following an *ex post* review by the regulatory body.

The past experiences of a range of regulators applying *ex post* review frameworks (including the ACCC in electricity) points to the strong need for appropriate definition and guidance on this inherently challenging regulatory function. To this end, industry proposes specific additional guidance, and reconsideration of the introduction of the proposed capital expenditure objective.

## Regulatory process changes

The network sector has closely considered how the regulatory process can best foster engagement with energy consumers and other stakeholders to ensure regulatory outcomes are efficient, robust and transparent, and contribute to rebuilding community confidence in network price and revenue setting processes.

Broadly, the ENA supports the direction of the Commission's proposed rules in this area, including the additional features and steps in the regulatory process, greater encouragement of early engagement and information provision on the part of the network business and the regulator. As an area of significant detail, however, the network sector has developed a significant number of minor amendments based on industry's perspectives of how the regulatory process can be improved.

## Suggested provision of additional 'workability check' workshops

The Commission's rule change assessment process has been focused on changes of both extensive scope and significant volume, based on the original proposals placed before the Commission by the AER and Energy Users Rule Change Committee. As a result of the Commission's approach to date, the review process has permitted considerable policy-level discussion on appropriate future approaches and alternatives. With the publication of the draft rules, however, the process moves to a different stage, focusing critically on the potential application and effect of the rules as drafted.

Given the complexity and range of the individual rule changes proposed, and their interactions, the ENA therefore encourages the Commission to consider further dedicated workshops with interested parties to focus, prior to the final rule determination, on the correction of any errors, unintended effects, or other purely drafting issues.

Such workshops would be an opportunity to bring together technical expertise from experienced regulatory practitioners to seek to provide a final 'check' on the practical workability of the final rules. It would not be appropriate for any such workshops to be a forum to re-agitate issues around the Commission's final policy position - rather, taking the Commission's decision on the policy direction as a given, the focus would be on the drafting proposed to give effect to that policy direction.

Industry's experience of similar opportunities prior to the implementation of the original Chapter 6 *National Electricity Rules* and the revised National Gas Rules was that these opportunities were able to provide a valuable final 'screening mechanism' for rule workability, and avoided further resource intensive rule processes to correct clear errors. Industry is keen to engage constructively with the Commission's staff in any feasible timeframe or format to facilitate such workshops.

# 2. Background

## 2.1 Approach

This submission has been developed through close consultation with the ENA members, which are energy distribution and transmission network businesses operating through Australia. It represents the agreed policy perspectives of the networks sector as a whole based on its collective experience under existing national energy frameworks.

The submission is broadly structured in accordance to major thematic proposals discussion in the AEMC's Draft Rule Determination Paper published on 23 August 2012 in relation to the AER and EURCC rule change proposals. Each section provides an outline of the AEMC's proposals, details industry views on the relevant issues, and then provides wherever appropriate specific suggested amendments to the draft rule.

The ENA has taken the approach of drafting specific amendments or alternatives to the draft rules that it considers would be the *minimum* required to protect the legitimate business interests of the network service providers, and in so doing, are more broadly consistent with the national electricity and gas objectives, and the revenue and pricing principles. The amendments proposed by the ENA seek to build on the deliberately structured and layered guidance of the National Electricity and Gas Laws, the relevant revenue and pricing principles, and the associated National Electricity and Gas Rules.

## 2.2 Structure of response

The remainder of the submission is structured as follows:

**Section 3** discusses network businesses' overall observation on the entire proposed rule determination (p.6)

**Section 4** sets out industry views on an appropriate rate of return framework (p.9)

**Section 5** consider the proposed Commission rules in relation to the return on debt (p.22)

**Section 6** provides industry responses to the draft determination in the areas of capital and operating forecasts and related mechanisms (p.29)

**Section 7** outlines network businesses responses to proposed changes in relation to capital expenditure mechanisms (p.50)

**Section 8** discusses proposed amendments to the regulatory process (p.66)

**Attachment A** provides a consolidated summary of ENA's suggested amendments to the draft rules (p.82)

**Attachment B** provides a review of international and Australian examples of conducting ex post capital expenditure reviews and lessons arising from these experiences (p.126)

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# 3. Overall observations on the Commission's proposed rule

### *Changes proposed are revolutionary, not evolutionary*

The draft rule arguably represents a revolutionary, not evolutionary change in regulatory frameworks applying to electricity networks in Australia. Across many elements of the tests and guidance to be applied by the regulator in making critical regulatory determinations, the powers granted to the regulator, and the process to be followed, there are major changes proposed.

A theme running through the Commission's draft determination is the view that the AER may not have exercised the full scope of its existing powers under the *National Electricity Rules*. Industry shares this view in some cases. The package of rule changes proposed by the Commission provides for further discretionary powers to be given to the AER. The assessment of the outcome of the Rule change process will, as the Commission has previously noted, involve an interaction of both the black-letter drafting of the Rules themselves, and their implementation by the regulator.

A reasonable expectation given the review process and its findings to date would be that the AER will seek in future regulatory periods to more robustly and fully exercise what they believe to be the scope of their new powers. The existing trend of rising energy prices, and significant public focus on the performance of the energy framework as a whole is likely to reinforce this likelihood. This means that the regulator is likely to seek to utilise to their fullest extent the new powers that the Commission proposes to provide for under the Rules.

The AEMC is, in particular, providing significant new discretion to the AER in the exercise of its regulatory powers in a manner that represents a departure from the original implementation of the *National Electricity Rules* Chapters 6 and 6A from 2006-07.

This revised, more discretionary framework being proposed by the Commission is essentially predicated on wider, but guided discretion to the AER to implement approaches to achieve outcomes consistent with the national electricity and gas objectives and the revenue and pricing principles, and accountability for outcomes. The critical elements of this approach are sound meaningful guidance capable of promoting the investment certainty and accountability of the regulator for their decisions through merits based review.

The current shape and application of the merits review regime is not known, and may not be known until after the finalisation of the Commission's current rule making process. This should imbue the Commission with considerable caution in giving significant new discretions to the regulator, without firm assurance that the guidance provided will be sufficient of itself to promote decisions consistent with the national electricity and gas objectives and the revenue and pricing principles. The ENA has recommended that additional guidance be provided in several critical areas – including capital expenditure incentives, the conduct of ex post reviews of capital expenditure, and cost of debt estimation processes.

### *Distance between rule change proposals, problems found and changes proposed*

This rule change process has been characterised by an extremely large number of individual rule changes being put forward, but major modifications being made to the nature of many of those originally submitted changes through the review process.

As an example, the AER originally proposed movement of the both the electricity and gas cost of capital estimation processes across to the more prescriptive model in the electricity transmission framework in Chapter 6A. It also proposed a highly prescriptive 60/40 'risk-sharing' cap on capital expenditure in excess of forecasts, and rejected the use of an *ex post* review mechanism. Further, the AER proposed that major elements of its revised framework not apply until the regulatory process beyond that which has recently commenced for NSW and ACT electricity businesses.

The proposed draft rules put forward as preferable by the Commission include a far less prescriptive rate of return framework and the wide scope for *ex post* assessments of capital expenditure to effectively strand past investments made by networks in response to inflexible service and reliability standards. As it stands, the Commission is seeking to implement major elements of these revised rules to businesses that have already entered in the intensive preparation phase for their regulatory proposals.

The Commission has commented across a range of areas of significant change that it remains to be convinced that the primary rules in question are themselves deficient, or the cause of any outcomes inconsistent with the national electricity and gas objectives. This means that many of its rule amendments effectively represent an intention to either further clarify intent that the Commission considers was contained in the original rules, or make significant policy and rule changes in the absence of definitive evidence of an unintended operation of a current rule.

### *Importance of promoting regulatory certainty*

An important objective in the finalisation of proposed rules must be the promotion of regulatory certainty. This is critical to give current and future investors the confidence to make long-lived investments in assets with economic and technical lives measured in multiples of decades.

In finalising these rules, this consideration should guide the Commission towards rule amendments that provide clear guidance, address identified deficiencies in a targeted way, and which are capable of forming part of a stable framework over the medium term. In particular, guidance should be readily capable of interpretation by the regulator, and explained in clear terms in the accompanying Commission reasoning. By targeting specific changes, rather than engaging in wholesale changes to key rule elements, the Commission will also be usefully signalling to stakeholders, including potential investors and the regulator, where it considers future regulatory development and 'effort' is required.

A significant issue for the Commission to give focus on in its consideration of the final rules are the longer-term consequences of providing the regulator significant future scope to develop alternative approaches across a range of areas. These include cost of debt estimation approaches, reviews of past capital expenditure, and the development and trialling of new incentive schemes. In the short term, until the AER develops required guidance on these issues, there is considerable uncertainty about key practical elements of the regulatory framework, due to the sheer scope of discretion proposed to be delegated to the AER.

In all of these areas, regulatory practice and guidance has the potential to substantially evolve over time and in ways that will not necessarily be within stakeholders' current contemplation. These significant delegations of discretion carry with them the need to ensure that future changes in approach undertaken by the regulator occur in a manner which fully considers long-term consequences on the matters specified in the national electricity and gas objectives and the revenue and pricing principles. Due to the extremely broad discretion, in several cases the ENA has made positive suggestions for the type of additional guidance that is appropriate (for example, in relation to future changes of the AER in respect of departing from its Rate of Return Guideline, or movement between cost of debt estimation techniques).

More broadly, given the range of changes proposed and their direct impacts on networks with sunk capital investments of over $65 billion, the ENA considers the Commission should, in areas of uncertainty about the need for change, or its long-term consequence, err towards preserving regulatory stability. This is consistent with the deliberate provision by the then Ministerial Council on Energy of a standing rule change process administered by the AEMC, which provides the opportunity for sequential amendments which are responsive to emerging issues and evidence relating to the operation of the regulatory regime.

The constant availability of the rule change mechanism has the advantage that the AEMC is not in a 'one shot game', and that future opportunities to amend the rules will arise. This capacity for a balance of regulatory stability and staged evolutionary changes based on established evidence of deficiencies is a subtle but considerable institutional strength and asset in an environment in which networks must compete in global markets to access competitively priced capital. In assessing a wide range of proposed changes, regard should be had to it being maintained over the medium term.

### *Transitional rules*

The transition to the revised set of electricity and gas rules is a substantial policy issue in its own right. ENA members have been in detailed and constructive discussions with relevant stakeholders, including the Commission and the AER around how to practically implement any revised rules. This process is expected to continue over coming weeks, with the goal of achieving a timely, and where possible streamlined implementation of transitional arrangements in a manner which is fully consistent with the National Electricity Objective, revenue and pricing principles, and procedural fairness.

ENA will be providing separate submissions and representations on the issue of the broad structure and timing of transitional arrangements that will in its view be necessary to ensure the transition rules (that is, the manner of their application, as distinct from the merits of the rules themselves) themselves are clearly capable of passing the rule-making test.

The ENA appreciates that the broad scope of proposed changes, and the complexity of their potential implementation has been a significant challenge to fully specifying and developing transitional rules simultaneously with the proposed revised rules within this process. The ENA has separately outlined to the Commission both its views on the underlying principles which should govern the development of transition arrangements, and the need for market clarity regarding the formal consultation processes around the release and finalisation of transition rules and intends to continue to work closely with the Commission and its members to facilitate positive and pragmatic outcomes in this area.

# 4. Cost of capital estimation framework

## 4.1 Allowed rate of return objective

### AEMC position

The draft rule determination establishes a single rate of return framework for Chapter 6, Chapter 6A and the NGR. The common rate of return framework contains an overarching objective followed by a number of secondary objectives and guidance. The draft rules define *the allowed rate of return objective* as:

> *The allowed rate of return is to correspond to the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of reference services*

### ENA response

The ENA supports the overall structure of the new rate of return framework, and its specification of a single overarching objective together with a number of secondary objectives and guidance. In particular, the new requirement to take account of all relevant estimation methods, financial models, market data and other evidence represents a significant improvement on the present rate of return frameworks.

Notwithstanding the ENA's support of the architecture of the new rate of return framework, the ENA submits that a number of improvements could be made to the drafting of the rules, specifically:

- the rate of return objective should ideally use terminology consistent with the NEL and other frameworks since, absent a clear purpose in doing so, the introduction of new terminology may give rise to unintended consequences: the term "correspond to" should therefore be replaced with the term "commensurate with";
- there should be clarification in relation to the requirement to apply a nominal post-tax rate of return; and
- clause 6.5.2 (d)(1) of the NER (and equivalent provisions of Chapter 6A and the NGR) should be deleted since its meaning is unclear and, to the extent a policy intent can be derived from the clause, this intent is in fact better reflected in clause 6.5.2(d)(2).

***Allowed rate of return objective***

The drafting of the allowed rate of return objective departs from the existing rate of return provisions in both the NER and NGR. This new term creates the potential for unanticipated changes to regulatory practice and interpretation to arise, without this necessarily representing the policy intent of the AEMC.

The ENA considers that the drafting of the rate of return objective should adopt, where possible, language that is well understood by all stakeholders. To this end, the ENA proposes that the words "be commensurate with" be substituted for "correspond to." The ENA's proposed language is consistent with the language in: rule 87(1) of the NGR; in clauses 6.5.4(e)(1) and 6A.6.2(j)(1) of the current NER; and in the revenue and pricing principle directly relevant to the return that a price or charge for the provision of a direct control network service should allow for (section 7A(5)). This language also previously appeared in the National Gas Code.

Further as a matter of drafting clarity, we note that *the allowed rate of return objective* as proposed repeats the term "efficient". In our opinion, the critical guidance provided by the *allowed rate of return objective* is that the rate of return should reflect benchmark efficient financing costs of an entity with a similar degree of risk as that which applies to the provision of the network services. The (cost) efficiency of a network service provider is a distinct concept that is unrelated to its benchmark efficient financing cost, and so the second reference to efficiency should be discarded from the specification of the objective.

***Post-tax rate of return***

A secondary requirement in the objective is that the allowed rate of return is to be determined on a nominal post-tax basis. However, the AER's post-tax revenue model (PTRM) uses a nominal "vanilla" WACC to estimate the regulated revenues of electricity networks and gas pipelines. This form of the WACC is distinct from a nominal "Officer" post-tax WACC which is also calculated in the PTRM and used to check the model's cash flows.

This change does not appear to be intentional and the ENA is proceeding on the basis that this is a slip in the AEMC's draft decision. If this assumption is wrong and the AEMC is proposing that the allowed rate of return is to be determined on a nominal post-tax basis, rather than a nominal vanilla basis, then the ENA considers that the AEMC should provide reasons for that proposed determination and give parties with the opportunity to respond to those reasons.

The ENA supports the continued use of a nominal vanilla WACC.

***Role of clause 6.5.2 (d)(1)***

The ENA considers that the requirement set out in proposed clause 6.5.2(d)(1) is unnecessary and apt to cause confusion. It is not clear from the drafting what this requirement is directed at or what it would achieve in practice. The drafting refers to using "an approach" which leads to "consistent application of any estimates" of parameters that are relevant to the estimates of the return on equity and the return on debt. From this drafting it is not clear what is meant by "consistent application" or how this is to be taken into account in developing the relevant "approach." "Consistent application" could potentially be interpreted in a number of different ways, including consistency in respect of a single parameter or in respect of multiple parameters relying on the same inputs or estimation methods.

It appears that the objective of this secondary requirement is to ensure internal consistency and consideration of inter-dependencies in the rate of return framework.[1] The ENA agrees that this is an important objective, but considers that the first of the proposed secondary requirements is not necessary to achieve this. Rather, the companion requirement in clause 6.5.2(d)(2) to have regard to relevant inter-relationships is sufficient to meet the AEMC's stated objective. Therefore the ENA proposes that only the second of the secondary requirements be retained in any final rule.

**Proposed way forward**

The ENA is supportive of the overall structure of the new rate of return framework. However, we have a number of drafting suggestions that would better give effect to the stated intention of the AEMC. Specifically:

- redrafting of the allowed rate of return objective;

[1] AEMC, Draft Determination, p.57

- amend the requirement for a nominal post-tax WACC so that the rate of return is calculated on a nominal vanilla basis; and

- the deletion of clause 6.5.2(d)(1).

- Proposed drafting in respect of Chapter 6 is set out below. Consolidated proposed drafting for the electricity rules and the gas rules is set out in an attachment to this submission.

**Proposed drafting amendments to Chapter 6,**

**Amendment to clause 6.5.2 (b)**

…

(b) The *allowed rate of return* for a *Distribution Network Service Provider* ~~must correspond to~~ is to be commensurate with the benchmark efficient financing costs of an ~~benchmark efficient~~ entity ~~with~~ facing a similar degree of risk as that which applies ~~to the~~ ~~*Distribution Network Service Provider*~~ in respect of the provision of *standard control services* (the *allowed rate of return objective*).

**Amendment to clause 6.5.2 (c)(2)**

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(2) on a nominal ~~post-tax~~ vanilla basis that is consistent with the estimate of the value of imputation credits referred to in clause 6.5.3; and

**Amendment to clause 6.5.2 (d)**

…

(d) In determining the *allowed rate of return*, regard must be had to~~:~~

~~(1) the desirability of using an approach that leads to the consistent application of any estimates of financial parameters that are relevant to the estimates of, and that are common to, the return on equity and the return on debt; and~~

~~(2)~~ any interrelationships between estimates of financial parameters that are relevant to the estimates of the return on equity and the return on debt.

## 4.2 Removal of 'persuasive evidence test'

**AEMC position**

In assessing the current Chapter 6 rate of return framework the AEMC considered whether to retain the existing requirement for the need for persuasive evidence before changing a parameter value, method or credit rating. The AEMC characterised this assessment as a trade-off between the need for flexibility and the desire for certainty in the framework.

The draft rule determination omits the requirement for persuasive evidence, or any other form of words that provide certainty, on the basis that:[2]

> *it considers that achieving an estimate of the rate of return that best reflects the benchmark efficient financing costs is the overriding consideration for a rate of return framework in terms of achieving the NEO, the NGO and the RPP.*

**ENA response**

Certainty around the future framework for determining the rate of return is critical to promoting efficient investment by energy network businesses. Electricity and gas network owners have collectively invested over $65 billion in regulated energy infrastructure. Furthermore, these investments have a typical economic life of four to five of decades. To attract the necessary capital to finance these long lived assets it is necessary for the rules to deliver both: an appropriate rate of return today and over the life of the assets.

Whilst it is important that there be flexibility to allow the approach to the rate of return to develop over time, it is also important that there be a clear process around this. Most importantly, development of the approach to the rate of return must be based on clear reasoning and robust evidence, and undertaken in an open and transparent manner that is understood by all stakeholders.

The ENA supports the setting of an estimate of rate of return that best furthers the NEO, the NGO and the RRP. However, the ENA has some concerns with the integrity of the process in the draft rule determination for setting the rate of return in the future. The ENA's primary concern is that the draft rule does not strike an appropriate balance between providing flexibility in the rate of return model on the one hand and ensuring that decisions are transparent and evidence-based on the other.

As a matter of principle all material decisions made by the regulator under the rules should establish a process that can be understood by all interested parties and where conclusions are reached on the basis of sound theoretical arguments and supported by verifiable market evidence.

The need for a clear process is of particular importance in the context of the rate of return, where there is range of evidence and models available. As the AEMC has acknowledged in its draft rule determination:[3]

> … *all these financial models are based on certain theoretical assumptions and no one model can be said to provide the right answer.*

In this context, it is important that decisions on the rate of return clearly set out which models and evidence are being relied on, and how they are being used to derive both the return on equity and the return on debt components. Such transparency is critical to promoting confidence in the regulatory regime and providing for investment certainty.

The ENA believes that the materiality of the rate of return element and the importance of transparency in rate of return decisions reinforces the need for a strengthening of the process set out in the draft rule determination, specifically:

- a requirement that any party proposing to depart from the guidelines must state its *reasons and evidence* for the departure; and

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2 AEMC, Draft Determination, p.51
3 AEMC, Draft Determination, p.48

- where a new guideline is not in accordance with the existing guideline the AER must provide its reasons and evidence for the departure.

The requirement for parties to provide *reasons and evidence* for departing from the rate of return guideline appears to be an intention of the draft rule determination that is not fully reflected in the drafting of the proposed rule change. Furthermore, there should be a clear requirement for the AER to provide any data that has been relied on in a rate of return decision.[4]

In addition, the proposed rule change does not require the AER in developing the rate of return guidelines to provide its reasons and evidence for departing from the approach specified in the previous guideline. Given the intention for the guidelines to be developed in an open and transparent manner the ENA supports a requirement on the AER to explain why the rate of return approach has changed. This requirement should also be extended to the first guideline so that the AER is required to explain changes in the rate of return from the 2009 Statement of Regulatory Intent (SORI), to the extent that there are matters which are dealt with in both the SORI and the first guideline.

These requirements ensure that the process under which the WACC evolves over time has integrity and decisions that have the potential to be controversial are effectively communicated to interested parties and the wider community.

**Proposed way forward**

The ENA believes that in addition to providing a framework for setting a rate of return today, the rules also have a critical role in establishing a process for the evolution of the rate of return over time. Central to this process is the principle that material regulatory decisions should be accompanied by the reasons for the decision and the requirement to communicate any evidence relied on by the decision maker in a transparent and accountable manner.

The ENA proposes that rate of return guidelines be modified so that:

- a regulatory decision must be consistent with the rate of return guidelines unless there are reasons and evidence in support of a departure; and

- the AER is required to provide reasons and evidence supporting:

    - for the first rate of return guideline, any change in approach from the SORI to the extent that there are matters which are dealt with in both the SORI and the first guideline; and

    - in any subsequent rate of return guideline, any change in approach from the previous rate of return guideline.

**Proposed drafting amendments to Chapter 6**

Refer to proposed drafted amendments set out in section 4.3 below, specifically proposed new paragraphs (n)-(p) and (r)-(s) of clause 6.5.2.

4 We note that the consultation procedures in Chapter 6 and Chapter 6A, only require the AER to provide reasons for departing from a guideline. The ENA believes that it is unclear whether the AER is obliged to provide all data relied on in making its rate of return decision, to remove any doubt the requirement to provide both reasons and evidence should be express requirement in the rules.

## 4.3 Rate of return guidelines

**AEMC position**

The AER is required to publish non-binding rate of return guidelines that set out:

- the methodologies that the AER proposes to use in estimating the allowed return on equity and debt; and
- the estimation methods, financial models, market data and other evidence the AER proposes to take into account in estimating the return on equity, the return on debt and the value of imputation credits.

The proposed rule is intentionally drafted by the AEMC to provide the regulator with a fair degree of discretion on the precise contents of these guidelines, but:[5]

> *The Commission anticipates that the guidelines would allow a service provider or other stakeholder to make a reasonably good estimate of the rate of return that would be determined by the regulator if the guidelines were applied.*

With the exception of the first guideline it should be made according to the distribution consultation procedure and must reviewed at intervals not exceeding three years.

**ENA response**

The stated purpose of the guidelines is to:

- allow a more focused discussion on wider issues around estimating the rate of return; and
- to provide a focal point for engaging all stakeholders on rate of return issues without having to commit the resources that would be required to participate at each and every electricity determination or gas access arrangement decision.

The ENA believes there is a material risk that the rules as currently drafted will not deliver an effective forum for stakeholders to effectively engage on cost of capital matters. Our concern is that without a requirement for the AER to produce indicative values for the key elements of the rate of return it may be impossible for stakeholders to make a reasonable estimate of the rate of return that would be determined by the regulator if the guidelines were to apply. That is, the policy objective set by the AEMC and outlined above would not be met in practice.

This issue is illustrated if the guidelines specify that the AER will have regard to a number of financial models to estimate the return on equity. In April 2009, NERA provided an expert report to the Energy Regulatory Authority of Western Australia (ERA) on behalf of Westnet.[6] In that report NERA specified four different financial models, i.e.:

- the Sharpe-Lintner CAPM;
- the Black CAPM;
- the Fama- French model; and
- a zero beta form of the Fama-French model

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5 AEMC, Draft Determination, p.60

6 NERA, *Estimates of the Cost of Equity: A report for WAGN*, 22 April 2009.

Furthermore, NERA specified two data sources for each model, that is, a domestic data source and an international data source.

Drawing on this material, NERA provided eight separate estimates of the prevailing cost of equity, ranging from 6.74% to 12.13%. A rate of return guideline that produces a similar range of cost of equity estimates would not provide any useful information to stakeholders of the AER's current thinking on the cost of equity.

Missing from the draft rules is a requirement for the AER to articulate how these different financial models and data sets would be assessed in its decision on the prevailing cost of equity. Without specifying actual values (and/or methodologies that can be applied to derive a value) of constituent components of rates of return it is not possible for stakeholders to engage on substantive rate of return issues. The ENA supports the AEMC's intent for the rate of return guidelines to allow stakeholders to make a reasonably good estimate of the rate of return. However, without a requirement on the AER to explain how relevant methodologies and data will be assessed to reach a final rate or return this objective will likely be frustrated.

The ENA also believes that 30 business days is insufficient timeframe for stakeholders to effectively engage with any substantive issue that arises from either the consultation paper or draft decision. Our experience with the 2009 statement of regulator intent was that the consultation periods were insufficient to engage in all issues raised by the AER. For example, in the 2009 issues paper raised important questions on how benchmark debt and equity raising costs should be calculated. However, these issues were never considered by the industry or the regulator as the compressed timeframe meant that other issues were given higher priority.

Furthermore, the new rate of return framework means that the guidelines will need to consider substantially more issues which strongly suggests that an expanded timeframe is required. The ENA proposes that stakeholders be given at least 60 business days to respond to both consultation paper and the draft decision.

One issue which the Commission may wish to clarify in relation to the Rate of Return Guideline is that there is no intention of the requirements of proposed Clause 6.5.2 (e) being capable of an interpretation which unnecessarily restricts the use of cost of equity estimation approaches or models which rely in part on historical evidence surrounding required or realised equity returns. This issue could perhaps be best addressed by way of clarification in the Commission's reasoning on Clause 6.5.2 in its final determination, rather than being a matter on which specific amendments are sought.

Our final comment on guidelines is to question whether the requirement for three yearly reviews of the rate of return guidelines is appropriate. Our concern is that a three yearly cycle means that the AER and stakeholders will be in near constant WACC reviews. While we accept that a five year cycle may be too long, especially in light of the global financial crisis, we believe that a four year cycle would be a reasonable compromise.

**Proposed way forward**

The ENA supports the AEMC's intention for the guidelines to be an effective forum that allows all stakeholders engage on the substantive issues associated with the regulated rate of return. However, the ENA strongly believes that this objective will be frustrated if the AER is not required to articulate how various financial models and data sets would be assessed in its decision on the return on equity and the return on debt. The only effective method for ensuring that this objective will be achieved is if the rules require the AER to ensure that the guidelines provide estimates of key constituent components.

The ENA proposes that rate of return guidelines be modified so that::

- the guidance in clause 6.5.2 (k) (and equivalents) includes a requirement for the AER to provide an estimate of the:

  - gearing level
  - return on equity
  - return on debt
  - value of gamma.

The ENA also believes that the time allotted for stakeholders to respond in the guideline process is insufficient for effective engagement on all likely rate of return issues. Therefore, the ENA proposes that:

- clause 6.5.2 (l)-(m) be expanded to set out a bespoke Rate of Return Guideline procedure featuring, for example, 60 days for a response, better defined time periods between key stages, and potentially an extra step of a 'preliminary views' paper; and

- extend the minimum requirement for review to 4 years.

The ENA also notes that the previous section it proposes that the Rate of Return guidelines need to require the AER to provide its reasons and evidence for its departure from previous rate of return approaches.

**Proposed drafted amendments to Chapter 6**

**Amendments to paragraphs (j) – (o) of clause 6.5.2 (note these paragraphs have been renumbered due to insertion of new paragraphs).**

(m) The *AER* must, in accordance with ~~the *distribution consultation procedures*~~ this clause 6.5.2 make and publish guidelines (the *Rate of Return Guidelines*)~~, except that the first *Rate of Return Guidelines* must be made in accordance with paragraph (m) and not the *distribution consultation procedures*~~.

(n) Subject to paragraph (o), a *Rate of Return Guideline* only applies to distribution determinations in respect of which the *framework and approach paper* was published after publication of the *Rate of Return Guideline*.

(o) A *Rate of Return Guideline* may only apply to a distribution determination in respect of which the *framework and approach paper* was published prior to publication of the *Rate of Return Guideline* if the *Distribution Network Service Provider* to which the distribution determination will apply consents to such application.

(p) A distribution determination to which a *Rate of Return Guideline* applies must be consistent with the *Rate of Return Guideline* unless there are reasons and evidence in support of a departure from the *Rate of Return Guideline*.

(q) The *Rate of Return Guidelines* must set out:

~~(1) the methodologies that the AER proposes to use in estimating the allowed rate of return, including how those methodologies are proposed to result in the determination of a return on equity and a return on debt in a way that is consistent the allowed rate of return objective; and~~

~~(2) the estimation methods, financial models, market data and other evidence the AER proposes to take into account in estimating the return on equity, the return on debt and the value of imputation credits referred to in clause 6.5.3.~~

(1) in relation to the return on equity:

(i) the financial models which the *AER* proposes to use in determining the return on equity;

(ii) for each parameter in the applicable financial models, either a value which the *AER* proposes to use or the information and data sources which it proposes to use to derive such a value;

(iii) the way in which the *AER* proposes to use the financial models, information and data sources to derive a value for the return on equity; and

(iv) an estimate of the return on equity which would apply as at the date of publication of the *Rate of Return Guidelines*, based on the *AER's* ~~proposed~~ use of the financial models, information and data sources;

(2) in relation to the return on debt:

(i) the form of debt finance which will be used to determine benchmark efficient debt financing costs of an entity with a similar nature and degree of risk as that which applies to a *Distribution Network Service Provider* in respect of the provision of *standard control services*;

(ii) the information and data sources which the *AER* proposes to use to determine the return on debt applicable to the relevant form of debt finance as at any point in time; and

(iii) an estimate of the return on debt which would apply as at the date of publication of the *Rate of Return Guidelines*, based on the *AER's* proposed form of debt finance and proposed information and data sources;

(3) the relative proportions of equity and debt finance that would be employed by an efficiently financed 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 (as referred to in clause 6.5.2(c)(1); and

(4) the value of imputation credits referred to in clause 6.5.3.

(r) A Rate *of Return Guideline* must be accompanied by a statement of reasons setting out:

(1) the evidence relied upon by the AER in formulating the guideline; and

(2) reasons and evidence supporting:

(i) for the first *Rate of Return Guideline*, any change in approach from the Statement of Regulatory Intent, in respect of any of the matters referred to in clause 6.5.2(p) which are addressed in the Statement of Regulatory Intent;

(ii) for any subsequent *Rate of Return Guideline*, any change in approach from the previous *Rate of Return Guideline*, in respect of any of the matters referred to in clause 6.5.2(p).

(s) For the purposes of paragraph (r), Statement of Regulatory Intent means the '*Statement* of regulatory intent on the revised WACC parameters (distribution)' issued by the *AER* on 1 May 2009, pursuant to clause 6.5.4 of the *Rules*.

(t) The AER must publish the first *Rate of Return Guideline* by [29 ~~August~~ December 2013] and there *must* be *Rate of Return Guideline* in force at all times after that date.

(u) For the purpose of *making* the first *Rate of Return Guideline*, the *AER* must:

(1) by no later than [29 March 2013], publish a consultation paper that sets out its preliminary views on the material issues that are to be addressed by the Rate *of* Return *Guidelines*;

(2) publish an invitation for written submissions on the consultation paper, with such submissions to be made within the time specified in the invitation (which must not be earlier than ~~30~~ 60 business days after the invitation for submissions is published);

(3) by no later than ~~31 July~~ 15 August 2013, publish a draft of the *Rate of Return Guidelines*; and

(4) publish an invitation for written submissions on the draft *Rate of Return Guidelines*, with such submissions to be made within the time specified in the invitation (which must not be earlier than ~~30~~ 60 business days after the invitation for submissions is published).

(v) The *AER* must~~, in accordance with the *distribution consultation procedures*,~~ review the *Rate of Return Guidelines*:

(1) at intervals not exceeding ~~three~~ four years, with the first interval starting from the date referred to in paragraph (t~~l~~); and

(2) at the same time as it reviews the Rate of Return Guidelines made under clause 6A.6.2.

(w) A *review* of the *Rate of Return Guidelines* under paragraph (v) must be conducted in accordance with the *distribution consultation procedures*, subject to:

(1) the reference in clause 6.16(c) to 30 *business days* being read as a reference to 60 *business days*; and

(2) the reference in clause 6.16(e) to 80 *business days* being read as a reference to 180 *business days*.

(x) For the avoidance of doubt, nothing prevents the *AER* from publishing the *Rate of Return Guidelines* made *under* this clause 6.5.2 in the same document as the *Rate of Return Guidelines* made under clause 6A.6.2.

## 4.4 AER determination of substitute allowed rate of return

### AEMC position

In the draft rule determination the AEMC states that in order for the draft rule on the rate of return framework to work as intended under the Rules, the AER should not be limited to assessing a rate of return proposal on the basis of what the NSP proposes, with any departure from that proposal being the minimum necessary for the rate of return to comply with the requirements in the Rules.[7]

The AEMC therefore proposes to amend clause 6.12.3(f) in Chapter 6 so that it no longer applies to the AER's decision on the allowed rate of return under the new framework and proposes to make a similar amendment to Chapter 6A in clause 6A.14.3(b).[8]

### ENA response

The ENA strongly disagrees that any amendments to clauses 6.12.3(f) and 6A.14.3(b) are required in order to enable the AEMC's proposed rate of return framework to operate as the AEMC intends.

Clause 6A.13.2 provides that if the AER's final decision is to refuse to approve an amount of value referred to in clause 6.14.1(1) (which sets out the contents of a final decision), the AER must include in its final decision a substitute amount of value which is: (a) determined on the basis of the current revenue proposal; and (b) amended from that basis only to the extent necessary to enable it to be approved in accordance with the Rules. However, this clause is expressed not to operate in respect of the AER's decision to refuse the total of the forecasting operating or capital expenditure in a revenue proposal. A similar clause is found in Chapter 6 (6.12.3(f)) which the AEMC also proposes to amend so that it does not apply to the allowed rate of return.

The ENA submits that the carve out in clause 6A.13.2 was designed to place an incentive on NSPs to put forward in their proposals forecast operating and capital expenditure amounts that the NSP considered were reasonable and which were consistent with the requirements of the Rules. In the drafting of Chapter 6A, the AEMC noted the very significant task of determining forecast operating and capital expenditure for a large and complex business such as a TNSP over a five year period.[9] The AEMC noted that the resolution of these forecast amounts requires the exercise of judgement about the level of further demand, the likely scale and timing of various market developments and about the likely variation of costs of inputs in that period.[10]

The AEMC then noted that the decision making process and the criteria in the Rules would provide the AER with sufficient powers and safeguards to be able to achieve regulatory outcomes that are not overly distorted by strategic behaviour on the part of TNSPs putting in "ambit proposals" with a view to getting the AER to reveal what the AER considers to be reasonable, as opposed to the TNSP first revealing what it considers to be reasonable.[11]

The AEMC draft decision noted:

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[7] AEMC, Draft Determination, p.61

[8] AEMC, Draft Determination, p.61.

[9] AEMC, *Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 – Draft Rule Determination*, 26 July 2006, p 52.

[10] AEMC, *Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 – Draft Rule Determination*, 26 July 2006, p 52.

[11] AEMC, *Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 – Draft Rule Determination*, 26 July 2006, p 52.

> *In particular, the AER's capacity to deal with exaggerated proposals will be strengthened by the requirement for TNSPs to make a complete proposal…including information and evidence consistent with the assessment criteria in support of their expenditure forecasts. The Commission also considers that the decision making process to be followed by the AER in assessing the expenditure forecasts is more likely to provide an incentive to submit well documented and supported expenditure forecasts rather than to submit forecasts that are grossly exaggerated.*[12]

The ENA submits that the carve-out of forecast operating and capital expenditure amounts from clause 6A.13.2 was designed to avoid "ambit claims". As noted in the legal advice procured by the AEMC when drafting Chapter 6A:

> *We should observe that in practice TNSPs may be likely to pitch their estimates above their own 'best estimates' of what they require, but will be constrained in doing so by a desire to avoid the outcome that their estimate is rejected, and the regulator's own estimate substituted. If the TNSP's estimate is rejected as not reasonable, it might be expected that the amount the regulator will determine for itself will fall significantly below the top of the reasonable range, and perhaps below the median of that range. That is an outcome that rational TNSPs may try to avoid, and the facility for a regulator-determined amount in substitution for the TNSP estimate may moderate any tendency toward ambit claims.*[13]

Developing and assessing an estimate of the allowed rate of return and forecasts of operating and capital expenditure are fundamentally different exercises.

In the case of the allowed rate of return, the NSP, the AER and stakeholders all have access to the full suite of information that may be used to estimate the allowed rate of return, these parties may just take different views as to, for example, the methodology to be adopted or the inputs to be used. The exercise is a relatively discrete one in the sense that the inquiry generally relates to a relatively small number of inputs and parameters, and that although data inputs may be extensive, the issues generally arise in relation to the approach taken to overall methodological issues.

In the case of forecasts of operating and capital expenditure, the NSP, the AER and stakeholders may not have access to the full suite of information that could be used to generate these forecasts, including because of the sheer volume of business records and information that underpin a forecast. The exercise of assessing the forecasts cannot be considered discrete or contained, regardless of the assessment techniques that the AER may adopt to assess the forecasts.

The ENA submits that the nature of the motivations behind the Commission's drafting of the carve out of operating and capital expenditure forecasts from clause 6A.13.2(a) do not apply to the assessment and ultimate determination of the allowed rate of return. There is no need to create any further incentive under clause 6A.13.2(a) to discourage strategic behaviour in respect of the allowed rate of return aspect of a regulatory proposal, that incentive already exists as there is nothing to be gained from putting an "ambit" allowed rate of return value in a regulatory proposal.

The ENA further submits that the AEMC's proposed amendments are not necessary to enable the AEMC's proposed rate of return framework to have effect. Requiring the AER to determine any substitute value for the rate of return on the basis of the current revenue proposal and amended from that basis only to the extent necessary to enable it to be approved in accordance with the Rules would, on the basis of how the provision in Chapter 6 has been interpreted, allow the AER to use an alternative methodology to that put forward by the NSP *where that is necessary* to enable the allowed rate of return to be approved.

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[12] AEMC, *Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 – Draft Rule Determination*, 26 July 2006, p 52.

[13] N Williams SC and R Higgins, *Memorandum of Advice: In the Matter of the Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, 24 October 2006, [67].

The Australian Competition Tribunal has considered the meaning of clause 6.12.3(f) and has determined that the clause requires the AER to consider what amendments to the proposal may be made in order for the relevant value or amount to be approved. In circumstances where a change in methodology is required to enable the value or amount to be approved in accordance with the Rules, the Tribunal has held that it is open to the AER to use a different methodology. The Tribunal decision states:

> *EA submits that the AER is not permitted to reject EA's entire methodological approach and adopt some other approach. That is, the AER is only permitted to amend EA's methodology, not depart from it. To do otherwise, it is submitted, is not to approve an amount, value or methodology based on EA's regulatory proposal amended only to the extent necessary to enable it to be approved in accordance with the Transitional Rules as required by cl 6.12.3(f)(2).*
>
> *In this circumstance, the approach taken by the AER was in accordance with the Transitional Rules.*
>
> *The primary discretion given to the AER by cl 6.12.3(a) is to refuse to accept or approve any element of a regulatory proposal. The AER's power to substitute an amount or value or methodology exists so that it may properly perform its obligation under cl 6.12.1(4)(ii) to set an estimate of the total opex that the AER is satisfied reasonably reflects the opex criteria.*
>
> *Once the basis of EA's approach to the assessment of maintenance costs is rejected as above, then the approach undertaken by the AER is an appropriate way to proceed. No other 'amendment' to the 'extent necessary' to be approved in accordance with the Transitional Rules is appropriate or possible in keeping with the primary purpose of the Transitional Rules.*[14]

It is both appropriate and important that clauses 6.12.3(f) and 6A.13.2(a) of the Rules continue to apply to the determination of the allowed rate of return. NSPs should have certainty that:

- where they put forward a proposal that is reasonably close to being accepted by the AER as being consistent with the requirements of the Rules and the Law,

- but where the AER, perhaps in respect of some minor matter does not accept the allowed rate of return set out in their proposals,

that wholesale amendments that may have little or no relationship to the proposal of the NSP are not permitted. Carving out the allowed rate of return from clauses 6.12.3(f) and 6A.13.2(a) has the potential to give rise to significant uncertainty. This is particularly important if the AEMC proceeds to make such fundamental changes to the Rules, particularly the Rules relating to the rate of return. In circumstances where such significant changes are being made it is important to maintain and potentially strengthen existing protections in the Rules.

[14] *Application by EnergyAustralia and Others* [2009] ACompT 8, [253] – [256].

# 5. Return on debt estimation

## 5.1 Return on debt guidance

### AEMC position

The AEMC's proposed rule changes substitute the relatively structured approach to the return of debt element of the existing NER (a structure that, voluntarily, was also adopted by the AER for gas determinations) with a broad discretion permitting the development of one or a number of potential methodological approaches to the return on debt element of the regulatory rate of return, as set out in NER Clause 6.5.2 (f).

### ENA response

***Return on debt factors***

Given the broad discretion under the draft rule to develop an alternative return on debt methodology, it is critical that there are appropriate principles guiding this discretion.

The factors to which the AER should have regard [clause 6.5.2(h)] in determining the "methodology" referred to clause 6.5.2(f) do not provide adequate guidance to the AER and are unlikely to be consistent with the NEO, NGO or RPP. Our primary concerns with the factors fall into two broad categories:

- as drafted the factors are ambiguous and the AEMC's stated intention in the draft rule determination does not appear to have been carried across to the proposed rules; and
- to the extent that we have been able to interpret the factors they appear to be conflicting and do not provide any guidance on how these conflicts should be resolved.

By way of example, conflict appears to arise between:

- factor (1), being the likelihood of *significant differences* between the costs of servicing debt of a benchmark efficient entity and the return on debt over the regulatory control period, which appears to give emphasis to the adoption of a trailing average approach; whereas
- factor (3), being the incentive effects for capital expenditure, which appears to emphasise that the return on debt should reflect its current opportunity cost or spot rate.

However, the clause provides no basis for reconciling or prioritising these factors and so provides inadequate guidance to the AER on how the return on debt methodology should be developed.

The ENA also notes a number of further issues with the factors including:

- factor (2), requiring the AER to have regard to the impact on electricity consumers, appears to duplicate the NEO/NGO and so does not provide any further guidance to the AER and, to the extent that factor (2) is different from the NEO/NGO it appears to give undue emphasis to the narrow, short term interests of consumers in determining whether a trailing or spot rate approach is appropriate, without any recognition of the circumstances of the NSP and the implication of those circumstances for which return on debt methodology is best; and

- factor (4), requiring the AER to have regard to the impact of changing from one approach to the other, does not pose this consideration in a manner that sets up a presumption against unnecessary change and the uncertainty for investors that this is likely to cause.

A further issue with the cost of debt methodology and the factors contained in the proposed rules is the absence of any measures to ensure that businesses are afforded with a reasonable opportunity to recover benchmark debt costs in the long term. The possibility that the cost of debt methodology may change over time means that while each methodology meets this requirement, switching between approaches could result in an over (or under) recovery of these costs over the average life of the network asset, which typically extends to 40 to 50 years. The ENA believes that the factors should reflect this requirement to ensure that the return on debt methodology is consistent with the NEO, the NGO and the RPP.

The factors also do not require the AER to have regard to the legitimate business interests of network firms both around transition to these new arrangements, and changes in methodology once the rules are in normal operation (i.e. between regulatory periods using different approaches).

This is of critical importance because some potential cost of debt estimation processes, such as the historical trailing average approach, have the potential to effectively retrospectively penalise businesses that have undertaken prudent and efficient debt financing approaches (for example, hedging or reliance on floating rate instruments) which are not adequately recognised in any measurement methodologies adopted for a future reviews, or changes between different cost of debt estimation approaches.

The application of such a methodology without transition arrangements to avoid any financial penalties associated with this, or the specific allowance for such costs to the network business to be recognised and accounted for in future revenue requirements, has the potential to represent a retrospective 'stranding' of efficiently incurred costs, and a net increase in regulatory risk. It is understood that Commission's draft clauses providing for 'hybrid' approaches to be adopted is designed to facilitate transitions which do not have the effect of stranding past debt costs in this way. Given the critical and potentially retrospective application of the discretion proposed to be granted, however, the ENA considers clearer rules-based guidance to avoid these outcomes is essential.

The principles to which regard must be had need to be clear and to include at least the following methodological principles:

- that the return on debt should allow for recovery of the benchmark expected cost of debt financing over the life of the assets used to supply the relevant services; and

- that the methodology adopted to estimate the return on debt should reflect the efficient financing costs of a prudent operator in the circumstances of the service provider.

Since changes in the return on debt methodology have the potential to create windfall gains or losses, the first principle would require the AER to have regard to the long term consequences of the new methodology. A return on debt methodology that does result in an expected windfall gain or loss to the network service provider would therefore need to be phased in on a prospective basis.

The second principle ensures that in assessing the return on debt methodology the AER is to have regard to the circumstances of the network service provider. The SFG Consulting expert report on the cost of debt highlighted that a particular return on debt methodology may have substantially different impacts to the variability of equity returns depending on the network service provider's actual financing practices. For example, a trailing average total cost of debt methodology is more likely to suit those businesses that periodically issue fixed rate debt.

However, this approach would be sub-optimal for those network service providers that issue floating rate debt or networks that are owned by an entity that has a portfolio of networks. In other words, a "one size fits all" approach to the return on debt methodology is unlikely to further the NEO/NGO.

Only a return on debt methodology that complements the current and future financing practices of the particular network service provider is likely to deliver the benefits envisaged by this draft rule. For this reason the ENA believes that the appropriate role for the AER is to assess the return on debt methodologies proposed by the network service provider, rather than for the appropriate methodology to be determined unilaterally by the AER and imposed on each and every network service provider (as the proposed draft appears to allow).

***Framework for determining the return on debt***

The regulatory approach to determining the return on debt is a fundamental and highly significant aspect of the rate of return provisions. It has the potential to directly affect the long-term financing choices made by network firms, and their incentives and ability to make efficient investment decisions.

Given the very significant changes being proposed to the return on debt methodology, and the potential for large impacts on businesses and consumers as a result, care should be taken in introducing such changes. In this respect, it is important that the existing methodology remain as a default position, particularly if businesses and the AER cannot agree to an appropriate alternative.

The nature and extent of the discourse over the period since the current rule change process began has highlighted that network service providers adopt a variety of different financing debt practices. These differences are each explicable by reference to:

- firm size, relative to Australian corporate debt markets;
- the extent of ownership of both similar as well as other assets; and
- ownership interests more generally.

The AEMC proposes a major shift in approach, both in terms of the process that is to be followed and the considerations that are to apply. By way of illustration, under the existing NERs, the AER is required to distinguish two elements of the decision-making process for determining the return on debt, ie:

- the establishment of a benchmark gearing, credit rating and new issue maturity for debt costs; and
- the basis on which market evidence as to the debt risk premium (net of the risk free rate) for the specified credit rating and maturity will be gathered.

The AEMC's response to the wide ranging and complex considerations arising for the return on debt – including whether the benchmark and its associated market evidence should be applied on an opportunity cost or an historic, embedded cost basis – has been to eschew distinguishing any of these issues. Rather, the proposed rule simply provides for the AER to determine any of the relevant matters by reference to a new, guiding allowed rate of return objective in combination with four factors listed at NER 6.5.2(h).

The ENA believes it appropriate for the AEMC to adopt a more permissive rule so that the approach to the return on debt can be adapted to fit the circumstances of particular network service providers. Notwithstanding this position, the proposed draft rule needs significant reform in order to ensure the legitimate business interests of the regulated network service providers are adequately protected - specifically by not permitting decisions that may deliver short term price decreases at the expense of undermining financing decisions that are efficient and prudent in the long term.

Recognising this, it is appropriate to clarify that the question of:

- the establishment of a benchmark gearing, credit rating and new issue maturity for debt costs; and

- the basis on which market evidence as to the debt risk premium (net of the risk free rate) for the specified credit rating and maturity will be gathered

are elements of the return on debt that will be addressed in the AER's Rate of Return Guidelines, rather than forming part of the return on debt methodology.

Consistent with this, it should be clarified that the 'methodology' component referred to in clause 6.5.2(f) refers only to the question of whether the return on debt component should be applied:

- on an opportunity cost (or spot rate) basis or on a trailing average basis and

- at the start of the regulatory control period or updated annually throughout the regulatory control period.

It is important that these various elements of the return on debt estimation process be distinguished in the NER and NGR. In particular, it is critical that the 'methodology' aspect be identified as an area in which the service provider's proposal must be the starting point. The reason for this is that the methodology aspect is highly business-specific, and it is the business that will have the greatest knowledge of it circumstances and embedded financing practices. As in the case of expenditure forecasts, the business will be best placed to determine what methodology will provide for a return on debt which meets the relevant objectives, given its specific circumstances.

As noted above, it is important that the existing methodology remain as a default where the AER does not accept the methodology being proposed by the business. This approach avoids potentially serious consequences associated with a change in methodology which is not agreed between the business and the AER. Given the:

- significant expansion to the methodologies that may be adopted for measuring the return on debt under the proposed Rule;

- the significance to businesses of the return on debt component to the overall revenue requirement; and

- the possibility that a change in methodology could fundamentally affect whether debt financing costs are recovered over the life of assets,

the minimum safeguard required to protect the legitimate business interests of NSPs should be that, if the AER does not accept that the methodology put forward by the NSP is consistent with the requirements of the NER and the NEL, the default is that the methodology that applied in the previous regulatory period continues to apply. In other words, the AER should not be able to force a change to a different methodology. In light of the highly uncertain nature of differing methodologies and guidance in the Rules on how one may transition from one methodology to another, at least as an interim solution, the existing methodology must be the default if the AER does not accept the methodology in the NSPs regulatory proposal.

The other elements of the return on debt estimation process are matters which are not business-specific and should therefore be clearly set out in the rate of return guidelines. These other elements include identification of the benchmark gearing, credit rating and new issue maturity for debt costs and the basis on which market evidence will be used to derive an estimate of the return on debt at any particular point in time.

In ENA's view, the operation of future cost of debt approaches should lead to the AER reaching view on the cost of debt that are informed a range of information sources – including evidence on the actual cost of debt in the preceding regulatory period. The AER should, as a result of any estimation principles adopted, be required to review the cost of debt in the light of the market reality of a network having to source funds in the manner implicit in any estimate. As an example, an approach which assumed that the debt portfolio of a set of large number of distributors could be refinanced over a short period should be required to take into account liquidity restrictions present in some debt capital markets. A regulatory estimate of the cost of debt which failed to account of such 'real world' market realities would not be consistent with the NEO, NGO or revenue and pricing principles.

**Proposed way forward**

The ENA has a number of concerns with the draft rules in relation to the return on debt methodology, specifically:

- the factors do not provide sufficient guidance to the AER on how to exercise its discretion in developing the return to debt methodology, furthermore some of the factors are unlikely to be consistent with the NEO/NGO or RPP; and
- the wide discretion provided to the AER to establish the return on debt methodology that needs to complement the business-specific financing arrangements of the network service provider.

To address these concerns the ENA proposes that:

- the AER be required to address elements of the return on debt estimation process that are not business-specific in its guidelines (specifically the identification of the form of debt used to determine benchmark efficient debt financing costs and the basis on which market evidence will be used to derive an estimate of the return on debt at any particular point in time);
- that businesses be required to propose a return on debt methodology that is consistent with the allowed rate of return objective and the return on debt methodology principles;
- that the AER must accept the methodology if it is satisfied that the proposed methodology is consistent with the allowed rate of return objective and the return on debt methodology principles;
- if the AER is not satisfied the methodology for estimating the return on debt must be the same as the methodology that applied in the immediately preceding regulatory control period; and
- delete the current cost of debt methodology factors and replace with the following return on debt methodology principles:
    - that the return on debt should allow for recovery by a *Distribution Network Service Provider* of the expected cost of debt financing over the life of the assets used to supply *standard control services* (including to the extent that the life of these assets may extend over more than one regulatory control period); and

- o that the methodology adopted to estimate the return on debt should reflect the efficient financing costs of a prudent operator in the circumstances of the *Distribution Network Service Provider*.

**Proposed drafted amendments to Chapter 6**

**Amendments to paragraphs (f) – (l) of clause 6.5.2 (note some of these paragraphs have been renumbered due to insertion of new paragraphs).**

(f) 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 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 (l~~i~~).

(g) A *building block proposal* must include a methodology for estimating the return on debt which the *Distribution Network Service Provider* considers is consistent with the *allowed rate of return objective* and the *return on debt methodology principles*.

(h) The *AER* must accept the methodology for estimating the return on debt that included in a *building block proposal* if the *AER* is satisfied that the proposed methodology is consistent with the *allowed rate of return objective* and the *return on debt methodology principles*.

(i) If the *AER* is not satisfied as referred to in paragraph (h), the methodology for estimating the return on debt must be the same as the methodology that applied to the *Distribution Network Service Provider* in the immediately preceding *regulatory control period*.

(j) Subject to paragraph (f), the methodology adopted to estimate the return on debt may, without limitation, be designed to result in the return on debt reflecting:

(1) the return that would be required by debt investors in a benchmark efficient entity if it raised debt at the time or shortly before the making of the distribution determination for the *regulatory control period*;

(2) the average return that would have been required by debt investors in a benchmark efficient entity if it raised debt over an historical period prior to the time when the distribution determination for that *regulatory control period* is made; or

(3) some combination of the returns referred to in subparagraphs (1) and (2).

(k) In determining whether the methodology adopted to estimate the return on debt for a *regulatory year* is ~~estimated in a way that is~~ consistent with the *allowed rate of return objective*, regard must be had to the following ~~factors~~ principles (the *return on debt* methodology *principles*):

~~(1) the likelihood of any significant differences between the costs of servicing debt of a benchmark efficient entity referred to in subparagraph (c)(1) and the return on debt over the regulatory control period;~~

~~(2) the impact on electricity consumers, including due to any impact on the return on equity of a benchmark efficient entity referred to in subparagraph (c)(1);~~

~~(3) the incentive effects of inefficiently delaying or bringing forward capital expenditure; and~~

~~(4) the impact of changing the methodology for estimating the return on debt across regulatory control periods.~~

(1) that the return on debt should allow for recovery by a *Distribution Network Service Provider* of the expected cost of debt financing over the life of the assets used to supply *standard control services* (including to the extent that the life of these assets may extend over more than one *regulatory control period*); and

(2) that the methodology adopted to estimate the return on debt should reflect the efficient financing costs of a prudent operator in the circumstances of the *Distribution Network Service Provider*.

(l) A methodology referred to in paragraph (f)(2)(ii) must provide for any change in ~~the Distribution Network Service Provider's annual revenue requirement for the regulatory year that would result from a change to the allowed rate of return for that regulatory year, as a result of~~ the return on debt ~~for that~~ as between different *regulatory years* within the same *regulatory control period* ~~being different from that estimated under subparagraph (f),~~ to be effected through the automatic application of a formula that is specified in the distribution determination.

# 6. Capital and operating expenditure forecasting

## 6.1 Standardised AER forecasting methodology

### AEMC position

The Draft Rules contain three key revisions relating to the forecasting methodologies used by NSPs to develop the capital and operating expenditure forecasts included in their regulatory proposals:

- A requirement on the AER to develop and publish a 'standard expenditure forecasting methodology' for both opex and capex forecasts.[15]
- A requirement on the AER to specify a particular forecasting methodology in the Framework and Approach paper applying to a particular determination, which may be the standard methodology or an alternative.[16]
- A requirement on NSPs to adopt the forecasting methodology specified by the AER in preparing their regulatory proposals.[17] The NSP may also use another forecasting methodology or other methodologies, in addition to the methodology specified by the AER.

### ENA response

The ENA recognises that it is important for businesses and the AER to have a dialogue about important aspects of a proposal, such as the forecasting method applied, prior to a revenue proposal being submitted. However, the ENA does not consider it appropriate that the AER be able to specify a particular forecasting methodology which the NSP is then obligated to incorporate in its regulatory proposal.

A regulatory proposal should contain the best information available to the NSP on what expenditure it considers meets the expenditure objectives. Under the current framework NSP's are incentivised to disclose the best possible information to satisfy the AER of its forecast. In addition, the forecasting methodology applied by an NSP will necessarily be based on its approach to the day-to-day planning and operation of the network. For these reasons the forecasting methodology used for the purpose of a regulatory proposal should be nominated by the NSP.

The ENA understands that the policy goal behind the AEMC's proposed changes is to bring forward a shared understanding between the AER and the businesses of the forecasting methodology adopted, prior to the presentation of the NSP's forecasts in its regulatory proposal.[18] This goal of 'early engagement'[19] between stakeholders on the expenditure methodology could be more appropriately achieved by requiring NSPs to provide an informal briefing to the AER on the methodology that it is using to develop its forecasts, prior to the formal lodgement of its proposal (for instance, at the Framework and Approach paper stage). This approach would not change the primary responsibility for development of the forecasts

[15] See NER 6A.5.6; 6.4.5.
[16] See NER 6A.10.1A; 6.8.1(b)(2)(viii).
[17] See NER S6A.1.1;S6.1.1.
[18] In its submission to the AEMC's Directions Paper, the AER claimed that unfamiliarity with particular forecast models makes it difficult to identify deficiencies in NSP proposals, exacerbating time constraints and worsening the information problem between NSPs and the AER ( AER Submission to AEMC direction paper, pp. 11-14).
[19] AEMC, Draft Determination, pp. 111

(which would remain with the NSPs), but would facilitate early discussions and improved understanding in relation to the forecasting methodology adopted. The ENA also notes that the AER's familiarity with different forecasting approaches adopted by the DNSP's in particular is likely to be increased going forward, as it begins its second round of determinations.

***NSP forecasting methods can be expected to provide the best information***

The best information that is available to an NSP for forecasting purposes is based upon the practices that the NSP uses on a day-to-day basis to plan and to run its network. This includes the methodologies the NSP uses to forecast capital and operating expenditure as part of its business operations. These are then adjusted as necessary for the development of forecasts for a regulatory proposal which requires a business to forecast as accurately as possible its expenditure over the five year regulatory period.

The forecasts included in a NSP's regulatory proposal should be determined by reference to the forecasting methodology that the NSP uses in the day-to-day planning and operation of its network. This methodology includes how the inputs to the methodology are derived from the actual business records of the NSP. However, importantly, it must be recognised that the methodology for a regulatory reset will necessarily be adapted to address future uncertainties versus at the time of making the investment decision. There is no better information as to the requirements of the relevant network over the regulatory period than the information that comes from the business itself.

The ENA submits that requiring an NSP to incorporate methodologies supporting its case for satisfying the regulator that the NSP does not itself use or necessarily believe are forecasts that are consistent with the requirements of the Rules would weaken the overall effectiveness of the framework.

***NSPs should maintain responsibility for their revenue proposals***

The requirement in the Draft Rules for the AER to develop a 'standard expenditure forecasting methodology' and for NSPs to adopt this methodology (or an alternative specified by the AER) in its regulatory proposal confuses the responsibility between the regulator and the business in preparing and updating expenditure forecasts. The AEMC acknowledges in its Draft Determination that the NSP's proposals are 'the most significant input into the AER's decisions' and that, given NSP's experience in operating their networks and the data available to them, that NSPs are 'in the best position to make judgments about what expenditure will be required in the future'.[20] Indeed the AEMC has reaffirmed that the NSP's proposals are the procedural starting point for the determination of capex and opex allowances.[21] The AEMC also recognises that '[t]he expenditure models to be used to prepare capex and opex forecasts are a critical part of an NSP's proposal'.[22]

The ENA strongly supports the AEMC's statements above. However, proposing that the AER develops an expenditure forecasting methodology which is then imposed on the business would mean the AEMC's intention for the framework could not be properly implemented. By specifying a forecasting methodology, the AER would in effect be substantially determining

[20] AEMC, Draft Determination, pp. 102
[21] Ibid.
[22] AEMC, Draft Determination, 110.

the outcome of the expenditure forecasts, which would therefore no longer be based on the NSP's best judgement of future expenditure requirements.

Having NSPs continue to retain the responsibility for the development of expenditure forecasts, including the methodology adopted, is integral to the proper operation of the regulatory approach set out in the Rules. This is wholly consistent with the NSPs also being the party with primary accountability for expenditure outcomes (including the commercial risks associated with spending above the forecast level). It also reflects the internal executive level business sign-off required that the forecasts reflect a true view of the expenditure required.[23]. The forecast included in the regulatory proposal should reflect the level of expenditure that the business considers necessary, and inevitably this requires responsibility for the forecast to remain solely with the business.

***Two-track review processes should be avoided***

The proposal in the Draft Rules to require the business to provide expenditure forecasts prepared using the prescribed AER methodology *in addition* to those based on their own methodology has the potential to lead to the unhelpful development of a 'two-track' review process. The AER would be required to assess the NSP's proposed forecast, just as it does currently, but would also be required to assess a forecast prepared on the prescribed basis, which may not necessarily be supported by the NSP. Such an approach is unlikely to improve early engagement and understanding in relation to the business' forecasting approach. Conversely, having two forecasts would be more likely to increase the costs and complexity of the determination process for forecast expenditure, for both the AER and the businesses - and as such appears to run counter to the policy intent.

***The concept of a 'standard' forecasting methodology is misleading***

The ENA also considers that the concept of a 'standard' forecasting methodology that would be applicable in all circumstances is misleading. Individual circumstances at the time of each determination will inevitably require specific consideration, and may make a particular forecasting approach more or less relevant. As a consequence, it appears inevitable that the forecasting approach specified by the AER at the Framework and Approach would need to vary from the 'standard methodology'. This would create considerable uncertainty for the businesses, who are typically well-advanced in the preparation of their expenditure forecasts by the time the Framework and Approach paper is finalised.

***Forecasting methods and assessment methods are different***

It is important to recognise that there is a difference between the overall methodology used to develop the expenditure forecasts, and the techniques that the AER then uses to assess those forecasts. This should not, and does not preclude the AER from imposing information requirements on a DNSP to provide information which allows it to assess forecasts using its own preferred methodology. DNSPs routinely provide thousands of rows of information based on templates specified by the AER. The information in these templates are often supported by statutory declarations by the CEO and are provided under the threat of civil or criminal penalty for incorrect or misleading information.

[23] The ENA notes that the Rules also require certification by directors of the reasonableness of the key assumptions, as part of the businesses' Revenue Proposal (s6.1.1(5); S6A .1.1 (5)).

For example, the repex model adopted by the AER is an assessment tool, which it has used to help inform its decision as to the reasonableness of the NSP's proposed replacement expenditure. The AER has previously been clear that its repex model and its augmentation capex model are assessment techniques, rather than forecasting methodologies.[24] The AER is already able to specify in the RINs the data required for application of these assessment techniques. The AER itself, in consultation on these techniques has always advised that these techniques are not substitutes for a DNSPs forecasts. Indeed, if a DNSP was to only provide these assessment methodologies in support of forecasts, it is highly unlikely that it would be sufficient for the AER to be satisfied that the forecasts were prudent and efficient.

The AER maintains that these techniques are informative for the AER in understanding potential areas of further investigation and not an end point in determining the efficiency of forecasts.

To the extent it is considered beneficial the ENA would support the AER developing and publishing standard assessment techniques (such as the repex model). This approach might be expected to facilitate an early engagement on these techniques.

***Implementation of the Draft Rule approach is complex***

The ENA also notes that if the AEMC maintains the position that an NSP is required to include in its regulatory proposal forecasts based on methodologies that have been specified by the AER, more extensive changes would be required to the Rules and documents made under the Rules in relation to what a regulatory proposal is to contain, how forecasts are to be assessed by the AER and the level of assurance that NSPs (and in particular, their Boards) are required to give as to the reasonableness and accuracy of forecasts in their regulatory proposals.

The ENA notes that the proposal would also likely extend the timeframe required for the NSP to prepare its regulatory proposal and, consequently, increase the costs which would ultimately be passed through to consumers. The ENA does not consider that the benefits would outweigh the costs in this instance.

**Proposed way forward**

The ENA proposes that the Draft Rules should be amended to reflect the following approach:

- Responsibility for the development of the expenditure forecasts, including the methodology used to generate forecasts should remain solely with the NSP.
- NSPs be required to advise the AER via the Framework and Approach Paper process of the expenditure forecasting methodology they are proposing to adopt.
- The AER should be required to develop and publish standard assessment techniques in relation to the assessment of expenditure forecasts.

**Proposed drafting amendments**

**<u>Amendments to clause 6.5.4 to remove requirement on the AER to develop a standard expenditure forecast methodology and to replace it with a requirement on the AER to develop forecast expenditure assessment techniques</u>**

[24] See AER NSW Framework and Approach Paper, pp. xiii

### 6.5.4 Expenditure forecast ~~methodology~~ assessment techniques

(a) The *AER* must, in accordance with the *distribution consultation procedures*, develop and *publish* ~~a methodology~~ the assessment techniques that it may use in determining whether it is satisfied that the total of the forecast operating expenditure or forecast capital expenditure of a *Distribution Network Service Provider* included in a *building block proposal* reasonably reflects the *operating expenditure criteria* or the *capital expenditure criteria*, as relevant ~~for the preparation of forecasts of operating expenditure and capital expenditure that are included in *Distribution Network Service Providers'* regulatory proposals~~ (~~the *standard*~~ *forecast expenditure* ~~*forecasting methodology*~~ *assessment techniques*).

(b) Subject to paragraph (c), the *AER* may, from time to time and in accordance with the *distribution consultation procedures*, amend the ~~*standard*~~ *forecast expenditure* ~~*forecasting methodology*~~ *assessment techniques*.

(c) The *AER* may make administrative or minor amendments to the ~~*standard*~~ *forecast expenditure* ~~*forecasting methodology*~~ *assessment techniques* without complying with the *distribution consultation procedures*.

(d) The *AER* must *publish* the first ~~*standard*~~ *forecast expenditure* ~~*forecasting methodology*~~ *assessment techniques* by [~~30~~ 28 June 2013], and there must be ~~*standard*~~ *forecast expenditure* ~~*forecasting methodology*~~ *assessment techniques* in force at all times after that date.

**Amendments to insert requirement on NSPs to advise the AER via the framework and approach paper process of the expenditure forecasting methodology they are proposing to adopt**

### 6.8.1A Notification of expenditure forecasting methodology

(a) A *Distribution Network Service Provider* must advise the *AER* of the expenditure forecasting methodology that the *Distribution Network Service Provider* proposes to adopt in developing the forecast operating expenditure and forecast capital expenditure for its *building block proposal* at the same time or as soon as practicable after, the *AER* commences preparation of, and consultation on, the relevant *framework and approach paper* under clause 6.8.1(e).

(b) Subject to any claim for confidentiality, the *AER* may *publish* details of the expenditure forecasting methodology provided to it pursuant to paragraph (a) and consult on that methodology as part of the *framework and approach paper*.

## 6.2 Consideration of individual circumstances of businesses

### AEMC position

The AEMC is proposing to amend the wording of the capital and operating expenditure criteria for both Chapter 6 and Chapter 6A, 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/TNSP'.

The proposed amendment is intended to remove a potential ambiguity in the Rules that could hinder the application of benchmarking. The AER earlier commented that it considers that the phrase ‘in the circumstances of the relevant NSP’ is capable of being interpreted ‘extremely broadly’, potentially making benchmarking difficult and less meaningful.[25]

**ENA response**

The ENA does not agree that the current reference to ‘in the circumstances of the relevant NSP’ hinders the application of benchmarking analysis, and does not consider that the AEMC has made a valid case for the removal of the phrase. In fact, for the reasons set out below, ENA considers it is important for it to be retained.

*Importance of the reference to the circumstances of the relevant NSP*

The expenditure criteria have three elements. The first element refers to ‘the efficient costs of achieving the [..] expenditure objectives’.[26] There is no reference in this part of the criteria to ‘the circumstances of the NSP’. Moreover, the expenditure factors clearly allow the AER to have regard to ‘the benchmark capital expenditure that would be incurred by an efficient [NSP] over the regulatory period’ in assessing what ‘the efficient costs’ may be.[27]

The reference to ‘the circumstances of the relevant NSP’ is included in the second element of the expenditure criteria,[28] which relates to the ‘costs that a prudent operator [..] would require’. The concept of ‘prudency’ reflects that of ‘good industry practice’ and includes both the process followed by the NSP in developing its expenditure forecasts; and the principles adopted in deriving the forecasts, and hence the level of those forecasts. The inclusion of the term ‘prudent’ within the expenditure criteria provides guidance on how the assessment of the ‘efficiency’ of the expenditure forecasts should be approached in practice, given that the ‘efficient’ level of expenditure is something that cannot be directly observed, and is always changing.

Importantly, the prudency of a business’ actions needs to be assessed in the context of the circumstances facing that businesses network. For example, a prudent business operating in a CBD environment, where there would be substantial implications from a service outage, may undertake investments reflecting a greater degree of risk aversion than a prudent business operating in a more remote area. To that extent, what is of consequence is that the circumstances of a particular network for a particular NSP is given proper regard.

*Implications of removing or relocating the reference to the circumstances of the relevant NSP*

The AEMC notes that there is ‘little doubt about how the AER should undertake a benchmarking exercise, including the circumstances that should be taken into account’.[29] However, the fact that the relevant circumstances are ‘well agreed upon’ does not make the reference to them in the Rules ‘unnecessary’.[30] Rather, the expected increased emphasis on benchmarking analysis by the AER going forward increases the importance of ensuring that the Rules make formal reference to ‘the circumstances of the NSP’. The general agreement as to which circumstances are relevant should make the inclusion of such a reference less contentious.

The AER makes reference in its submission to a Tribunal decision which found that the AER’s consultant ‘failed to pay proper regard to the differences between Powercor’s network and those of the other DNSPs and failed to take proper account of the differences between the

25 AER, Submission to AEMC Directions Paper, pp. 9
26 See 6.5.6(c)(1) and 6.5.7 (c)(1); 6A.6.6(c)(1) and 6A.6.7(c)(1)
27 See 6.5.6(e)(4) and 6.5.7(e)(4); 6A.6.6(e)(4) and 6A.6.7(e)(4)
28 See 6.5.6(c)(2) and 6.5.7 (c)(2); 6A.6.6(c)(1) and 6A.6.7(c)(1)
29 AEMC, Draft Determination, pp. 106.
30 AER Submission to AEMC Directions Paper, pp. 9.

work programs which had been put in place by Powercor, in particular, and those which the other DNSPs proposed to undertake'.[31] Rather than this decision highlighting a shortcoming with the current Rules, the ENA considers that it is imperative that the businesses have the reassurance that the Rules will continue to require the AER to recognise relevant differences in the circumstances facing their businesses.

Removal of the reference to "in the circumstances of the relevant NSP" does not adequately recognise the importance of the individual characteristics of an NSP in the AER's assessment of that NSP's expenditure forecasts. If the decision making test requires satisfaction that the forecasts reasonably reflect the expenditure criteria, and those criteria do not expressly require consideration of a prudent operator facing the same exogenous circumstances as the specific NSP, this would potentially permit an outcome where:

- the AER forms a view about the costs that a prudent operator in the circumstances of the NSP would require to achieve the expenditure objectives (perhaps informed by a properly specified benchmarking analysis which appropriately reflects circumstances exogenous to the service provider);

but

- in determining the forecast expenditure the AER effectively reduces that level of costs because it is not satisfied that level of expenditure reflects the costs of an efficient and prudent operator more generally.

The ENA submits that such a possibility should not be permitted by the Rules.

The ENA reiterates its position that no evidence or material has been provided to suggest that the operation of the Rules have in any way limited or otherwise hampered the AER in using benchmarking information. The Rules should not be amended in these circumstances. This includes because when an authority (administrative or judicial) is required to apply and interpret the Rule provisions the authority may seek to read something into the amendment that has been made. If amendments are going to be made to the Rules to require the AER to generate an annual benchmarking report and have regard to that report in deciding whether the AER is satisfied that the forecasts reasonably reflect the expenditure criteria, the Rules and the decision document should be absolutely clear that the AER is required to consider the circumstances of the NSP whose forecasts it is considering, as a fundamental element of its decision making.

The ENA also notes that relocation of "in the circumstances" from the expenditure objectives to the expenditure factors would also be inappropriate. Such relocation would mean that the exogenous circumstances of the service provider may, at most, be interpreted to be information the AER is required to consider when determining if it is satisfied that the forecasts are reasonable, as opposed to a matter that directly guides the AER in determining whether the forecast allowance is appropriate for a specific service provider.

**Proposed way forward**

The reference to 'in the circumstances of the relevant NSP' should continue to be included in the expenditure criteria.

[31] *Application by United Energy Distribution Pty Limited [2012] ACompT 1* (6 January 2012), para 666.

**Proposed drafting amendments**

**6.5.6 Forecast operating expenditure**

...

(c) The *AER* must accept the forecast of required operating expenditure of a *Distribution Network Service Provider* that is included in a *building block proposal* if the *AER* is satisfied that the total of the forecast operating expenditure for the *regulatory control period* reasonably reflects each of the following (the *operating expenditure criteria*):

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

(2) the costs that a prudent operator in the circumstances of the relevant *Distribution 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*.

## 6.3 Development of small scale incentive schemes

**AEMC position**

The Draft Rule would allow the AER to develop any form of small scale incentive scheme having regard to a number of requirements. The schemes would be temporary (up to two regulatory periods) and the maximum annual revenue at risk for schemes in aggregate would be capped. The maximum annual revenue at risk in aggregate would be capped at 1 per cent of MAR if NSPs agree to the introduction of the scheme and 0.5% of MAR if NSPs do not agree to the introduction of the scheme. The AER would be required to have regard to a number of principles when designing any scheme.

**ENA response**

The ENA considers that there are benefits in ensuring that innovation in the incentives framework is encouraged and properly aligns the incentives for NSPs with outcomes that are desirable for customers. As such, the AEMC's Draft Rule is a welcome balance between allowing for regulatory innovation and retaining important distinctions between rule-making and regulatory application.

However, the ENA considers that the framework could be strengthened by making a number of minor enhancements.

In particular, the ENA considers that the guidance to the AER could be improved by requiring the AER to have regard to the prospective costs and benefits of a scheme when deciding whether to implement, and when designing such a scheme. The development of a new scheme will involve costs, including the administrative cost to the AER and the NSP of designing and implementing the scheme as well as the costs of any new risks that might be created. Therefore, before the AER develops any scheme it should have regard to the likelihood that the scheme is likely to deliver benefits that outweigh its costs.

The ENA notes that one of the principles of any scheme is that it should be consistent with other incentives that NSPs may have under the Rules. This is an important principle in order to avoid conflicting incentives. The ENA considers it is important for this to be interpreted as requiring the AER to also have regard to the overall balance of incentive schemes. That is, what effect would the introduction of a new scheme have on the incentives within another existing scheme.

The ENA notes that the Draft Rule allows the AER to develop an asymmetric small-scale incentive scheme. As discussed further in section 7.2, where the AER is able to develop an asymmetric scheme it is important that it be required to acknowledge the need to compensate NSPs for the expected liability under this scheme. This is necessary to ensure that an NSP has the opportunity to recover at least its efficient costs.

In addition, as a matter of procedural fairness, as well as to maximise the integrated nature of the regulatory proposal, NSPs should have certainty on applicable schemes at the Framework and Approach stage. Therefore, the ENA recommends that any schemes that are to apply to individual businesses are specified at this time.

**Proposed way forward**

The guidance to the AER on the small scale incentive scheme should be amended so that it is required to consider the likely costs and benefits of implementing a scheme and that the AER must include compensation for the NSP where there is an expected net cost to NSPs under the scheme. In addition, the regulatory process should be amended to clarify that any small scale incentive schemes that will apply to an NSP are made known at the Framework and Approach stage or where this is not the case, only to apply when agreed by the business.

**Proposed drafting amendments**

### 6.6.4 Small-scale incentive scheme

(a) The *AER* may, in accordance with the *distribution consultation procedures*, develop and *publish* an incentive scheme or schemes (*small-scale incentive scheme*) that provides *Distribution Network Service Providers* with incentives to provide *standard control services* in a manner that contributes to the achievement of the *national electricity objective*.

(b) In developing a *small-scale incentive scheme*, the *AER* must have regard to the following requirements:

(1) *Distribution Network Service Providers* should be rewarded for efficiency gains in respect of their *distribution systems*, and penalised for efficiency losses in respect of their *distribution systems*;

(2) the rewards and penalties should be commensurate with the efficiency gains or efficiency losses in respect of a *distribution system*, but a reward for efficiency gains need not correspond in amount to a penalty for efficiency losses, however, if it is anticipated that the operation of the scheme will result in penalties exceeding rewards, the scheme must provide for inclusion in forecast operating expenditure an amount that compensates the *Distribution Network Service Provider* for the expected net cost under the scheme;

(3) penalties should not be imposed on *Distribution Network Service Providers* that act in an efficient manner, in terms of both the degree and timing of that action;

(4) the benefits to electricity consumers that are likely to result from efficiency gains in respect of a *distribution system* should warrant the rewards provided

under the scheme, and the detriments to electricity consumers that are likely to result from efficiency losses in respect of a *distribution system* should warrant the penalties provided under the scheme;

(5) the scheme should be consistent with other incentives that *Distribution Network Service Providers* may have under the *Rules* and under any other incentive schemes; ~~and~~

(6) the scheme should not be inconsistent with any applicable *regulatory obligations or requirements* associated with the provision of *standard control services*; and

(7) that the benefits arising from the scheme should exceed the costs of the development, implementation and administration of the scheme, which, for the avoidance of doubt, includes the costs incurred by the *AER* and *Distribution Network Service Providers*.

(c) The *AER* may, from time to time and in accordance with the *distribution consultation procedures*, amend or replace any *small-scale incentive scheme*.

(d) Where the *AER* applies a *small-scale incentive scheme* to a *Distribution Network Service Provider* for a *regulatory control period*:

(1) the aggregate rewards or penalties for a *regulatory year* in that *regulatory period* that are provided or imposed under that scheme and any other *small-scale incentive schemes* that apply to that *Distribution Network Service Provider* must not exceed 0.5% of the *annual revenue requirement* for the *Distribution Network Service Provider* for that *regulatory year* unless the *Distribution Network Service Provider* consents to the contrary, in which case that aggregate must not exceed 1% of the *annual revenue requirement* for the *Distribution Network Service Provider* for that *regulatory year*; and

(2) the *small-scale incentive scheme* must cease to provide rewards or impose penalties in respect of a *regulatory year* after the expiry of such a period as is determined by the *AER*, being a period that is not more than two *regulatory control periods* after the commencement of that scheme.

(e) Notwithstanding anything else contained in this clause, the *AER* may require a *Distribution Network Service Provider* to participate in a trial of a *small-scale incentive scheme* under which, for the duration of that trial, the *Distribution Network Service Provider* is not required to bear any penalty and is not entitled to earn any reward.

(f) Unless a *Distribution Network Service Provider* otherwise consents, the *AER* may only apply a *small-scale incentive scheme* in a distribution determination where that *small-scale incentive scheme* had been *published* by the *AER* no less than 32 months prior to the commencement of that distribution determination.

## 6.4 Benchmarking

### AEMC position

The Draft Rules include a new requirement for the AER to produce an 'annual benchmarking report', the purpose of which is to describe, in reasonably plain language, the relative efficiency of each DNSP (TNSP) in providing direct control services (prescribed transmission services) over a 12 month period.[32] The AER is required to have regard to the most recent annual benchmarking report together with the benchmark expenditure that would be required by an efficient NSP, in assessing the reasonableness of both the NSP's operating and capital expenditure forecasts.[33]

**ENA response**

The ENA supports improving the collection of information by the AER to facilitate the application of benchmarking, and notes that the AER has previously identified 'limited access to comparable data' as a constraint to meaningful benchmarking.[34] TNSPs already submit annual information to the AER,[35] which is used in the compilation of the AER's annual Electricity Performance Report. The AER also publishes an annual Comparative Performance Report in relation to the five Victorian DNSPs.[36]

There is no regulatory impediment to the AER seeking information from DNSPs. However, it has been widely acknowledged that the development of information sets that allow for meaningful comparisons across businesses is not an overnight process. We understand the AER is already working toward more consistent information provision across businesses.

The AEMC highlights two aims in relation to the publication of the annual benchmarking reports. The first is that it would improve information available to consumers in relation to an NSP's network performance – including relative to other NSPs. The AEMC also considers that the reports would assist the AER in assessing capex and opex forecasts as part of a regulatory determination.

The ENA considers that whilst the preparation of annual benchmarking reports may provide some assistance to the AER in undertaking a later regulatory determination, it is important to recognise that the benchmarking of past performance is most relevant in the comparative assessment of a NSP's historical expenditure, rather than in the forward-looking assessment of forecast expenditure at the time of each determination. That is, annual benchmarking of past performance is not a substitute for the analysis required under the Rules of the benchmark expenditure that would be required by a prudent and efficient firm in the circumstances of the relevant NSP going forward. The forecast of future expenditure needs to take into account the circumstances that are expected to apply to the business going forward, which may differ materially from the circumstances applying in the past.

The ENA noted in its submission to the Productivity Commission's review of electricity network regulation[37] that the results of benchmarking are likely to be most appropriately used as an input to expert analysis by network engineers. Benchmarking analysis may suggest that a certain level of expenditure is efficient. In assessing the results network engineers may however agree that a higher or lower level of expenditure is required, due to factors not captured in the benchmarking analysis.

The AER's annual benchmarking report appears likely to fall within the category of 'pure statistical' benchmarking. 'Pure statistical' benchmarking is where the researcher attempts to make all adjustments for comparability within the analysis itself, without being guided by

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[32] Draft NER Clause 6.27 and 6A.31.

[33] Draft NER Clause 6.5.6(e)(4), 6.5.7(e)(4), 6A.6.6(e)(4) and 6A.6.7(e)(4).

[34] AER, Submission to AEMC Directions Paper, pp. 9.

[35] The ACCC/AER has been collecting information from transmission network service providers (TNSPs) and reporting on their financial and operational performance since 2002-03.

[36] The AER's publication of this report is part of its responsibility for exercising certain powers and functions previously undertaken by the Essential Services AEMC of Victoria, under the *National Electricity (Victoria) Act 2005*.

[37] ENA Submission, Productivity AEMC Electricity Network Regulation, April 2012, available at http://www.pc.gov.au/__data/assets/pdf_file/0017/116612/sub017-electricity.pdf

expert engineering assessments, Such analysis is likely to be most useful as a means of identifying anomalies in an expenditure proposal that require closer more detailed examination, or when applied at low levels of expenditure aggregation.

The ENA also considers that to the extent the AER is to be required by the Rules to have regard to benchmarking information in determining whether it is satisfied that forecast expenditure reasonably reflects the expenditure criteria, the AER should not be directed by the Rules to have particular regard to the annual benchmarking report. This is particularly the case where the last available benchmarking report lags the proposal forecasts by 1 or 2 years. If the Rules are to direct the AER to have regard to benchmarking material (a position which the ENA supports), the Rules should refer to benchmarking material generally, as there is potentially a wide range of benchmarking information that may be relevant, including, but certainly not limited to, any annual benchmarking report published by the AER. Similarly, the Rules should not specifically pick out the AER's most recent annual benchmarking report as the material the AER is required to have regard to, earlier reports would also likely be of relevance.

The ENA also notes that the AEMC in its draft determination has chosen not to provide guidance on the manner in which the annual benchmarking report is to be prepared, and has also highlighted that the availability of information may affect the robustness of the analysis in those reports. The relevance of the information contained in the annual benchmarking report to the determination of the reasonable forecast of future expenditure is therefore not able to be determined beforehand.

Finally, it is important that the AER's conclusions on the 'relative efficiency' of each NSP in the annual benchmarking report should not be construed as bringing forward to an annual report the AER's assessment of the efficiency of an NSP's previous expenditure. This assessment of efficiency is more properly a matter for the AER's determination at the time of the NSP's regulatory review.

**Proposed way forward**

The ENA proposes that Draft Rules 6.5.6 (e)(4), 6.5.7(e)(4), 6A.6.6(e)(4) and 6A.6.7(e)(4) be reworded, to clarify that in having regard to the benchmark expenditure that would be incurred by an efficient NSP the AER is able to have regard to any relevant benchmarking information. This would include the latest AER annual benchmarking report, where the AER considers the information in that report to be relevant, but does not presuppose the primacy of that source over other potential sources of benchmarking analysis, including that undertaken by the AER in the context of the determination itself, and/or that provided by the NSP or any third party.

**Proposed drafting amendments**

### 6.5.6 Forecast operating expenditure

...

(e) In deciding whether or not the *AER* is satisfied as referred to in paragraph (c), the *AER* must have regard to the following (the operating expenditure factors)...

(4) relevant benchmarking material that takes into account differences in the environments of different *Distribution Network Service Providers*, including ~~the most recent~~ *annual benchmarking reports* ~~that has been~~ *published* under rule 6.27, and the benchmark efficient operating expenditure that would be incurred by an efficient *Distribution Network Service Provider* over the relevant *regulatory control period*;...

### 6.5.7 Forecast capital expenditure

...

(e) In deciding whether or not the *AER* is satisfied as referred to in paragraph (c), the *AER* must have regard to the following (the capital expenditure factors)...

(4) relevant benchmarking material that takes into account differences in the environments of different *Distribution Network Service Providers*, including ~~the most recent~~ *annual benchmarking reports* ~~that has been~~ *published* under rule 6.27, and the benchmark efficient capital expenditure that would be incurred by an efficient *Distribution Network Service Provider* over the relevant *regulatory control period*;...

## 6.5 Uncertainty mechanism – contingent projects

**AEMC position**

In the draft determination the AEMC proposes to apply a contingent projects mechanism to distribution. The threshold for a project that can be included as a contingent project is the greater of the RIT-D threshold or 5 per cent of the value of the annual revenue requirement.

**ENA response**

The ENA maintains that a contingent projects regime is not suited to the electricity distribution context. In contrast to transmission networks, which are made up of a small number of large assets, distribution networks have a large number of smaller assets and require regular investments to facilitate new connections, system augmentation and asset replacement. Therefore, whereas capital expenditure forecasts put forward by TNSPs may be significantly impacted by individual projects, capital expenditure forecasts put forward by DNSPs are not. If the monetary threshold is set such that the contingent projects regime has ready application in a distribution context it would not promote the NEO or be consistent with the RPPs because:

- the administrative burden associated with the regime would be much higher than in a transmission context as a larger number of trigger events would need to be specified at the time of the distribution determination and a larger number of 'triggered' contingent projects would need to be considered during the course of a regulatory control period; and

- there would be increased risk that prudent and efficient capex would not be recovered by a DNSP as the AER would have to be satisfied that the event falls within the definition of the defined 'trigger event' and that the forecast capex meets the monetary threshold (in addition to the expenditure being reasonably required for the purposes of undertaking the contingent project).

Further, and more significantly, in such circumstances, the ENA is concerned that a contingent projects regime may lead the AER to seek to 'micro-manage' distribution networks. The ENA observes that under the equivalent transmission provisions, the AER has transferred capex amounts from proposed capex to contingent projects. Under a contingent projects regime with low monetary thresholds, the AER may be encouraged to go into the minute detail of each of the projects proposed by DNSPs and remove those projects that while probable are not (in the AER's view) certain to go ahead in the next regulatory control period. This would adversely impact on the incentives of the CPI-X regime under which DNSPs retain a proportion of unanticipated cost reductions and absorb unanticipated cost increases. Specifically, it would remove any benefit associated with unanticipated cost reductions, but leave the DNSP to absorb unanticipated cost increases, thereby magnifying the risks of regulatory error. The cost pass through and proposed capex reopener provisions do not remedy this problem given the relatively narrow range of events to which they apply.

In addition, the ENA observes that, under the existing regime, an AER decision regarding the incremental revenue required in respect of a contingent project would not be subject to merits review.[38] This further increases the risk of DNSPs not being provided with an opportunity to recover prudent and efficient capex, contrary to the NEO and the RPPs.

The ENA therefore considers that no contingent projects regime should be introduced in respect of distribution networks. In the event a contingent projects regime is to be imposed in the distribution context, the ENA considers that it would better promote the NEO and the RPPs if the AER was not permitted to:

- have regard to whether proposed opex or capex should 'more appropriately be included as a *contingent project*' (as it would be required to do under proposed clauses 6.5.6(e)(9A) and 6.5.7(e)(9a)); or

- propose its own contingent projects by transferring opex or capex proposed in a regulatory proposal to a contingent project.

Such measures would ensure that the AER could not be tempted to micro-manage distribution networks. Rather, the AER would either be satisfied that proposed capex reasonably reflects the capex criteria (in which case it must accept the forecast), or not be so satisfied (in which case it would reject the forecast and substitute its own that does).

***Threshold for a distribution contingent projects regime***

If it is the AEMC's final position to introduce a contingent project regime for distribution, it should only apply in respect of very large individual projects. This is to ensure that the mechanism, to the extent it is possible, operates only for projects that have similar features to contingent projects that might apply for transmission. To ensure this objective is achieved, the Businesses submit that:

- a minimum threshold being the greater of $30 million or 5% of a DNSP's annual revenue requirement should be applied. The ENA considers that raising the threshold to this level is important for the following reasons:

    - It is only projects above this threshold in distribution that have the characteristics of projects that are suitable for contingent projects in transmission. That is, these projects are sufficiently large, appropriately small in number, and are more likely to have a well defined trigger event associated with them. The current threshold proposed by the AEMC risks a significant number of projects that are ill suited to a contingent projects mechanisms falling within the possible bounds of the mechanism.

    - It ensures the mechanism's operation is proportionate to the size of the business. Unlike for transmission there is far more diversity in the relative size and value of distribution businesses in the NEM. Applying thresholds to the level proposed here seeks to ensure that the contingent projects mechanism does not apply disproportionately depending on the size and value of a distribution business' network. ; and

- the NER should expressly state that the contingent projects regime applies only to capex related solely to an individual project and not capex that is related to more than one identifiable project.

Finally, it is important to recognise that there is no clear rationale for linking the threshold of the contingent projects mechanism to the threshold for the regulatory investment test (**RIT**). While the characteristics of transmission projects (including the higher threshold for the RIT-T) might have made such a link convenient in this context, this is not the case for distribution. Specifically, a RIT is intended to apply to most augmentations to a network to ensure that businesses consider a range of options for addressing capacity constraints, and thus the threshold will be set at a relatively low level[39]. A contingent projects regime, on the other hand, is intended to apply only to very large individual projects where there is sufficient uncertainty about them proceeding. A contingent projects regime also applies to a much broader range of projects than the RIT process (which excludes, for example, expenditure relating to connection assets, maintenance, replacement and refurbishment). The appropriate threshold for a contingent projects regime is likely to be higher than the threshold for the RIT and should be the subject of separate consideration.

**Proposed way forward**

The ENA proposes that the Rules do not include a contingent projects mechanism for distribution and the mechanism and references to it should be deleted from the proposed amendments to Chapter 6.

The following proposed clauses should be deleted:

- proposed clause 6.5.6(e)(9A);
- proposed clause 6.5.7(e)(9A);
- proposed clause 6.5.7(f) – (j);
- proposed Rule 6.6A;
- proposed clause 6.12.1(4A); and
- proposed clause S6.1.3(14).

The following clauses should be amended to remove the reference to contingent projects:

- proposed clause 6.6.5(7);
- proposed clause 6.12.1; and
- proposed clause S6.2.1(e)(1) and (2).

To the extent the AEMC continues to hold the view that Chapter 6 should contain a contingent projects regime, the ENA submits that, at a minimum, the following amendments should be made:

[39] The objectives behind the thresholds for the RIT and contingent projects are fundamentally different. The RIT-D threshold assumes it would be desirable in principle for the test to be applied to all projects, but that it should be limited to keep administrative costs proportionate to the benefit. In contrast, the threshold for contingent projects should identify projects that cannot be accommodated in a standard price cap regime with ex-ante forecasts.

- delete proposed clauses 6.5.6(e)(9A) and 6.5.7(e)(9A); and
- amend the threshold in proposed clause 6.6A.1(b)(2)(iii) to provide a threshold of the greater of $30 million or 5% of the value for the annual revenue requirement for the relevant DNSP (and not refer to the proposed threshold to apply to the Regulatory Investment Test – Distribution).

## 6.6 Uncertainty mechanism - materiality for pass through for distribution

**AEMC position**

In the draft determination the AEMC proposes to include a one per cent materiality threshold for cost pass through applications lodged by DNSPs.

**ENA response**

The ENA considers that, if any materiality threshold for pass through events is to be specified in the Rules, the threshold should be expressed to apply cumulatively.

A threshold of one per cent of the annual revenue requirement for a regulatory year (distribution) or the maximum allowed revenue for a regulatory year (transmission) represents a material impact on a business' profit after tax, as such pass through events flow straight through to the bottom line of the business. Based on recent AER and Tribunal decisions on post-tax WACC, in the range of 8.8 per cent to 10.7 per cent, one per cent of annual revenue represents about 6.5 per cent to 8 per cent of profit after tax—clearly a very significant amount.

It appears to be agreed, including by the AER and the AEMC, that one per cent of annual revenue is a "material" amount. The ENA considers that having agreed that one per cent is material, it must logically follow that it is irrelevant whether the increase in costs of one per cent or more arises from one event, or multiple events. It would seem illogical and unfair that a business which experiences a pass through event that increases costs by one per cent of annual revenue is able to lodge a pass through application in respect of that event, but that, a business that experiences two events, which separately have an impact on costs in the order of 0.8 per cent of annual revenue (and collectively have an impact of 1.6 per cent) is not able to apply for a pass through event in respect of those events.

Failure to have a threshold that applies in a cumulative manner risks being inconsistent with the revenue and pricing principles, in particular that an NSP should be provided with a reasonable opportunity to recover at least the efficient costs it incurs in providing services and complying with regulatory obligations or requirements, or making a regulatory payment.

The ENA does not consider that a cumulative threshold will provide NSPs with "too much of an avenue to submit applications, which may or may not be trivial in nature"[40]. The relatively limited scope of the pass through events is a constraint on the nature of events that may be the subject of pass through applications and while it is possible that one or more of these events could be experienced in one year, it is unlikely that an amendment to the Rules to apply the threshold in a cumulative way would result in pass through applications that rely on many events.

From an administrative cost point of view, the ENA is not aware of any evidence which suggests that the assessment of pass through events of a less significant nature place an

[40] AEMC, Draft Determination, pp.196 – 197

unreasonable administrative burden on the AER. In fact the events which are attended by a higher administrative burden are typically those events which well exceed the one per cent threshold.

The ENA believes that businesses should not be exposed to more than one per cent of annual revenue at risk each year (distribution) or the maximum allowed revenue for a regulatory year (transmission) and therefore the one per cent threshold should apply cumulatively for all pass through events each year..

The ENA also submits that the AEMC should clarify in the proposed rule whether it is the value of the revenue impact, or the value of the cash flow impact, which is to be assessed in determining whether the one per cent threshold has been met. The ENA considers that the original intent behind the drafting of "costs incurred" was directed at the cash flow impact, otherwise the Rules would have specifically referred to the impact on revenue, as opposed to the increase or decrease in "costs".

The ENA submits that the correct measure of increase of decrease in "costs" is the actual expenditure incurred by the NSP (both capital and operating expenditure) as a consequence of the pass through event as opposed to the revenue impact. Although the revenue impact and the costs associated with a pass through event may (taking account of the time cost of money) be equivalent over the long term, they are not necessarily equivalent over a regulatory period, and in respect of expenditure on capital assets, are highly unlikely to be equivalent as most electricity network assets have lives exceeding five years.

In reviewing pass through applications the AER has discussed that the term "costs" is open to differing interpretations, and that while it has a preference for approaching the assessment of whether the threshold is satisfied on the basis of the revenue impact of the event, an alternative approach that could be open on the language of the current Rules is to assess whether the quantum of total expenditure that the NSP will incur as a consequence of the event meets the materiality threshold.[41]

**Proposed way forward**

- Amendment to impose a consistent one per cent cumulative threshold across electricity distribution and transmission rules

- Amendment to clarify that, for the purposes of determining whether an event gives rise to a "material" increase in costs, the determination of the "costs" is by reference to the total expenditure that the NSP will incur as a consequence of the event

**Proposed drafting amendments**

**Definition of "materially"**

For the purposes of the application of clause 6.6.1, an event results in a *Distribution Network Service Provider* incurring materially higher or materially lower costs if the change in the total of operating and capital expenditure ~~costs~~ (as opposed to the revenue impact) that the *Distribution Network Service Provider* has incurred and is likely to incur in any *regulatory year* of a *regulatory control period*, as a result of that event either in isolation or together with any other *pass through event* which occurs in the same *regulatory year* as the first event, exceeds 1% of the *annual revenue requirements* for the *Distribution Network Service Provider* for that *regulatory year*.

[41] See in particular the AER's decision on Powercor's pass through application: AER, *Powercor Pass Through Application of 13 December 2011 for Costs Arising from the Victorian Bushfire Royal AEMC*, 7 March 2012, pp 30 – 31.

### 6.6.1 Cost pass through

**Positive pass through**

...

(c1) Where the *Distribution Network Service Provider* is seeking the approval of the *AER* to pass through to *Distribution Network Service Users* a *positive pass through amount* in respect of more than one *positive change event* where those events have occurred during the same *regulatory year*, the *Distribution Network Service Provider* is required to submit the written statement referred to in paragraph (c) to the *AER* within 90 *business days* of the later of the *positive change events* occurring.

**Negative pass through**

...

(f2) Where the *Distribution Network Service Provider* is required to submit to the *AER* a written statement pursuant to paragraph (f) and that statement is in respect of more than one *negative change event* where those events have occurred during the same *regulatory year*, the *Distribution Network Service Provider* is required to submit the written statement referred to in paragraph (f) to the *AER* within 90 *business days* of the later of the *negative change events* occurring.

## 6.7 Treatment of shared assets

**AEMC position**

The Rules as currently drafted address the issue of shared assets by ensuring that:

1. Capital expenditure is rolled into a regulatory asset base only to the extent it provides standard control services. It would logically follow that to the extent that it did not provide standard control services the expenditure would not form part of the RAB; and

2. The RAB is adjusted where an asset used to provide a service classified as standard control services changes classification.

The current Rules therefore has some deficiency to the extent that assets in the existing RAB are used to provide services other than standard control services.

The AEMC attempts to resolves this by making an adjustment to the revenue requirement to the extent that other revenue recovery from these assets are occurring.

The Draft Rules would allow the AER to reduce an NSP's annual revenue requirement by an amount it considers reasonable to reflect asset costs that are being recovered through non-standard control or non-prescribed means. The intended effect of the mechanism is that part of the asset cost of shared assets would not be recoverable from standard/prescribed network service charges.

**ENA response**

The ENA agrees with the AEMC that it is appropriate for the AER to be able to acknowledge where some assets, which may be required to provide prescribed or standard control services, might be able to be used to provide non-regulated services and so have some of their costs recovered through those other services.[42] The ENA notes that at the heart of the AEMC's proposal is the proposition that *assets* should be allocated between different activities rather than *capital expenditure* at the point it enters the RAB. The ENA supports this as allocating assets rather than capital expenditure provides an efficient means of allocating between prescribed/standard control activities and additional commercial activities in cases where the intensity of use of the asset in that alternative activity changes over time.

While the ENA supports the AEMC's intent on this matter it considers a number of improvements could be made for the Final Rule. These improvements relate to the following:

- Extending the approach to within other classes of regulated services,
- Addressing an ambiguous criterion that may impact on the incentive for NSPs to identify additional services for prescribed / standard control services, and
- How past assets are addressed.

***Extension to between categories of regulated services***

The ENA notes that the AEMC's proposal relates only to allocations between prescribed /standard control and unregulated activities.[43] The logic that led to the AEMC proposing that *assets* be allocated between activities rather than *capital expenditure*, suggests that the same principle should also apply to allocations between services that are regulated under the price/revenue cap (standard control for distribution, prescribed for transmission) and those that are subject to alternative forms of regulation (alternative control and negotiated for distribution and negotiated and or non-regulated for transmission).[44] It is noted that effecting this change would require a number of further changes to the Rules, including:

- A change to the Rules guiding the capital expenditure that is included in the RAB to ensure that any expenditure that may be used to provide standard control / prescribed services is included in the RAB. From this initial RAB value an allocation can be made between the services, and
- Changes to the principles governing the Cost Allocation Method are required given this refers to the allocation of capital expenditure rather than assets.

***Incentive for NSPs to identify additional services***

The ENA agrees with the AEMC that it is important for NSPs to have a positive incentive to identify additional services for assets that provide prescribed or standard control services. Providing such an incentive is in the interests of both the NSP and customers and is the intent behind principle 1 in the Draft Rule. The ENA is concerned, however, that the intent of the principle that a shared asset cost reduction should not be dependent on the NSP deriving a positive commercial outcome is ambiguous and potentially conflicts with principle 1 .

Providing NSPs with an incentive to identify alternative commercial uses for assets implies allowing them to share in any additional revenue that is obtained from those alternative uses. Under this type of principle both NSPs and customers are better off. Providing such an

[42] For the avoidance of doubt, those assets that are constructed to provide services other than prescribed/standard control services should still be excluded from the RAB. This would include assets built to provide negotiated services and non-regulated services. The ENA notes that the Rules already allow these types of assets to be included in the RAB through a later process should they subsequently provide prescribed/standard control services.
[43] While the decision document makes reference to an allocation between standard control services and alternative control services this is not reflected in the Draft Rule.
[44] Queensland DNSPs currently operate on this basis under a transitional arrangement.

incentive further implies that NSPs are at least left whole with respect to cost recovery. However, not having regard to positive commercial outcomes for additional services is ambiguous and potentially creates conflict with the incentive to identify additional services for the following reasons:

- It risks NSPs being left less than whole where an additional use does not deliver a positive commercial outcome (i.e. too much cost is allocated to the additional use), and

- It may not allow the NSP to achieve a share of any benefits that may be created if an alternative use does deliver a positive commercial outcome.

In either case, the incentive for an NSP to identify additional uses for prescribed or standard control services is substantially diminished. This is because the incentive for the NSP to search for such alternative uses is dependent on it at least remaining whole, and is further influenced by the extent it can expect a positive commercial outcome. In order to preserve the incentive for NSPs to identify additional uses for prescribed or standard control services, the Rules should require that an NSP can expect to at least be left whole from an allocation to additional uses. Relying on principle 1 and the NEO should be sufficient to achieve this aim given providing a positive incentive implies the NSP being left whole with respect to cost recovery.

***Addressing past assets***

The ENA is concerned that the scheme does not properly manage cases where part of the past capital expenditure has already been allocated to other services.

As noted above, the central proposition in the AEMC's proposal is that costs should be allocated between activities rather than capital expenditure. As was also noted above, giving effect to this principle properly requires a number of changes to the Rules, including that the whole of any assets that are not a capital contribution that are principally for the purpose of prescribed / standard control services are initially included in the RAB so that the RAB is a gross figure. Allocation between activities can then be subsequently done from this RAB figure (rather than a RAB with only part of the asset value included).

The potential exists that some of the costs associated with prescribed / standard control assets may have already been allocated to other activities in the past. Thus care is required to avoid an inadvertent "double allocation" of costs to alternative activities – once from capital expenditure being allocated to the alternative activity and then part of the RAB (i.e., if the RAB is erroneously interpreted as a gross figure) being allocated to that activity). Accordingly, the ENA considers that the Rules should direct the AER to ensure that efficient allocation is to occur; strengthening what may be the intended operation of principle (4) of the current drafting.

**Proposed way forward**

The ENA proposes that the allocation of shared assets should be done with the full costs of any assets required to provide prescribed or standard control services being included in the RAB. This should be done irrespective of whether the assets also provide additional services. An allocation to additional services can then be made from this initial RAB. In addition, the Rules should require on an ex-ante basis that an NSP can expect to at least be left 'whole' from an allocation to additional uses. This may be achieved through deleting principle 2 and relying on principle 1 and the NEO.

The ENA has not at this stage provided detailed drafting amendments to give effect to the proposal that the allocation of shared assets be done with the full costs of any assets required to provide prescribed or standard control services being included in the RAB. The drafting required to give effect to this proposal would require amendments to a number of clauses in the Rules. The ENA proposes that if the AEMC is minded to consider the ENA's proposal, that a workshop be held to canvass the drafting options that would give effect to this proposal.

The ENA notes that if the AEMC is not minded to consider the ENA's proposal, the ENA is concerned that the AEMC's proposed drafting amendments would not give effect to the AEMC's intent that revenue received from shared assets be dealt with via an adjustment to the revenue requirement. This includes because the current Rules only permit the value of the RAB to be increased by actual or estimated capital expenditure to the extent that all such expenditure is properly allocated to the provision of standard control services (see for example: clauses 6.5.1(a); S6.2,1(e)(4); 6A.6.1; S6A.2.1(f)(4) and (8)(i) and (ii)).

In light of the above, the ENA considers that it is important that the AEMC hold a workshop on the specific drafting relating to shared assets to ensure that any amendment to the Rules is effective.

# 7. Capital expenditure incentive mechanisms

The AEMC has found that there is no incentive for NSPs to spend more than approved forecast amounts. The ENA agrees with this finding. Specifically, the ENA also notes that the evidence would suggest that:

- The current rules provide an incentive to underspend relative to forecast and as such, there is no incentive to spend more than approved forecast amounts
- The incentive is strongest for assets with a shorter life where actual depreciation is applied to the roll-forward of the RAB, and
- The power of the incentive declines throughout the regulatory period.

The AEMC has also found that there is a lack of supervision for expenditure more than approved forecast amounts, and considers this to be a potential problem with the current arrangements. The ENA does not support this finding and reiterates that such supervision is unnecessary when there are well designed ex-ante incentives in place. Indeed, where practicable and well-designed incentive arrangements are in place, the regulator is able to conclude that historic expenditure is prudent and efficient without needing to undertake a resource intensive ex-post review. As such, the supervision proposed by the AEMC would only increase costs and risks without delivering a corresponding benefit.

The ENA supports the ability for the AER to apply a variety of tools to promote prudent and efficient capital expenditure. However, it is concerned that the Draft Rule has introduced a wide variety of possible measures without having regard to the costs or risks that might be created by the combination of measures. To that extent, the AEMC should be concerned to ensure that the focus on prudent and efficient capital expenditure is not to the detriment of providing incentives for necessary capital expenditure to be undertaken.

In light of the AEMC's finding that there is no incentive within the current framework for NSPs to spend more than approved forecast amounts, the ENA is particularly concerned that the Draft Rule appears to go much further than a mere incremental strengthening of incentives. Under the Draft Rule the AER would have the ability or requirement to apply one or all of the following capital expenditure efficiency measures:

- A capital expenditure incentive objective and guideline
- A capital expenditure sharing scheme
- An ex-post prudence test of capital expenditure
- An AER statement on the efficiency of all past capital expenditure
- A contingent projects framework to exclude uncertain projects for the general revenue allowance

In the context of an uncertain framework for merits review, the ENA considers that it is important for the AEMC to be fully aware of the likely behaviours this will induce and the risks this framework may create. For instance, the risk associated with an ex-post prudence test may drive businesses to inefficiently defer or avoid expenditure to ensure expenditure is under forecast amounts. The risks of such an outcome would be particularly pronounced should the AER set an inefficiently low expenditure forecast.

The remainder of this section considers the individual elements of the AEMC's approach to capital expenditure incentives.

## 7.1 Capital expenditure incentive objective and guideline

**AEMC position**

The Draft Rules introduce a new capital expenditure incentive objective and the requirement for the AER to develop a capital expenditure incentive guideline. The new objective requires the AER to *ensure* that *only* capital expenditure that reasonably reflects the capital expenditure criteria be included in the RAB. The guideline would be required to identify:

- The design of any capital expenditure sharing scheme
- How the AER intends to undertake its ex-post prudence test function
- How the AER will determine whether to apply forecast or actual depreciation
- The AER's approach to related margin expenditure, and
- How each scheme and capital expenditure mechanism work together and are consistent with the capital expenditure incentive objective.

**ENA response**

The ENA agrees that it is appropriate for the AER to have range of tools that can be used to create incentives for NSPs to undertake prudent and efficient capital expenditure. It is also appropriate that the AER be provided with guidance on how to implement those tools. However, given the presence of the NEO and RPP it is unclear that a new capital expenditure incentive objective is necessary. Further to this, the capital expenditure incentive objective in the Draft Rule appears clearly inconsistent with the RPP, with which the AEMC is required to have regard to in making Rules in this area (this is discussed in more detail below). The ENA does consider, however, that there is benefit in requiring the AER to provide further guidance on how it intends to apply the various capital expenditure incentive tools to individual businesses.

The AER is already required to undertake its functions in accordance with the NEO. The use of sub-principles and objectives is beneficial where they assist in the resolution of difficult design issues or to provide clarity about how the NEO is to be interpreted in a particular instance. For the reasons set out below, the ENA considers that the capital expenditure incentive objective in the Draft Rule does not perform either of these functions. On this basis the ENA considers that reliance on the NEO is sufficient in this instance and the capital expenditure incentive objective should not be included in the Final Rule.

However, if the AEMC nevertheless decides that a capital expenditure incentive objective be retained for the Final Rule, it is important that it is consistent with the NEO and the R&PP. The concerns with the current drafting are as follows:

- First, the requirement for the AER to "ensure" that "only" capital expenditure that meets the capital expenditure criteria is included in the RAB (discussed below) is equivalent to requiring the AER to ensure that "no more than" efficient cost is recovered. That is, if the AER was unsure about the efficiency of previous expenditure that had been undertaken, there is a risk that the proposed drafting would require the AER to err on the side of excluding the expenditure (where this was within its power) given allowing it into the RAB may be not permitted on the face of the capital expenditure efficiency objective. This objective stands in direct contrast to the first principle of the RPP, which requires NSPs to be provided "a reasonable opportunity to recover *at least* efficient cost" (emphasis added).

- Secondly, the objective is backward looking, focussing on what is done with past (sunk) expenditure. Such an objective provides poor guidance for an incentive scheme, which should have as a focus arrangements that alter the forward-looking behaviour of regulated businesses. Thus, the ENA considers that any objective should instead be focused on promoting efficient expenditure into the future.

- Thirdly, a particular concern of the ENA is the effect of the objective when considered in combination with the power for the AER to undertake an ex post prudence test and disallowance.

    - As noted above, the objective would require the AER to err in favour of disallowing recovery of expenditure that the AER considers to be borderline. As such, the objective amplifies the risk created by the ex post test.

    - In addition, the reference in the objective to only allowing recovery of capital expenditure that meets the "capital expenditure criteria" would require expenditure to be disallowed that is judged not to reflect the "efficient cost". This reference, in turn, would invite the application of benchmarking techniques to test the efficiency of the expenditure, which will mean considering information that was not available to the NSP at the time of the expenditure decision.

In addition, the approach in the Draft Rule would allow the AER to apply different schemes to different NSPs and also to apply a particular scheme in different ways to each NSP. The ENA supports the requirement on the AER to produce a guideline in which it sets out its approach to incentive schemes and mechanisms. However, the ENA considers that the role of this guideline would be furthered by requiring the AER set out the criteria that it would apply to select the incentive schemes (and modify them as necessary) to apply to individual NSPs. Doing so would strengthen the certainty and predictability of the framework, as well as providing user representatives with a greater capacity to be involved in the development of capital expenditure incentive schemes.

**Proposed way forward**

The ENA proposes that the AEMC remove the proposed capital expenditure incentive objective from the Rules. The existing guidance in the NEL is sufficient to guide the AER's decision making and is also consistent with the approach to other incentives such as service incentives and the demand management and embedded generation incentive.

The ENA also proposes that the AER be required to set out its criteria for selecting the incentive schemes (and modifying if necessary) for individual businesses. To further improve certainty the AER should be required to specify its approach for individual businesses in the relevant Framework and Approach papers.

**Proposed drafting amendments**

### 6.4A Capital expenditure incentive mechanisms

~~(a) The *capital expenditure incentive objective* is to ensure that, where the value of a regulatory asset base is subject to adjustment in accordance with the *Rules*, then (except as otherwise provided in the *Rules*) the only capital expenditure that is included in an adjustment that increases the value of that regulatory asset base is capital expenditure that reasonably reflects the *capital expenditure criteria*.~~

(a) The *AER* must, in accordance with the *distribution consultation procedures*, make and *publish* guidelines (the *Capital Expenditure Incentive Guidelines*) that set out:

(1) any *capital expenditure sharing schemes* developed by the *AER* in accordance with clause 6.5.8A, and how the *AER* has taken into account the *capital expenditure sharing scheme principles* in developing those schemes;

(2) the manner in which it proposes to make determinations under clause S6.2.2A(a) if the *overspending requirement* is satisfied;

(3) the manner in which it proposes to determine whether depreciation for establishing a regulatory asset base as at the commencement of a *regulatory control period* is to be based on actual or forecast capital expenditure;

(4) the manner in which it proposes to assess capital expenditure that represents a margin that is paid by a *Distribution Network Service Provider* in circumstances where the margin is referable to arrangements that, in the opinion of the *AER*, do not reflect arm's length terms; ~~and~~

(4a) the manner in which it proposes to make determinations under clause S6.2.2A(j) where the *capitalisation requirement* is satisfied; and

(5) the manner in which it proposes to approach what *capital expenditure incentive scheme,* combination of *capital expenditure incentive schemes*, or combination of *capital expenditure incentive schemes* and any other incentive scheme, should apply to a *Distribution Network Service Provider* in a *regulatory period* ~~how each scheme and proposal referred to in subparagraphs (1) to (4) and all of them taken together, are consistent with the *capital expenditure incentive objective*~~.

(c) The *AER* must publish the first *Capital Expenditure Incentive Guidelines* by [30 August 2013], and there must be *Capital Expenditure Incentive Guidelines* in force at all times after that date.

### S6.2.2A Reduction of amounts by which the value of the regulatory asset based may be increased where certain requirements are satisfied ~~for efficiency of past capital expenditure~~

. . .

(g) The amount determined by the *AER* under paragraph (f):

(1) must not be greater than the amount calculated in accordance with paragraph (c);

~~(2) must be determined in a manner that is consistent with the *capital expenditure incentive objective*;~~ and

(2) must be determined taking into account the *Capital Expenditure Incentive Guidelines* that were in operation at the beginning of the relevant *regulatory control period* in which the capital expenditure being assessed was incurred.

. . .

(k) ~~A determination made under paragraph (i) or (j) must be consistent with the *capital expenditure incentive objective* and, i~~In making ~~such~~ a determination under paragraph (i), the *AER* must take into account the *Capital Expenditure Incentive Guidelines* that were in operation when the arrangements that gave rise to the margin being payable or paid by the *Distribution Network Service Provider*.

(l) In making a determination under paragraph (j) the *AER* must take into account the *Capital Expenditure Incentive Guidelines* that were in operation when the relevant capital expenditure was incurred. ~~Nothing in this clause S6.2.2A is to be taken to preclude the *AER* from:~~

~~(1) requiring a *Distribution Network Service Provider* to provide such information; or~~

~~(2) undertaking such analysis,~~

~~as the *AER* considers appropriate to enable it to make a statement, with supporting reasons, as referred to in clause 6.12.2(b).~~

### S6.2.2B Depreciation

(a) Pursuant to clause 6.12.1(18), the *AER* must decide, for a distribution determination, whether depreciation for establishing the regulatory asset base for a *distribution system* as at the commencement of the following *regulatory control period* is to be based on actual or forecast capital expenditure.

~~(b) The decision referred to in paragraph (a) must be consistent with the *capital expenditure incentive objective*.~~

(b) In making the decision referred to in paragraph (a), the *AER* must have regard to:

(1) the incentives that the *Distribution Network Service Provider* has in relation to undertaking efficient capital expenditure, including as a result of the application of any ~~*service target performance*~~ incentive scheme or any other incentives under the *Rules*;

(2) the substitution possibilities between assets with relatively short economic lives and assets with relatively long economic lives and the relative benefits of such asset types;

(3) any determination made by the *AER* under clause S6.2.2A(j) ~~the extent to which any capital expenditure incurred by the *Distribution Network Service Provider* has exceeded the corresponding amount of forecast capital expenditure accepted or substituted by the *AER* and the amount of that excess expenditure [which] is not efficient~~;

(4) the *Capital Expenditure Incentive Guidelines* that were in operation at the time the *framework and approach paper* which applies to the distribution determination being made was *published*.; and

(5) the *capital expenditure factors*.

## 7.2 Capital expenditure sharing scheme

### AEMC position

The Draft Rule allows the AER to develop a capital expenditure sharing scheme. In designing and implementing the scheme the AER is required to have regard to a number of principles. The scheme must also be consistent with the capital expenditure incentive objective.

**ENA response**

The ENA supports Rules allowing the AER to strengthen the incentives for efficient capital expenditure through an ex-ante incentive scheme. As indicated in previous submissions, the ENA considers that the best means to overcome the shortcomings of the existing framework is to provide for a symmetric and continuous incentive scheme that shares benefits and costs associated with changes in expenditure between NSPs and customers. While the ENA supports the intent of the AEMC's proposed scheme in the Draft Rule, it considers that the principles for the scheme require further consideration so that the AEMC's intended outcomes are achieved.

The ENA has previously advocated that an ex-ante, symmetrical incentive scheme for capital expenditure would deliver the following benefits:

- It would strengthen the incentive to minimise expenditure in the later years of a regulatory period, i.e. a continuous scheme

- It would improve the balance of incentives between capital and operating expenditure, and

- A symmetrical scheme would ensure that an incentive applies not only to capital expenditure in excess of the regulatory allowance but also to all capital expenditure within the NSP's allowance.

While the AEMC's discussion clearly finds that the appropriate incentive scheme should be both continuous and symmetric with respect to the incentives for capital expenditure, the AEMC has held back from reflecting this as a requirement or even objective in its proposed drafting. While the ENA recognises that it may be challenging to develop a scheme with these features, it is nonetheless feasible (a view the AEMC has accepted), and as such this should be the objective of the scheme, and the AER should be discouraged from pursuing a simpler but inferior approach. This is particularly the case given the AEMC's finding that there is no incentive for NSPs to spend more than their approved forecast but the power of the incentive declines over the regulatory period.

The ENA considers that the capital expenditure sharing scheme would be considerably enhanced if the AEMC reconsidered the proposed principles for an EBSS for capital expenditure that were developed in the Joint Expert Report on Capital and Operating Expenditure. This report was attached to the ENA submission to the AEMC's Directions Paper. These principles would direct the AER to consider a number of important matters, including the desirability of a continuous and symmetrical incentive. It would also require the AER to focus on how it determines the power for the scheme.

The ENA considers that even if the AEMC does not adopt the principles identified in the Joint Expert Report, then two changes to the proposed principles are required.

First, the first of the proposed principles for the scheme – that NSPs be rewarded for undertaking efficient expenditure and penalised for inefficient expenditure - suggests a level of precision that is not possible and would be very difficult to turn into an effective scheme. Rather, a more appropriate objective for the scheme – and one that is consistent with the central tenets of incentive regulation – is to instead focus on providing rewards and penalties for *improvements* or *declines* in efficiency. It is noted that this focus would be consistent with the current 'efficiency benefit sharing scheme' criteria and with the draft rules for the small scale incentive scheme.

Secondly, given the Draft Rule would enable the AER to develop an asymmetric scheme, it is also important that proper recognition is given to the need for compensation for the expected liability under the scheme. An asymmetric scheme, all else constant, would mean that an NSP would not have a "reasonable opportunity to recover at least its efficient costs", and hence be inconsistent with the RPP.

The standard practice where there are asymmetric incentive schemes is for a forecast of the expected payments under a scheme to be included in the building block revenue allowance. An example is the approach to Guaranteed Service Level payments. This approach maintains a positive incentive for NSPs (because the compensation is fixed for the regulatory period) while ensuring consistency with the RPP discussed above.

**Proposed way forward**

The ENA recommends that the AEMC implement the principles for an ex-ante capital expenditure incentive scheme that were identified in the Joint Expert Report on Capital and Operating Expenditure. Should the AEMC not adopt these principles it should amend clauses 6A.6.5A(c)(1) and 6.5.8(c)(1) so that NSPs are rewarded or penalised for improvements or declines in efficiency. Further, the Draft Rules should require that the AER is required to allow for appropriate compensation for NSPs when an asymmetric scheme is applied.

**Proposed drafting amendments**

### 6.5.8A Capital expenditure sharing scheme

(a) A *capital expenditure sharing scheme* is a scheme developed for *Distribution Network Service Providers* that is designed to share the benefits of efficiency gains and efficiency losses in a manner that promotes the *national electricity objective* ~~provides *Distribution Network Service Providers* with an incentive to undertake efficient capital expenditure during a *regulatory control period*~~.

~~(b) If the *AER* develops a *capital expenditure sharing scheme* in accordance with this clause, the *capital expenditure sharing scheme* must be consistent with the *capital expenditure incentive objective*.~~

(b) In developing and implementing a *capital expenditure sharing scheme*, the *AER* must have regard to ~~take into account~~ the following principles (the *capital expenditure sharing scheme principles*):

(1) that efficiency gains and efficiency losses should be measured by way of comparison between all capital expenditure incurred during the relevant period relative to the forecast capital expenditure accepted or substituted by the *AER* in respect of that period, with those expenditure amounts appropriately adjusted by a method in contained in the scheme pursuant to paragraph (c);

(2) the need to ensure that benefits to electricity consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme;

(3) the need to provide *Distribution Network Service Providers* with a continuous incentive of equal strength in each *regulatory year*;

(4) the need for the scheme to operate symmetrically, that is, that where there is an efficiency gain or efficiency loss of equal size (in absolute terms) this will accrue the same reward or penalty (in absolute terms);

(5) the desirability of the scheme providing an incentive of appropriate strength scheme given:

(i) any other incentives that *Distribution Network Service Providers* may have under other incentive schemes or other incentives under the *Rules* and the need for these taken together to provide *Distribution Network Service Providers* with an incentive to operate in a manner consistent with the *national electricity objective*;

(ii) the *regulatory obligations or requirements* applying to the *Distribution Network Service Providers* or classes of *Distribution Network Service Providers*; and

(iii) the residual risk created by the scheme for *Distribution Network Service Providers*;

(6) the desirability of the scheme providing for a quantitative limit being set on the impact on *Distribution Network Service Providers* and customers of the effect of differences between actual and forecast expenditure;

(7) the desirability of a *capital expenditure sharing incentive scheme* containing a method for adjusting capital expenditure incurred during the relevant period relative to the forecast capital expenditure accepted or substituted by the *AER* in respect of that period for the purposes of applying the scheme, with such method designed to reduce the impact on *Distribution Network Service Providers* and customers events that are not within the full control of *Distribution Network Service Providers*. For example:

(i) a method that defines in advance the adjustments that will be made to actual or forecast expenditure where specified events occur in a *regulatory control period*;

(ii) a method for considering whether certain classes of projects should be excluded from the operation of the scheme;

(iii) a method for authorising adjustments to the forecast expenditure, actual expenditure, or to the calculated *efficiency benefit sharing scheme* amounts where necessary to ensure that the calculated *efficiency benefit sharing scheme* amounts are consistent to the extent practicable with rewarding or penalising *Distribution Network Service Providers* for the actual change in efficiency, with the method for making such adjustments defined in advance of the regulatory period to which the expenditure relates.

(c) The *AER* must, when designing a *capital expenditure sharing incentive scheme*, take into account the characteristics of distribution projects, including the typical size and drivers of such projects and the regulatory obligations applicable to different classes of distribution projects [(including, without limitation, the role of the *regulatory investment test for distribution*)].

(d) A *capital expenditure sharing incentive scheme* must provide that parameters or values under the scheme may vary between *Distribution Network Service Providers* or classes of *Distribution Network Service Providers* over time.

~~(1) *Distribution Network Service Providers* should be rewarded for undertaking efficient capital expenditure and penalised for undertaking inefficient capital expenditure;~~

~~(2) the rewards and penalties should be commensurate with the efficiencies or inefficiencies in capital expenditure, but a reward for efficient capital expenditure need not correspond in amount to a penalty for the same amount of inefficient capital expenditure; and~~

~~(3) penalties should not be imposed on *Distribution Network Service Providers* that undertake capital expenditure in an efficient manner, in terms of both its amount and timing.~~

~~(d) In developing a *capital expenditure sharing scheme*, the *AER* must also take into account:~~

~~(1) the interaction of the scheme with other incentives that *Distribution Network Service Providers* may have in relation to undertaking efficient operating or capital expenditure; and~~

~~(2) any applicable *regulatory obligations or requirements* associated with the provision of *standard control services*.~~

(e) In deciding:

(1) whether to apply a *capital expenditure sharing scheme* to a *Distribution Network Service Provider* for a *regulatory control period*; and

(2) the nature and details of any *capital expenditure sharing scheme* that is to apply to a *Distribution Network Service Provider* for a *regulatory control period*,

the *AER* must:

~~(3) make that decision in a manner that contributes to the achievement of the *capital*~~ *expenditure* ~~*incentive objective*; and~~

(3) take into account:

(i) both the *capital expenditure sharing scheme principles*, and the matters referred to in paragraph (b ~~d~~), as they apply to the *Distribution Network Service Provider*; and

(ii) the circumstances of the *Distribution Network Service Provider*.

## 7.3 *Ex post* review of capital expenditure

### AEMC position

When an NSP exceeds its forecast allowance the Draft Rule allows the AER to determine that the RAB is not increased by the full amount of capital expenditure undertaken over the relevant period. In making its determination the AER is to have regard to the capital expenditure incentive objective and guidelines, the capital expenditure criteria and factors and only take into account information and analysis that the NSP could reasonably be expected to have considered or undertaken at the time it undertook the relevant capital expenditure.

**ENA response**

The ENA maintains the view that financial incentives are the best mechanism for encouraging expenditure behaviour that is consistent with the NEO. An ex-post review of capital expenditure is a particularly difficult mechanism to design and apply without creating undue cost and risk. The ENA therefore considers that the option for an ex-post expenditure review should be removed from the Rules. Should it be maintained it is necessary to improve the guidance to the AER so that it has proper regard to the costs and risks of deciding to adopt such a tool and of undertaking such a review.

A key concern with any form of ex post prudence test is the difficulty in restricting the application of hindsight by a regulator in practice. The implication of this is that a potentially substantial and unmanageable risk is created as no business can meet a hurdle where the prudence assessor is able to learn from subsequent events, either by unconsciously taking account of subsequent facts, or using the subsequent experience to apply more weight to information available at the time than would have been prudent at the time. The ENA considers that an example of this risk has already played out in the NEM with respect to the ACCC's previous ex-post assessment for TransGrid. This case study, along with a number of others that describe the difficulties and protections necessary to properly undertake an ex-post prudence test, can be found in Attachment B.

Given the high likelihood of an ex-post review mechanism imposing new risks that are difficult, if not impossible, for any NSP to manage, it should not be the preferred method for promoting efficient capital expenditure. Added to this, considerable administrative costs for all parties in undertaking such a review imply that the net benefits of an ex-post review mechanism are unlikely to be higher than for ex-ante incentive schemes. The ENA notes that the AER has also identified the difficulties with such an approach in its original Rule change proposal.

Should the AEMC continue with its proposal to include an ex-post review mechanism, then the guidance needs to be improved from that contained in the Draft Rule in order to maximise the net benefit of the measure. A key objective in this respect is to ensure that the AER takes a proportionate approach to undertaking an ex-post assessment, having full regard to all other capital expenditure incentives and measures that might exist.

The ENA strongly advocates that the AEMC reconsider the application of the principles for an ex-post prudence test that were identified in the Joint Expert Report on Capital and Operating Expenditure. This report was attached to the ENA submission to the AEMC's Directions Paper. Particularly important considerations in these draft principles include:

- That a review ought to based on whether expenditures were the result of prudent decision making at the time the relevant investment decisions were taken. This is distinct from a review of 'best practice' or of the 'efficiency' of expenditure. Tests other than for prudency impose significant uncertainty about whether an investment passes the test and increase the scope for hindsight to be inappropriately applied.

- The test should be limited only to large investments that are materially above forecast (or were not included in the forecast of all). This is to recognise the significant costs and burden of undertaking an ex-post prudence test and therefore limiting its application only the most obvious potential candidates for imprudent expenditure.

- The onus of proof should be on the AER to prove that expenditure was imprudent, rather than on the NSP to prove its efficiency. This is to limit the risk that the regulator, in error, does not allow a prudent investment to be rolled into the RAB.

Alternatively, the ENA also notes that the Rules already include a framework for an ex-post prudence test, which is contained in the preceding clauses to the ex-post review mechanism contained in the Draft Rule (S6.2.2 for distribution and S6A.2.2 for transmission). Appropriately, the guidance in these clauses direct the AER to consider matters such as whether expenditure was undertaken in a manner consistent with good industry practice, the desirability of minimising investment uncertainty, and the need to provide effective incentives to NSPs to promote economic efficiency in the provision of the relevant services. As a fall back, the extension of this guidance to the new ex post prudence test clause would be an improvement.

In addition to improving the guiding principles for any ex-post review mechanism, the framework needs to allow for any disallowed capital expenditure to be carried forward. This would be to accommodate a circumstance where the capital expenditure is subsequently used and useful. For instance, if the AER found that a project was undertaken several years too early, it is appropriate that the costs of those assets are recovered from customers once the assets associated with the disallowed capital expenditure are used by customers. The ENA considers that arrangements similar to those that apply in S6.2.1(d) and S6A.2.1(d) would be appropriate for this purpose. This is because these clauses require the AER to have regard to the prudent and efficient value of assets used to provide relevant services, but only to the extent they are used to provide such services.

**Proposed way forward**

The ENA recommends that the AEMC remove the option for the AER to undertake an ex-post review of capital expenditure on the basis that it will increase costs and risks without a corresponding benefit.

Should the option for an ex-post review of capital expenditure be retained the ENA recommends that the AEMC adopt the suggested principles contained in the previously published Joint Expert Report on Capital Expenditure Efficiency and consider the use of the criteria contained in S6.2.2 and S6A.2.2 respectively.

The ENA considers that the drafting could be simplified to refer to the AER reviewing the preceding five year period from the time a revenue proposal is submitted. The ENA considers this is far simpler than the drafting in S6.2.2A(c) and 6A.2.2A(c) respectively.

**Proposed drafting amendments**

**S6.2.2AReduction of amounts by which the value of the regulatory asset base may be increased where certain requirements are satisfied ~~for efficiency of past capital expenditure~~**

…

(c) The *overspending requirement* is satisfied where ~~the sum of~~:

(1) all actual capital expenditure incurred in the five *regulatory years* prior to a *regulatory proposal* being submitted under clause 6.8.2(a) ~~during the previous control period (excluding the last two *regulatory years* of that previous control period); and~~;

~~(2) the actual capital expenditure incurred during the last two *regulatory years* of the *regulatory control period* preceeding the previous control period,~~

exceeds the sum of:

(2) the forecast capital expenditure accepted or substituted by the *AER* for the period in which the capital expenditure referred to in subparagraph (c)(1) (the **review period**) was incurred, subject to any adjustment pursuant to clauses 6.6.5(f) ~~and 6.6A.2(h)~~; and

(3) any capital expenditure that is recovered by way of such part of an *approved pass through amount* as is permitted to be passed through to *Distribution Network Users* during that period less any capital expenditure that is included in a *negative pass through amount* that is required to be passed through to *Distribution Network Users* during that period,

excluding any forecast or actual expenditure that:

(4) represents a margin payable or paid by the *Distribution Network Service Provider* in circumstances where the margin is referable to arrangements that, in the opinion of the *AER*, do not reflect arm's length terms; or

(5) ~~is constituted by the capitalisation of operating expenditure in circumstances where that capitalisation is inconsistent~~ comprises expenditure which was treated as capital expenditure and that ~~capitalisation~~ treatment was ~~is~~ inconsistent with the capitalisation policy submitted to the *AER* under clause S6.1.1(8) in relation to that review period or any part of it.

…

(f) Where the *overspending requirement* is satisfied, and subject to paragraphs (f1), (g) *and* (h), the *AER* may determine that the amount of the capital expenditure as a result of which the previous value of the regulatory asset base would otherwise be increased in accordance with clause S6.2.1(e) should be reduced ~~by such amount as the *AER* is satisfied correspondences to capital expenditure incurred during that period that does not reasonably reflect the *capital expenditure criteria*~~.

(f1) The *AER* may only make a determination under paragraph (f) where the *AER* is satisfied that the amount by which the capital expenditure will be reduced under paragraph (f) is capital expenditure that would not have been incurred by a prudent operator in the circumstances of the *Distribution Network Service Provider*

(g) The amount determined by the *AER* under paragraph (f):

(1) must not be greater than the amount calculated in accordance with paragraph (c);

~~(2) must be determined in a manner that is consistent with the *capital expenditure incentive objective*;~~ and

(2) must be determined taking into account the *Capital Expenditure Incentive Guidelines* that were in operation at the beginning of the relevant *regulatory control period* in which the capital expenditure being assessed was incurred.

(h) In making a determination under paragraph (f), the *AER* must:

(1) have regard to the matters in clause S6.2.2(1) to (7)~~capital expenditure factors~~; and

(2) only take into account information and analysis that the *Distribution Network Service Provider* could reasonably be expected to have considered or undertaken at the time that it undertook the relevant capital expenditure.

## 7.4 Requirement to provide statement on past expenditure efficiency

**AEMC position**

The Draft Rules include a requirement for the AER to include a statement in its draft and final decisions, with supporting reasons, as to the extent to which the roll forward of the regulatory asset base from the previous regulatory control period to the commencement of the new regulatory control period contributes to the achievement of the capital expenditure incentive objectives.

**ENA response**

As indicated in the previous section, a review of previous expenditure is an extremely complex and costly exercise. Imposing an obligation on the AER to review, and make a statement on, the efficiency of all capital expenditure undertaken in the preceding regulatory control period is likely to far outweigh the benefits of doing so. It will require the AER to take on significant additional resources in order to review all the expenditure undertaken by every NSP in their previous regulatory control period. Indeed, it is unclear whether there are sufficient engineering experts in Australia at present to perform this task.

The requirement to provide the statement on the efficiency of all past capital expenditure also ignores the effectiveness that well designed ex-ante incentives can have in encouraging efficient expenditure by NSPs. In a circumstance of well designed ex-ante incentives there is no benefit to be obtained from an extremely costly review of all capital expenditure in the preceding regulatory control period.

Testing the previous efficiency of past capital expenditure also does not provide much information about forecast capital expenditure. Future capital expenditure is driven by future demand conditions and expected costs. As such, an assessment of past capital expenditure can only provide very limited information on what a NSP might need to spend in the future.

It is important for the AEMC to be aware that the requirement to include a statement on the efficiency of past expenditure, in effect, imposes a requirement for the AER to apply the ex-post expenditure review mechanism. The Draft Rules appear to have, appropriately, allowed for the application of the ex-post expenditure review mechanism to be discretionary. However, a requirement to publish an efficiency statement on past capital expenditure in the draft and final decision effectively ties the hands of the AER such that it no longer has discretion on whether to apply S6.2.2A and SA6.2.2A respectively.

The ENA notes in addition that for transmission there is already a requirement for TNSPs to report on historical capital and operating expenditure, including identifying and commenting on any material cost or timing variances, as part of the submission guidelines.[45] Schedule 6.1.1 and 6.1.2 place obligations on DNPS to provide 10 year historic capital and operating expenditure information as well as an explanation of any significant variations.

Finally the AER routinely makes an assessment of historic expenditure in its assessment of forecast operating and capital expenditure and is now obligated to take that into account as a

[45] See: http://www.aer.gov.au/node/10532

factor in the Rules. We believe this gives sufficient discretion to "dig deeper" if the evidence would suggest that further interrogation of historic expenditure is required and the AER could take that information into account when forming a view as to the efficiency and prudency of the forecast.

**Proposed way forward**

On the basis that the present arrangements provide sufficient transparency with respect to past expenditure, the ENA recommends that the AEMC remove the requirement for the AER to make statements about efficiency of past expenditure. The only time such as assessment should be undertaken is if the AEMC decides to retain some form of ex-post prudence test and the AER decides that such an assessment is warranted.

The following proposed clauses should be deleted:

- proposed clause 6.12.2(b);
- proposed clause S6.2.2A;
- proposed clause 6A.14.2(b); and
- proposed clause S6A.2.2A(l).

## 7.5 Capitalisation policy

**AEMC position**

The Draft Rule allows the AER to remove from disallow from the RAB expenditure that has been capitalised in a manner that is inconsistent with an NSP's capitalisation policy.

**ENA response**

The ENA agrees with the AEMC that is appropriate for the AER to have the power to address expenditure that has been capitalised in a manner that is inconsistent with an NSP's capitalisation policy. The ENA has acknowledged that incentive to reclassify operating expenditure as capital expenditure may exist and that it is appropriate for the AER to have the power to respond to this.

The AEMC Draft Rule, however, would remove the inappropriately classified expenditure from the RAB without simultaneously acknowledging it as operating expenditure. Importantly, there is no suggestion that the expenditure is inefficient, but just that it has been wrongly classified as capital. Hence, there is no rationale for excluding the misclassified expenditure from the reported figures altogether. Having this expenditure that has been disallowed in the RAB due to an inconsistency with an NSP's capitalisation policy transferred to operating expenditure is important for two reasons:

- Given the AER's practice in determining forecast operating expenditure, past operating expenditure is an important input into future allowances. Not acknowledging the expenditure removed from past capital as operating expenditure would mean that an NSP's base year operating expenditure may be lower than what it otherwise should be. In turn, this may lead to the NSP receiving a lower allowance than is efficient.

- Recognising the expenditure as operating expenditure is also important for the proper application of the Efficiency Benefits Sharing Scheme. That is, ignoring the expenditure as being operating expenditure would likely impact on the amounts that are carried-over into the next regulatory period.

**Proposed way forward**

The ENA recommend that the AEMC adopt the amendment below to ensure that operating expenditure is properly recognised. Further, the ENA considers that the drafting of the clause could be improved by it referring to capitalised expenditure rather than capitalised operating expenditure. By definition, capitalised expenditure cannot be operating expenditure.

**Proposed drafting amendments**

**S6.1.1 Information and matters relating to capital expenditure**

A *building block proposal* must contain at least the following information and matters relating to capital expenditure:

…

(8) the policy that the *Distribution Network Service Provider* applies in determining whether expenditure is to be treated as capital expenditure (capitalisation policy) ~~capitalising operating expenditure~~.

**S6.2.2A Reduction of amounts by which the value of the regulatory asset base may be increased where certain requirements are satisfied ~~for efficiency of past capital expenditure~~**

(e) The *capitalisation requirement* is satisfied where the amount of the capital expenditure as a result of which the previous value of the regulatory asset base would otherwise be increased in accordance with clause S6.2.1(c) includes ~~capital~~ expenditure that, under the ~~is constituted by the capitalisation of operating expenditure in circumstances where that capitalisation is inconsistent with~~ *Distribution Network Service Provider's* capitalisation policy submitted to the *AER* under clause S6.1.1(8) in relation to that review period or any part of it, should have been treated as operating expenditure.

…

(j) Where the *capitalisation requirement* is satisfied, and subject to paragraph (k), the *AER* may determine that the amount of the capital expenditure as a result of which the previous value of the regulatory asset base would be otherwise be increased in accordance with clause S6.2.1(e) should be reduced by any or all ~~such~~ of the ~~capitalised operating~~ amount of expenditure referred to in paragraph (e) which should have been treated as operating expenditure ~~as is included in the forecast operating expenditure accepted or substituted by the *AER* for the review period~~.

(j1) Where the *AER* makes a determination pursuant to paragraph (j), the *AER* must also make any consequential adjustments to any estimate of actual capital or operating expenditure amounts for the relevant *regulatory period* which reflect the *AER's* determination that expenditure which was treated by the *Distribution Network Service Provider* as capital expenditure should not have been treated as capital expenditure in accordance with the *Distribution Network Service Provider's* capitalisation policy and should have been treated as operating expenditure.

**Drafting note:** consequential amendment to clause S6.2.2A

~~(c)(6)~~ ~~is constituted by the capitalisation of operating expenditure in circumstances where that capitalisation is inconsistent~~ comprises expenditure which was treated as capital expenditure and that treatment was inconsistent with the capitalisation policy submitted to the *AER* under clause S6.1.1(8) in relation to that review period or any part of it.

# 8. Regulatory process

## 8.1 Timing of the regulatory process

**AEMC position**

The AEMC has redefined and aligned the timeframes for distribution and transmission regulatory determination processes to incorporate an additional six months to: extend the time for existing steps; and to add new consultation steps including the publication of an issues paper by the AER and the holding of a public forum.[46] The AEMC has also proposed an optional cross-submissions stage to occur at the AER's invitation. However, if the AER does not invite stakeholders to make submissions on the revised regulatory proposal the cross-submissions stage will not occur.[47]

**ENA response**

The ENA largely supports the AEMC's proposals, however it considers that there remains opportunity to amend the rules to more efficiently streamline the timing of the various steps to the regulatory process and enhance stakeholder engagement.

(a) Streamlining the revised regulatory proposal and service provider's submission on the draft determination and stakeholder submissions

A robust and streamlined consultation process is necessary and desirable to ensure that NSPs and stakeholders can efficiently respond to all relevant information. The draft rules require the revised regulatory proposal to be submitted not more than 45 business days after the draft determination and the NSP's submission on the draft determination to occur not earlier than 40 business days. This drafting leaves open the possibility that:

- an NSP submits its revised regulatory proposal after its submission on the draft determination; and
- stakeholders make submissions on the draft determination, not aware of the matters which the NSP is to incorporate in its revised regulatory proposal to address issues raised by the AER in its draft determination.

When the NSP evaluates the AER's draft determination, it will either:

- make revisions to incorporate the substance of any changes required by or to address matters raised in the draft determination; or
- not make revisions to incorporate the changes required by the draft determination and will address those relevant parts of the draft determination in its submission on the draft determination and continue to seek to persuade the AER of its position.

It should also be noted that an NSP may decide not to submit a revised regulatory proposal if it does not wish to revise any of the positions taken in the original regulatory proposal.

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[46] AEMC, Draft Determination, section 10.7
[47] AEMC, Draft Determination, section 10.8. Draft clauses 6.10.4 and 6A.12.4.

While the revised regulatory proposal and submission on the draft determination have separate functions,[48] both documents inform the AER and stakeholders of the NSP's position on the draft determination – such that it is sensible that they be submitted together in order that they can be responded to together.

To streamline the regulatory process, NSPs should submit at the same time, any revised regulatory proposal and their submission on the draft determination not later than 45 business days after the draft determination. Following this, and not earlier than 55 business days after the publication of the draft determination stakeholders can then make submissions on the entirety of the NSP's response to the draft determination comprising both the revised regulatory proposal and the submission on the draft determination, as well as the AER's draft determination. This way, stakeholders can more meaningfully engage in the regulatory process by responding to all relevant information.

The ENA's recommendations also address any perceived concerns about NSPs deferring their full assessment of the AER's draft determination after submitting the revised regulatory proposal in the submission on the draft determination.[49]

(b) Facilitating full and meaningful consultation by prescribing mandatory consultation

In further pursuit of the AEMC's objective to facilitate full and meaningful consultation by NSPs and stakeholders, the rules should hardwire as mandatory steps:

- stakeholder submissions on the draft determination / revised regulatory proposal / NSP's submission on the draft determination; and
- the cross submissions stage.

In respect of the cross submissions stage, the ENA proposes the rules be limited such that:

- the NSP may only address new matters raised by stakeholders in the submissions those stakeholders have made on the NSP's revised regulatory proposal and submission on draft determination, as well as the AER's draft determination, which it has not otherwise had the opportunity to previously address; and
- enable stakeholders to address new matters raised by other stakeholders in submissions on the draft determination / revised regulatory proposal / NSP's submission on draft determination.

This drafting will continue to reinforce the incentive on NSPs to submit material early in the regulatory process as the limited scope of the cross submissions stage will not provide NSPs with an opportunity to 'have another go' at its submission on the draft determination.

If the AEMC does not adopt the ENA's recommendations and maintains that submissions on the revised regulatory proposal by stakeholders should occur only at the AER's invitation, the ENA's secondary position is that the rules should prescribe that if the AER does exercise that discretion, it follows that the cross submissions process must occur. This affords procedural fairness to the NSP so that they may address new matters raised by stakeholders on which they have not previously had an opportunity to respond.

(c) Extending time to DNSPs to submit pricing proposals

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[48] The revised regulatory proposal is *limited* to address revisions to *incorporate* the substance of any changes required to address matters raised by the AER in its draft determination, whereas the submission on the draft determination enables the service provider to make comment on the AER's draft determination at large.
[49] ENA, *Response to AEMC Directions Paper*, April 2012, p 66.

The ENA previously submitted that the current timeframe for the submission of pricing proposals by DNSPs following the making of the final determination by the AER[50] was relatively short.[51] It is not apparent that the draft rule determination has addressed or otherwise responded to this issue.

The ENA submits that in respect of Chapter 6, the final determination be brought forward by 10 days so that it must be published not later than 10 weeks before the commencement of the regulatory period. This will increase the timeframe between the final distribution determination and the commencement of the new regulatory period to provide DNSPs an extra five days to submit pricing proposals and not place the AER under any additional time pressure to assess and approve the same.

Since the AER's preparation of the final determination may commence from the receipt of any revised regulatory proposal and the NSP's submission on the draft determination, the ENA does not consider that its recommendation will unduly restrict the time the AER has to make the final determination – the AER will have at least five months from the submission of any revised regulatory proposal to prepare and finalise its determination. The ENA proposes that timing of the final determination for transmission networks remain the same – the effect of this will be simply that the AER has slightly more time to make its final determination under Chapter 6A.

**Proposed way forward**

The ENA recommends the following:

- Align the submission of the revised regulatory proposal and NSP's submission on the draft determination to occur not more than 45 days after the publication of the draft determination.

- Stakeholders be provided with a right to make submissions on the AER's draft determination / revised regulatory proposal / NSP's submission on the draft determination at the same time, at least 55 business days after the publication of the draft determination.

- The process for cross-submissions by the service provider and stakeholders be mandatory.

- In respect of Chapter 6 only, bring forward the final determination by 10 days and extend the time which DNSPs submit pricing proposals by an extra five days (from 15 business days to 20 business days).

The ENA has set out these proposed changes to the transmission and distribution regulatory process timeframes in the figures below.[52]

[50] See NER Clause 6.18.2(1)(a).
[51] ENA, *Response to AEMC Directions Paper*, April 2012, p.63.
[52] The ENA has amended the AEMC's proposed regulatory process timeframe contained in the Draft rule determination. Changes to the transmission and distribution regulatory process timeframes reflect the recommendations made in this section. However, the ENA has also relocated the predetermination conference on the draft determination. The rules provide that the predetermination conference is held "for the purpose of explaining the draft determination" – not, as the AEMC has represented, for the additional purpose of explaining the NSP's revised regulatory proposal. It is more logical (and compliant with the rules) that the predetermination conference follow, proximate to, the publication of the draft determination to inform the NSP's preparation of the revised regulatory proposal and stakeholders submissions on the draft determination.

**Proposed drafting amendments**

### 6.10.2 Publication of draft determination and consultation

…

(c) Any person, other than the *Distribution Network Service Provider,* may make a written submission to the AER on the draft distribution determination within the time specified in the invitation referred to in the paragraph (a)(5), which must not be earlier than ~~30 *business days*~~ ~~40 *business days*~~ 55 *business days* after the making of the draft distribution determination.

### 6.10.3 Submission of revised proposal and submission on draft distribution determination

(a) ~~in addition to making written submissions, t~~The *Distribution Network Service Provider* may, not more than ~~30 *business days*~~ 45 *business days* after the publication of the draft distribution, submit to the AER:

(1) a revised regulatory proposal ~~to the AER~~; and

(2) a written submission on the draft distribution determination.

(b) A *Distribution Network Service Provider* may only make the revisions referred to in paragraph (a)(1) so as to incorporate the substance of any changes required to address matters raised by the draft distribution determination or the *AER's* reasons for it.

…

(e) The *AER* ~~may~~, ~~but need not,~~ must invite written submissions on any revised regulatory proposal and the written submission on the draft determination received under clause 6.10.3(1)(a) within the time specified in the invitation referred to in clause 6.10.2(c).

### 6.10.4 Submissions on specified matters

~~If the *AER* invites submission on a revised *regulatory proposal* under clause 6.10.3(e),~~ The *AER* ~~may~~ must invite further written submissions ~~on the submissions received under clauses 6.10.2(c) or 6.10.3(e)~~ by *publishing* an invitation which specifies:

(a) ~~the matters in respect of which submissions are invited~~ that the *Distribution Network Service Provider* and any person may make submissions on new matters raised by other persons in submissions made under clauses 6.10.2(c) and 6.10.3(e); and

(b) the time for making submissions, which must not be earlier than 15 *business days* after the date on which the invitation was published.

### 6.11.2 Notice of distribution determination

The *AER* must as soon as practicable, but not later than ~~2 months~~ 10 weeks before the commencement of the relevant *regulatory control period*, *publish*:

(1) notice of the making of the distribution determination; and

(2) the distribution determination itself; and

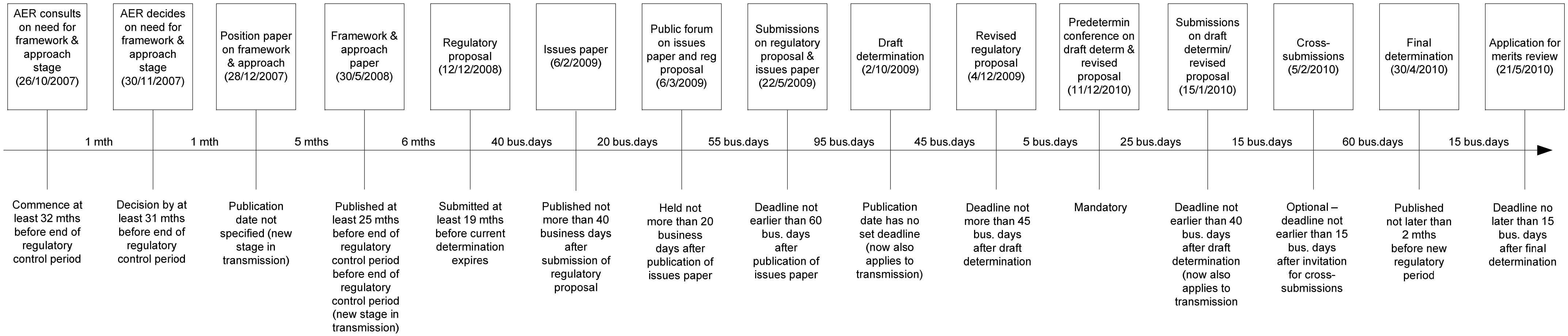
(3) the *AER's* reasons for making the distribution determination in its final form including the constituent decisions i.e. the decisions made in accordance with rule 6.12 on which the distribution determination is predicated.

### 6.18.2 Pricing proposals

(a) A *Distribution* Network *Service Provider* must:

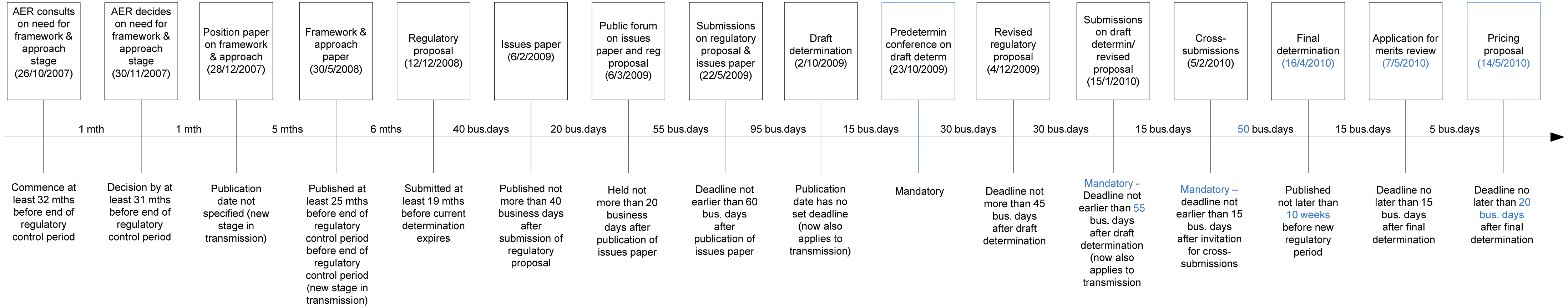
(1) submit to the *AER*, as soon as practicable, and in any case within ~~15~~ 20 *business days*, after *publication* of the distribution determination, a *pricing proposal* (the **initial *pricing proposal***) for the first *regulatory year* of the *regulatory control period*; …

**Example of the new regulatory determination process applicable to DNSPs and TNSPs**




Note: changes to the AEMC's proposed regulatory determination process are highlighted in blue text.

**Example of ENA's proposed regulatory determination process applicable to DNSPs**




Note: ENA changes to the AEMC's proposed regulatory determination process are highlighted in blue text.

## 8.2 Revocation criteria for material errors

### AEMC position

The AEMC has amended the power to revoke and substitute a decision for a material error or deficiency under Chapter 6A to be limited to "computational" errors by the AER or false or misleading information provided to the AER by another party.[53] The AEMC notes that this brings Chapter 6A into line with Chapter 6.[54]

### ENA response

The ENA maintains its position that the rules as presently expressed in relation to revocation and substitution for material errors should remain largely unamended.[55] The AEMC has not identified any deficiency in the existing rules in relation to the correction for material errors in Chapter 6A.

As the ENA previously submitted,[56] the scope of the AER's discretion to correct errors in determinations is yet to be tested. Therefore, risks or benefits posed by the proposed rule change and the extent to which the proposed amendment to clause 6A.15 will in fact promote certainty in the regulatory process or whether it will better contribute to the achievement of the national electricity objective in accordance with s 91A of the NEL cannot be known.

### Proposed way forward

Where no deficiency in the current rules has been demonstrated and no assessment of the risks and benefits posed by the rule change have been undertaken, it is not appropriate or justified to amend the rules as proposed other than the minor changes made to clauses 6.13(c) and 6A.15(c).

## 8.3 Framework and approach paper process

### AEMC position

The draft rule provides for an optional framework and approach paper for distribution as well as transmission. The contents to which the framework and approach paper are to consider have been substantially expanded.

The draft rule permits the AER to trigger consultation on the framework and approach paper if there already is one in place, and in respect of distribution, allows for departures from the classification of services and formulaic expression of the control mechanism as stated in the framework and approach paper where "unforeseen circumstances" justify the departure.[57]

### ENA response[58]

The draft rules enable the AER to apply its subjective judgment in determining whether the framework and approach paper in place may be revisited at the commencement of the

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[53] Draft NER Clause 6A.15.
[54] See NER Clause 6.13.
[55] ENA, *Response to AEMC Directions Paper*, April 2012, pp 77-78. The ENA agrees with the AEMC's proposed amendments to minor draft clauses 6.13(c) and 6A.15(c).
[56] ENA *Response to AEMC Directions Paper*, April 2012, p 77-78.
[57] Draft NER Clauses 6.12.3(b) and (c1).
[58] The ENA response on this matter principally relates to the operation of the electricity distribution rules process. ENA notes electricity transmission businesses will make specific comments on the application of the framework and approach stage in a separate submission. If the AEMC is minded to extend the framework and approach stage to transmission, similar considerations in respect of thresholds for application would apply.

regulatory process – that is, when "*the AER considers that it may be necessary or desirable* to make an amended or replacement framework and approach paper".[59] That drafting essentially gives the AER an unfettered ability to unilaterally decide to amend one or more components of the framework and approach paper as it sees fit.

In light of the significantly expanded role proposed for the framework and approach paper and the AEMC's apparent preference that only the AER be able to trigger the framework and approach paper process, the ENA now simply submits that the framework and approach paper process be mandatory. The ENA has previously proposed that the framework and approach paper process be optional with either the AER or the relevant NSP able to trigger the process. However, given: the expanded role proposed for the framework and approach paper process, and, following from this, the fact that the process will almost inevitably have to be gone through; its proposed extension to TNSPs; and for simplicity of drafting, the ENA submits that it would be preferable for the process to be a mandatory one.

If the AEMC continues to hold the view that the process should be an optional one, the ENA submits that the NSP should be able to trigger consultation on the framework and approach paper when it provides notice to the AER. As noted above, it is proposed that the framework and approach paper be given a significantly expanded role and, including for this reason, it is critical that the NSP also has the ability to trigger the framework and approach stage. This is so that it can meaningfully frame its regulatory process against, for example, new incentive schemes, the AER's proposed forecasting methodologies, as well as the binding components for DNSPs – the classification of distribution services and the formulae for control mechanisms.

If an optional process is maintained with the process being able to be triggered by either the AER or the NSP, consultation with stakeholders on whether or not the framework and approach paper process should be triggered should remain. In practice, third party input would be relevant if neither the AER, nor the NSP triggered a review of the framework and approach paper in place.

In respect of the threshold to depart from the framework and approach paper in Chapter 6,[60] the ENA reasserts its position on the Directions Paper and submits that the "unforeseen circumstances" is not the preferred formulation.[61] That threshold may not be appropriate and adapted to all situations where it is necessary to shift from the service classifications or formulae for control mechanisms specified in the framework and approach paper. For instance, developments in the degree of competition in the provision of an alternative control service may be foreseeable by the NSP during the consultation process on the framework and approach paper, however, the impact on the market for the provision of that service may not crystallise until later during the regulatory process, for example, with the entry of a new market participant. In those circumstances, the reclassification of control services may be necessary, but the inability to satisfy the "unforeseen circumstances" threshold (which requires an event to be not predicted or unexpected) would inflexibly prevent that change.[62]

Since the draft rules require that the framework and approach paper be published approximately 23 months prior to the making of the final determination[63] the happening of a contemplated but otherwise contingent event occurring during that time which alters the services classification would be unsurprising. In light of this, the ENA submits that an

[59] Draft NER clauses 6.8.1(d) and 6A.10.1A(d). Emphasis added.
[60] Draft NER clause 6.12.3(b) and (c1).
[61] ENA Response to AEMC Directions Paper, April 2012, p 74
[62] Macquarie Dictionary, Australian National Dictionary Online.
[63] The framework and approach paper is to be published at least 25 months before the end of the regulatory period and the final determination must be published at least two months prior to the commencement of the new regulatory period.

"unforeseen circumstances" test is too narrow and will obstruct change from those binding elements of the framework and approach paper where necessary.

The preferred threshold for departure from the framework and approach paper would require the service provider to provide evidence to the AER of material which has become available to it after the publication of the framework and approach paper, which justifies the departure from the framework and approach paper. A "new material" threshold ameliorates the inflexibility posed by the "unforeseen circumstances" formulation whilst still preserving discretion to the AER in determining whether the departure is justified.

**Proposed way forward**

The ENA proposes that the proposed rules be amended to:

- revert to the framework and approach paper process being a mandatory one; and
- provide that departures from the services classification and the formulaic expression of the control mechanism may occur when the NSP provides evidence of new material which has become available to it only after the publication of the framework and approach paper and that material justifies the departure.

**Proposed drafting amendments**

### 6.8.1 AER's framework and approach paper

(a) The *AER* must *prepare* and publish a *framework and approach paper* in anticipation of every distribution determination.

~~make and *publish* a document (a *framework and approach paper*) that applies in respect of a distribution determination for a matter listed in paragraph (b) in accordance with this clause if:~~

~~(1) there is no *framework and approach paper* that applies in respect of that distribution determination for that matter; or~~

~~(2) there is a *framework and approach paper* that would apply in respect of that distribution determination for a matter, but the *AER* considers it necessary or desirable to make and publish an amended or *replacement framework and approach paper* in so far as it relates to that matter.~~

(b) A *framework and approach paper* must set out:

(1) the *AER's* decision (together with its reasons for the decision) on the following matters:

(i) the form (or forms) of the control mechanisms;

(ii) as to whether or not Part J of Chapter 6A is to be applied to determine the pricing of *transmission standard control services* provided by any *dual function assets* owned, controlled or operated by the *Distribution Network Service Provider*.

**Note**

See cl. 6.25(6).

(2) the *AER's* proposed approach (together with its reasons for the decision) to the following matters:

(i) the classification of *distribution services* under this Chapter;

(ii) the formulae that give effect to the control mechanisms referred to in subparagraph (1)(i);

(iii) the application to the *Distribution Network Service Provider* of any *service target performance incentive scheme*;

(iv) the application to the *Distribution Network Service Provider* of any *efficiency benefit sharing scheme*;

(v) the application to the *Distribution Network Service Provider* of any *capital expenditure sharing scheme*;

(vi) the application to the *Distribution Network Service Provider* of any *demand management and embedded generation connection incentive scheme*;

(vii) the application to the *Distribution Network Service Provider* of any *small-scale incentive scheme*.~~;~~

(viii) the ~~methodology~~ forecast expenditure assessment techniques that the *AER* will use ~~is to be used~~ as part of its assessment ~~assess for the preparation~~ of forecasts of operating expenditure and capital expenditure that are to be included in the *Distribution Network Service Provider's building block* ~~*regulatory*~~ *proposal*~~, which may be the *standard expenditure forecasting methodology* or some different methodology~~.

(c) A *framework and approach paper* is to be prepared in consultation with the relevant *Distribution Network Service Provider* and with other interested stakeholders.

(d) Where a distribution determination applies to a *Distribution Network Service Provider* and none of the *AER*, the *Distribution Network Service Provider* or an interested stakeholder submits that it is necessary or desirable to amend or replace the approach that has been taken in that distribution determination to a matter listed in paragraph (b), the *AER* is not required to consult on that matter and the approach to that matter in the *framework and approach paper* is that set out in the distribution determination that applies to the *Distribution Network Service Provider* in the regulatory period preceding the regulatory period in respect of which the *framework and approach paper* is being prepared.

(e) The *AER* must commence preparation of, and consultation on, the *framework and approach paper* at least 32 months before the commencement of the distribution determination in respect of which the *framework and approach paper* is to apply.

~~(c) If there is a *framework and approach paper* that would apply in respect of the distribution determination for a matter listed in paragraph (b) then, no later than 32 months before the end of the *regulatory control period* that precedes that for which the distribution determination is to be made, the *AER* must *publish* a notice inviting submissions on whether it is necessary or desirable to amend or replace that *framework and approach paper* in so far as it related to that matter;~~

~~(d) If there is a *framework and approach* paper that would apply in respect of the distribution determination for a matter listed in paragraph (b) and the *AER* considers that it may be~~

~~necessary or desirable to make an amended or replacement *framework and approach paper* that applies in respect of that matter, then, no later than 31 months before the end of the *regulatory control period* that precedes that for which the distribution determination is to be made, the *AER* must:~~

~~(1) make and *publish* its decision to that effect; and~~

~~(2) give its reasons for that decision.~~

~~(d1) In making a decision under paragraph (d), the *AER* must have regard to any submissions made in response to the invitation under paragraph (c).~~

(f) ~~Where paragraph (a) applies then, a~~ At least 25 months before the commencement of the distribution determination in respect of which the *framework and approach paper* is to apply ~~end of the current *regulatory control period*~~, the *AER* must~~, after consulting with the relevant *Distribution Network Service Provider* and other persons as the *AER* considers appropriate,~~ make, amend or replace the *framework and approach paper*, as the case may be; and

(1) give a copy of it to the relevant *Distribution Network Service Provider*; and

(2) *publish* it,

as soon as is reasonably practicable.

(g) Subject to clauses 6.12.3 and 6.25(d), a *framework and approach paper* is not binding on the *AER* or a *Distribution Network Service Provider*.

(h) The *AER* may make and *publish* a *framework and approach paper* that applies in respect of a distribution determination for a matter that is not listed in paragraph (b) and, if it does so, this clause 6.8.1 applies as if that matter were listed in paragraph (b).

### 6.12.3 Extent of AER's discretion in making distribution determinations

(a) Subject to this clause and other provisions of this Chapter 6 explicitly negating or limiting the *AER's* decision, the *AER* has a discretion to accept or approve, or to refuse to accept or approve, any element of a regulatory proposal.

~~(b) The classification of services must be as set out in the relevant *framework and approach paper* unless the *AER* considers that, in the light of the *Distribution Network Service Provider's regulatory proposal* and the submissions received, there are good reasons for departing from the classification proposed in that paper.~~

(b) The classification of *distribution services* must be as set out in the relevant *framework and approach paper* unless the AER is satisfied that material which has become available after the publication of that paper justifies a departure ~~considers that unforeseen circumstances justify departing~~ from the classification as set out in that paper.

~~(c) The control mechanism must be as set out in the relevant framework and approach paper.~~

(c) The form of the control mechanism must be as set out in the relevant *framework and approach paper.*

(c1) The formulae that give effect to the control mechanisms referred to in paragraph (c) must be as set out in the relevant *framework and approach paper* unless the *AER* is satisfied that material which has become available after the publication of that paper justifies a departure ~~considers that unforeseen circumstances justify departing~~ from the formulae as set out in the paper.

## 8.4 AER reliance on unpublished information

### AEMC position

The draft rules require the AER to use its "best endeavours" to publish analysis on which it proposes to rely upon or refer to, prior to the making of the final determination.[64] The AEMC acknowledges that section 16(1)(b) of the NEL prevails over the "best endeavours" clause to the extent of any inconsistency.[65]

### ENA response

The ENA strongly agrees with the AEMC that to extent that there was any inconsistency between section 16(1)(b) of the NEL and the "best endeavours" clause, section 16 prevails to require the AER to inform the service provider of material issues under consideration, even if, after undertaking its best endeavours, it does not publish its analysis prior to making the final determination.

In the absence of any detailed judicial consideration of section 16 of the NEL, the interaction between that provision and the rules is unclear and will have to be considered on a case by case basis. In any case, it would be rare for the AER to not have progressed draft reports with its consultants / experts or prepared earlier versions of models prior to a determination, particularly in light of the AEMC's proposal to commence the regulatory process six months earlier to facilitate additional consultative steps at the front end of the regulatory process.

For that reason, it should only be in exceptional circumstances that the AER does not publish its analysis prior to the making of its final determination. From the perspective of transparency and accountability, the ENA submits that the rules proposed to be made by the AEMC should be amended to require the AER to provide notice to the NSP and stakeholders when making its final determination where it has relied upon or referred to analysis it has not published, as well as identify that analysis and provide reasons why it was unable to make that analysis available prior to the making of the final decision.

The ENA also observes that in relocating the obligation on the AER to have regard to its analysis from the capex / opex criteria to Part E of the rules, the AEMC has adopted the Chapter 6A formulation of that obligation,[66] rather than the Chapter 6 formulation – that is, the AEMC's draft rule, requires the AER to have regard to any analysis undertaken by or for it, that is published prior to the making of the final decision **or as part of the final decision**.[67] The current chapter 6 opex / capex criterion requires the AER to have regard to analysis published

[64] Draft NER Rules 6.11.1 and 6A.13.1.
[65] AEMC, Draft Determination, p.115
[66] Clauses 6.5.6.(e)(3) and 6.5.7(e)(3).
[67] For example, draft clause 6.11.1(b) states:
*In making a distribution determination in relation to the Distribution Network Service provider, and subject to rule 6.14, the AER must have regard to each of the following:*
…
*(3) any analysis undertaken by or for the AER that is published **prior to the making of the distribution determination or as part of the distribution determination.***

prior to the final decision.[68] It is unclear why the Chapter 6A formulation was adopted, other than, the general objective to create consistency in the expression of Chapters 6 and 6A.[69]

In order to promote objectives identified by the AEMC for the regulatory process – that is, to improve transparency and accountability in regulatory decision making[70] – the Chapter 6 formulation should be adopted in clauses 6.11.1(b)(3) and 6A.13.1(a1)(3). This way, the AER, in *having regard to* analysis it publishes prior to the final decision, will be required to give fundamental weight to that analysis, over and above analysis that it does not publish prior to the final decision. This would not prevent the AER from referring or relying upon analysis which it had not published prior to the final decision or it published as part of the final decision – while the AER is to use its best endeavours to make available its analysis prior to the final decision, that course is not mandatory.

By requiring the AER to give greater weight to analysis it publishes prior to the final decision and give less weight to analysis it publishes as part of, or after, the final decision, the NSP and stakeholders will have greater confidence that regulatory decisions are principally based upon information that has been tested and scrutinised, as well as greater assurance about the robustness of the AER's decision making.

**Proposed way forward**

The draft rules should be amended to require the AER to:

- provide notice when it has relied upon or referred to material that it has not published prior to the final decision;
- identify reasons why any material it has relied upon but not published prior to the distribution determination could not be made available; and
- give fundamental weight to material it has published prior to the final decision.

**Proposed drafting amendments**

**6.11.1 Making of distribution determination**

~~Subject to rule 6.14(a), the *AER* must consider any submissions made on the draft distribution determination, or on any revised regulatory proposal submitted to it under clause 6.10.3, and must make a distribution determination in relation to the *Distribution Network Service Provider*.~~

(a) The *AER* must make a distribution determination in relation to the *Distribution Network Service Provider.*

(b) In making a distribution determination in relation to the *Distribution Network Service Provider,* and subject to rule 6.14, the *AER* must have regard to each of the following:

(1) the information included in or accompanying the *regulatory proposal;*

(2) written submissions received under this Part E; and

[68] Clauses 6A.6.6(e)(3) and 6A.6.7(e)(3).
[69] AEMC, Draft Determination, p ii.
[70] AEMC, Draft Determination, p 20.

(3) any analysis undertaken by or for the *AER* that is published prior to the making of the distribution determination ~~or as part of the distribution determination.~~

(c) The *AER* must use its best endeavours to *publish*, a reasonable time prior to the making of the distribution determination, any analysis undertaken by or for it on which it proposes to rely, or to which it proposes to refer, for the purposes of the distribution determination.

(d) If the *AER* does not publish any analysis in accordance with paragraph (c), the *AER* must, in the distribution determination, identify the analysis that was not published and provide reasons why the *AER* was unable to make that analysis available prior to the making of the distribution determination.

Energy Networks Association

4 October 2012.

# 9. Attachments

**Attachment A – Consolidated proposed amendments to draft rules**

**Attachment B – Review of case studies of ex post review mechanisms**

**Attachment A**

# Consolidated proposed amendments to draft rules

## 10.1 Drafting Amendments to National Electricity Rules (Chapter 6)

# 4. Cost of capital estimation framework

### 6.5.2 Return on capital

…

(b) The *allowed rate of return* for a *Distribution Network Service Provider* ~~must correspond to~~ is to be commensurate with the benchmark efficient financing costs of an ~~benchmark efficient~~ entity ~~with~~ facing a similar degree of risk as that which applies ~~to the *Distribution Network Service Provider*~~ in respect of the provision of *standard control services* (the *allowed rate of return objective*).

### 6.5.2 Return on capital (Amendment to clause 6.5.2 (c)(2))

…

(2) on a nominal ~~post-tax~~ vanilla basis that is consistent with the estimate of the value of imputation credits referred to in clause 6.5.3; and

### 6.5.2 Return on capital (Amendment to clause 6.5.2 (d))

…

(d) In determining the *allowed rate of return*, regard must be had to~~:~~

~~(1) the desirability of using an approach that leads to the consistent application of any estimates of financial parameters that are relevant to the estimates of, and that are common to, the return on equity and the return on debt; and~~

~~(2)~~ any interrelationships between estimates of financial parameters that are relevant to the estimates of the return on equity and the return on debt.

### 6.5.2 Return on capital (Amendments to paragraphs (j) – (o) of clause 6.5.2 (note these paragraphs have been renumbered due to insertion of new paragraphs))

(m) The *AER* must, in accordance with ~~the *distribution consultation procedures*~~ this clause 6.5.2 make and publish guidelines (the *Rate of Return Guidelines*)~~, except that the first *Rate of Return Guidelines* must be made in accordance with paragraph (m) and not the *distribution consultation procedures*~~.

(n) Subject to paragraph (o), a *Rate of Return Guideline* only applies to distribution determinations in respect of which the *framework and approach paper* was published after publication of the *Rate of Return Guideline*.

(o) A *Rate of Return Guideline* may only apply to a distribution determination in respect of which the *framework and approach paper* was published prior to publication of the *Rate of Return Guideline* if the *Distribution Network Service Provider* to which the distribution determination will apply consents to such application.

(p) A distribution determination to which a *Rate of Return Guideline* applies must be consistent with the *Rate of Return Guideline* unless there are reasons and evidence in support of a departure from the *Rate of Return Guideline*.

(q) The *Rate of Return Guidelines* must set out:

~~(1) the methodologies that the AER proposes to use in estimating the allowed rate of return, including how those methodologies are proposed to result in the determination of a return on equity and a return on debt in a way that is consistent the allowed rate of return objective; and~~

~~(2) the estimation methods, financial models, market data and other evidence the AER proposes to take into account in estimating the return on equity, the return on debt and the value of imputation credits referred to in clause 6.5.3.~~

(1) in relation to the return on equity:

(i) the financial models which the *AER* proposes to use in determining the return on equity;

(ii) for each parameter in the applicable financial models, either a value which the *AER* proposes to use or the information and data sources which it proposes to use to derive such a value;

(iii) the way in which the *AER* proposes to use the financial models, information and data sources to derive a value for the return on equity; and

(iv) an estimate of the return on equity which would apply as at the date of publication of the *Rate of Return Guidelines*, based on the *AER's* ~~proposed~~ use of the financial models, information and data sources;

(2) in relation to the return on debt:

(i) the form of debt finance which will be used to determine benchmark efficient debt financing costs of an entity with a similar nature and degree of risk as that which applies to a *Distribution Network Service Provider* in respect of the provision of *standard control services*;

(ii) the information and data sources which the *AER* proposes to use to determine the return on debt applicable to the relevant form of debt finance as at any point in time; and

(iii) an estimate of the return on debt which would apply as at the date of publication of the *Rate of Return Guidelines*, based on the *AER's* proposed form of debt finance and proposed information and data sources;

(3) the relative proportions of equity and debt finance that would be employed by an efficiently financed 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 (as referred to in clause 6.5.2(c)(1); and

(4) the value of imputation credits referred to in clause 6.5.3.

(r) A Rate *of Return Guideline* must be accompanied by a statement of reasons setting out:

(1) the evidence relied upon by the AER in formulating the guideline; and

(2) reasons and evidence supporting:

(i) for the first *Rate of Return Guideline*, any change in approach from the Statement of Regulatory Intent, in respect of any of the matters referred to in clause 6.5.2(p) which are addressed in the Statement of Regulatory Intent;

(ii) for any subsequent *Rate of Return Guideline*, any change in approach from the previous *Rate of Return Guideline*, in respect of any of the matters referred to in clause 6.5.2(p).

(s) For the purposes of paragraph (r), Statement of Regulatory Intent means the '*Statement* of regulatory intent on the revised WACC parameters (distribution)' issued by the *AER* on 1 May 2009, pursuant to clause 6.5.4 of the *Rules*.

(t) The *AER* must publish the first *Rate of Return Guideline* by [29 ~~August~~ December 2013] and there *must* be *Rate of Return Guideline* in force at all times after that date.

(u) For the purpose of *making* the first *Rate of Return Guideline*, the *AER* must:

(1) by no later than [29 March 2013], publish a consultation paper that sets out its preliminary views on the material issues that are to be addressed by the *Rate of Return Guidelines;*

(2) publish an invitation for written submissions on the consultation paper, with such submissions to be made within the time specified in the invitation (which must not be earlier than ~~30~~ 60 business days after the invitation for submissions is published);

(3) by no later than ~~31 July~~ 15 August 2013, publish a draft of the *Rate of Return Guidelines*; and

(4) publish an invitation for written submissions on the draft *Rate of Return Guidelines*, with such submissions to be made within the time specified in the invitation (which must not be earlier than ~~30~~ 60 business days after the invitation for submissions is published).

(v) The *AER* must~~, in accordance with the *distribution consultation procedures*,~~ review the *Rate of Return Guidelines*:

(1) at intervals not exceeding ~~three~~ four years, with the first interval starting from the date referred to in paragraph (t~~l~~); and

(2) at the same time as it reviews the Rate of Return Guidelines made under clause 6A.6.2.

(w) A *review* of the *Rate of Return Guidelines* under paragraph (v) must be conducted in accordance with the *distribution consultation procedures,* subject to:

(1) the reference in clause 6.16(c) to 30 *business days* being read as a reference to 60 *business days*; and

(2) the reference in clause 6.16(e) to 80 *business days* being read as a reference to 180 *business days*.

(x) For the avoidance of doubt, nothing prevents the *AER* from publishing the *Rate of Return Guidelines* made *under* this clause 6.5.2 in the same document as the *Rate of Return Guidelines* made under clause 6A.6.2.

# 5. Return on debt estimation

**6.5.2 Return on capital (Amendments to paragraphs (f) – (l) of clause 6.5.2 (note some of these paragraphs have been renumbered due to insertion of new paragraphs).**

(f) 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 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 (l~~i~~).

(g) A *building block proposal* must include a methodology for estimating the return on debt which the *Distribution Network Service Provider* considers is consistent with the *allowed rate of return objective* and the *return on debt methodology principles*.

(h) The *AER* must accept the methodology for estimating the return on debt that included in a *building block proposal* if the *AER* is satisfied that the proposed methodology is consistent with the *allowed rate of return objective* and the *return on debt methodology principles*.

(i) If the *AER* is not satisfied as referred to in paragraph (h), the methodology for estimating the return on debt must be the same as the methodology that applied to the *Distribution Network Service Provider* in the immediately preceding *regulatory control period*.

(j) Subject to paragraph (f), the methodology adopted to estimate the return on debt may, without limitation, be designed to result in the return on debt reflecting:

(1) the return that would be required by debt investors in a benchmark efficient entity if it raised debt at the time or shortly before the making of the distribution determination for the *regulatory control period*;

(2) the average return that would have been required by debt investors in a benchmark efficient entity if it raised debt over an historical period prior to the time when the distribution determination for that *regulatory control period* is made; or

(3) some combination of the returns referred to in subparagraphs (1) and (2).

(k) In determining whether the methodology adopted to estimate the return on debt for a *regulatory year* is ~~estimated in a way that is~~ consistent with the *allowed rate of return objective*, regard must be had to the following ~~factors~~ principles (the *return on debt* methodology *principles*):

~~(1) the likelihood of any significant differences between the costs of servicing debt of a benchmark efficient entity referred to in subparagraph (c)(1) and the return on debt over the regulatory control period;~~

~~(2) the impact on electricity consumers, including due to any impact on the return on equity of a benchmark efficient entity referred to in subparagraph (c)(1);~~

~~(3) the incentive effects of inefficiently delaying or bringing forward capital expenditure; and~~

~~(4) the impact of changing the methodology for estimating the return on debt across regulatory control periods.~~

(1) that the return on debt should allow for recovery by a *Distribution Network Service Provider* of the expected cost of debt financing over the life of the assets used to supply *standard control services* (including to the extent that the life of these assets may extend over more than one *regulatory control period*); and

(2) that the methodology adopted to estimate the return on debt should reflect the efficient financing costs of a prudent operator in the circumstances of the *Distribution Network Service Provider*.

(l) A methodology referred to in paragraph (f)(2)(ii) must provide for any change in ~~the Distribution Network Service Provider's annual revenue requirement for the regulatory year that would result from a change to the allowed rate of return for that regulatory year, as a result of~~ the return on debt ~~for that~~ as between different *regulatory years* within the same *regulatory control period* ~~being different from that estimated under subparagraph (f),~~ to be effected through the automatic application of a formula that is specified in the distribution determination.

# 6. Capital and operating expenditure forecasting

### 6.5.4 Expenditure forecast ~~methodology~~ assessment techniques

(a) The *AER* must, in accordance with the *distribution consultation procedures*, develop and *publish* ~~a methodology~~ the assessment techniques that it may use in determining whether it is satisfied that the total of the forecast operating expenditure or forecast capital expenditure of a *Distribution Network Service Provider* included in a *building block proposal* reasonably reflects the *operating expenditure criteria* or the *capital expenditure criteria*, as relevant ~~for the preparation of forecasts of operating expenditure and capital expenditure that are included in *Distribution Network Service Providers'* regulatory proposals~~ (~~the *standard*~~ *forecast expenditure* ~~*forecasting methodology*~~ *assessment techniques*).

(b) Subject to paragraph (c), the *AER* may, from time to time and in accordance with the *distribution consultation procedures*, amend the ~~*standard*~~ *forecast expenditure* ~~*forecasting methodology*~~ *assessment techniques*.

(c) The *AER* may make administrative or minor amendments to the ~~*standard*~~ *forecast expenditure* ~~*forecasting methodology*~~ *assessment techniques* without complying with the *distribution consultation procedures*.

(d) The *AER* must *publish* the first ~~*standard*~~ *forecast expenditure* ~~*forecasting methodology*~~ *assessment techniques* by [~~30~~ 28 June 2013], and there must be ~~*standard*~~ *forecast expenditure* ~~*forecasting methodology*~~ *assessment techniques* in force at all times after that date.

### 6.8.1A Notification of expenditure forecasting methodology

(a) A *Distribution Network Service Provider* must advise the *AER* of the expenditure forecasting methodology that the *Distribution Network Service Provider* proposes to adopt in developing the forecast operating expenditure and forecast capital expenditure for its *building block proposal* at the same time or as soon as practicable after, the *AER* commences preparation of, and consultation on, the relevant *framework and approach paper* under clause 6.8.1(e).

(b) Subject to any claim for confidentiality, the *AER* may *publish* details of the expenditure forecasting methodology provided to it pursuant to paragraph (a) and consult on that methodology as part of the *framework and approach paper*.

### 6.5.6 Forecast operating expenditure

(c) The *AER* must accept the forecast of required operating expenditure of a *Distribution Network Service Provider* that is included in a *building block proposal* if the *AER* is satisfied that the total of the forecast operating expenditure for the *regulatory control period* reasonably reflects each of the following (the *operating expenditure criteria*):

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

(2) the costs that a prudent operator in the circumstances of the relevant *Distribution 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*.

### 6.6.4 Small-scale incentive scheme

(a) The *AER* may, in accordance with the *distribution consultation procedures*, develop and *publish* an incentive scheme or schemes (*small-scale incentive scheme*) that provides *Distribution Network*

*Service Providers* with incentives to provide *standard control services* in a manner that contributes to the achievement of the *national electricity objective*.

(b) In developing a *small-scale incentive scheme*, the *AER* must have regard to the following requirements:

(1) *Distribution Network Service Providers* should be rewarded for efficiency gains in respect of their *distribution systems*, and penalised for efficiency losses in respect of their *distribution systems*;

(2) the rewards and penalties should be commensurate with the efficiency gains or efficiency losses in respect of a *distribution system*, but a reward for efficiency gains need not correspond in amount to a penalty for efficiency losses , however, if it is anticipated that the operation of the scheme will result in penalties exceeding rewards, the scheme must provide for inclusion in forecast operating expenditure an amount that compensates the *Distribution Network Service Provider* for the expected net cost under the scheme;

(3) penalties should not be imposed on *Distribution Network Service Providers* that act in an efficient manner, in terms of both the degree and timing of that action;

(4) the benefits to electricity consumers that are likely to result from efficiency gains in respect of a *distribution system* should warrant the rewards provided under the scheme, and the detriments to electricity consumers that are likely to result from efficiency losses in respect of a *distribution system* should warrant the penalties provided under the scheme;

(5) the scheme should be consistent with other incentives that *Distribution Network Service Providers* may have under the *Rules* and under any other incentive schemes; ~~and~~

(6) the scheme should not be inconsistent with any applicable *regulatory obligations or requirements* associated with the provision of *standard control services*; and

(7) that the benefits arising from the scheme should exceed the costs of the development, implementation and administration of the scheme, which, for the avoidance of doubt, includes the costs incurred by the *AER* and *Distribution Network Service Providers*.

(c) The AER may, from time to time and in accordance with the *distribution consultation procedures*, amend or replace any *small-scale incentive scheme*.

(d) Where the *AER* applies a small-*scale incentive scheme* to a *Distribution Network Service Provider* for a *regulatory control period*:

(1) the aggregate rewards or penalties for a *regulatory year* in that *regulatory period* that are provided or imposed under that scheme and any other *small-scale incentive schemes* that apply to that *Distribution Network Service Provider* must not exceed 0.5% of the *annual revenue requirement* for the *Distribution Network Service Provider* for that *regulatory year* unless the *Distribution Network Service Provider* consents to the contrary, in which case that aggregate must not exceed 1% of the *annual revenue requirement* for the *Distribution Network Service Provider* for that *regulatory year*; and

(2) the *small-scale incentive scheme* must cease to provide rewards or impose penalties in respect of a *regulatory year* after the expiry of such a period as is determined by the *AER*, being a period that is not more than two *regulatory control periods* after the commencement of that scheme.

(e) Notwithstanding anything else contained in this clause, the *AER* may require a Distribution *Network Service Provider* to participate in a trial of a *small-scale incentive scheme* under which, for the duration of that trial, the *Distribution Network Service Provider* is not required to bear any penalty and is not entitled to earn any reward.

(f) Unless a *Distribution Network Service Provider* otherwise consents, the *AER* may only apply a *small-scale incentive scheme* in a distribution determination where that *small-scale incentive scheme* had been *published* by the *AER* no less than 32 months prior to the commencement of that distribution determination.

**6.5.6 Forecast operating expenditure**

...

(e) In *deciding* whether or not the *AER* is satisfied as referred to in paragraph (c), the *AER* must have regard to the following (the operating expenditure factors)...

(4) relevant benchmarking material that takes into account differences in the environments of different *Distribution Network Service Providers*, including ~~the most recent~~ *annual benchmarking reports* ~~that has been~~ *published* under rule 6.27, and the benchmark efficient operating expenditure that would be incurred by an efficient *Distribution Network Service Provider* over the relevant *regulatory control period*;...

**6.5.7 Forecast capital expenditure**

...

(e) In deciding whether or not the *AER* is satisfied as referred to in paragraph (c), the *AER* must have regard to the following (the capital expenditure factors)...

(4) relevant benchmarking material that takes into account differences in the environments of different *Distribution Network Service Providers*, including ~~the most recent~~ *annual benchmarking reports* ~~that has been~~ *published* under rule 6.27, and the benchmark efficient capital expenditure that would be incurred by an efficient *Distribution Network Service Provider* over the relevant *regulatory control period*;...

**Definition of "materially"**

For the purposes of the application of clause 6.6.1, an event results in a *Distribution Network Service Provider* incurring materially higher or materially lower costs if the change in the total of operating and capital expenditure ~~costs~~ (as opposed to the revenue impact) that the *Distribution Network Service Provider* has incurred and is likely to incur in any *regulatory year* of a *regulatory control period*, as a result of that event either in isolation or together with any other *pass through event* which occurs in the same *regulatory year* as the first event, exceeds 1% of the *annual revenue requirements* for the *Distribution Network Service Provider* for that *regulatory year*.

**6.6.1 Cost pass through**

**Positive pass through**

...

(c1) Where the *Distribution Network Service Provider* is seeking the approval of the *AER* to pass through to *Distribution Network Service Users* a *positive pass through amount* in respect of more than one *positive change event* where those events have occurred during the same *regulatory year*, the *Distribution Network Service Provider* is required to submit the written statement referred to in paragraph (c) to the *AER* within 90 *business days* of the later of the *positive change events* occurring.

**Negative pass through**

...

(f2) Where the *Distribution Network Service Provider* is required to submit to the *AER* a written statement pursuant to paragraph (f) and that statement is in respect of more *than* one *negative change event* where those events have occurred during the same *regulatory year*, the *Distribution Network Service Provider* is required to submit the written statement referred to in paragraph (f) to the *AER* within 90 *business days* of the later of the *negative change events* occurring.

# 7. Capital expenditure incentive mechanisms

## 6.4A Capital expenditure incentive mechanisms

~~(a)~~ ~~The *capital expenditure incentive objective* is to ensure that, where the value of a regulatory asset base is subject to adjustment in accordance with the *Rules*, then (except as otherwise provided in the *Rules*) the only capital expenditure that is included in an adjustment that increases the value of that regulatory asset base is capital expenditure that reasonably reflects the *capital expenditure criteria*.~~

(a) The *AER* must, in accordance with the *distribution consultation procedures*, make and *publish* guidelines (the *Capital Expenditure Incentive Guidelines*) that set out:

(1) any *capital expenditure sharing schemes* developed by the *AER* in accordance with clause 6.5.8A, and how the *AER* has taken into account the *capital expenditure sharing scheme principles* in developing those schemes;

(2) the manner in which it proposes to make determinations under clause S6.2.2A(a) if the *overspending requirement* is satisfied;

(3) the manner in which it proposes to determine whether depreciation for establishing a regulatory asset base as at the commencement of a *regulatory control period* is to be based on actual or forecast capital expenditure;

(4) the manner in which it proposes to assess capital expenditure that represents a margin that is paid by a *Distribution Network Service Provider* in circumstances where the margin is referable to arrangements that, in the opinion of the *AER*, do not reflect arm's length terms; ~~and~~

(4a) the manner in which it proposes to make determinations under clause S6.2.2A(j) where the *capitalisation requirement* is satisfied; and

(5) the manner in which it proposes to approach what *capital expenditure incentive scheme*, combination of *capital expenditure incentive schemes*, or combination of *capital expenditure incentive schemes* and any other incentive scheme, should apply to a *Distribution Network Service Provider* in a *regulatory period* ~~how each scheme and proposal referred to in subparagraphs (1) to (4) and all of them taken together, are consistent with the *capital expenditure incentive objective*~~.

(c) The *AER* must publish the first *Capital Expenditure Incentive Guidelines* by [30 August *2013*], and there must be *Capital Expenditure Incentive Guidelines* in force at all times after that date.

## S6.2.2A Reduction of amounts by which the value of the regulatory asset based may be increased where certain requirements are satisfied ~~for efficiency of past capital expenditure~~

…

(g) The amount *determined* by the *AER* under paragraph (f):

(1) must not be greater than the amount calculated in accordance with paragraph (c);

~~(2)~~ ~~must be determined in a manner that is consistent with the *capital expenditure incentive objective*;~~ and

(2) must be determined taking into account the *Capital Expenditure Incentive Guidelines* that were in operation at the beginning of the relevant *regulatory control period* in which the capital expenditure being assessed was incurred.

...

(k) ~~A determination made under paragraph (i) or (j) must be consistent with the *capital expenditure incentive objective* and, i~~In making ~~such~~ a determination under paragraph (i), the *AER* must take into account the *Capital Expenditure Incentive Guidelines* that were in operation when the arrangements that gave rise to the margin being payable or paid by the *Distribution Network Service Provider*.

(l) In making a determination under paragraph (j) the *AER* must take into account the *Capital Expenditure Incentive Guidelines* that were in operation when the relevant capital expenditure was incurred. ~~Nothing in this clause S6.2.2A is to be taken to preclude the *AER* from:~~

~~(1) requiring a *Distribution Network Service Provider* to provide such information; or~~

~~(2) undertaking such analysis,~~

~~as the *AER* considers appropriate to enable it to make a statement, with supporting reasons, as referred to in clause 6.12.2(b).~~

**S6.2.2B Depreciation**

(a) Pursuant to clause 6.12.1(18), the *AER* must decide, for a distribution determination, whether depreciation for establishing the regulatory asset base for a *distribution system* as at the commencement of the following *regulatory control period* is to be based on actual or forecast capital expenditure.

~~(b) The decision referred to in paragraph (a) must be consistent with the *capital expenditure incentive objective*.~~

(b) In making the decision referred to in paragraph (a), the *AER* must have regard to:

(1) the incentives that the *Distribution Network Service Provider* has in relation to undertaking efficient capital expenditure, including as a result of the application of any ~~*service target performance*~~ incentive scheme or any other incentives under the *Rules*;

(2) the substitution possibilities between assets with relatively short economic lives and assets with relatively long economic lives and the relative benefits of such asset types;

(3) any determination made by the *AER* under clause S6.2.2A(j) ~~the extent to which any capital expenditure incurred by the *Distribution Network Service Provider* has exceeded the corresponding amount of forecast capital expenditure accepted or substituted by the *AER* and the amount of that excess expenditure [which] is not efficient~~;

(4) the *Capital Expenditure Incentive Guidelines* that were in operation at the time the *framework and approach paper* which applies to the distribution determination being made was *published*.; and

(5) the *capital expenditure factors*.

**6.5.8A Capital expenditure sharing scheme**

(a) A *capital expenditure sharing scheme* is a scheme developed for *Distribution Network Service Providers* that is designed to share the benefits of efficiency gains and efficiency losses in a manner that promotes the *national electricity objective* ~~provides *Distribution Network Service Providers* with an incentive to undertake efficient capital expenditure during a *regulatory control period*~~.

~~(b)~~ ~~If the AER develops a *capital expenditure sharing scheme* in accordance with this clause, the *capital expenditure sharing scheme* must be consistent with the *capital expenditure incentive objective*.~~

(b) In developing and implementing a *capital expenditure sharing scheme*, the *AER* must have regard to ~~take into account~~ the following principles (the *capital expenditure sharing scheme principles*):

(1) that efficiency gains and efficiency losses should be measured by way of comparison between all capital expenditure incurred during the relevant period relative to the forecast capital expenditure accepted or substituted by the *AER* in respect of that period, with those expenditure amounts appropriately adjusted by a method in contained in the scheme pursuant to paragraph (c);

(2) the need to ensure that benefits to electricity consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme;

(3) the need to provide *Distribution Network Service Providers* with a continuous incentive of equal strength in each *regulatory year*;

(4) the need for the scheme to operate symmetrically, that is, that where there is an efficiency gain or efficiency loss of equal size (in absolute terms) this will accrue the same reward or penalty (in absolute terms);

(5) the desirability of the scheme providing an incentive of appropriate strength given:

(i) any other incentives that *Distribution Network Service Providers* may have under other incentive schemes or other incentives under the *Rules* and the need for these taken together to provide *Distribution Network Service Providers* with an incentive to operate in a manner consistent with the *national electricity objective*;

(ii) the *regulatory obligations or requirements* applying to the *Distribution Network Service Providers* or classes of *Distribution Network Service Providers*; and

(iii) the residual risk created by the scheme for *Distribution Network Service Providers*;

(6) the desirability of the scheme providing for a quantitative limit being set on the impact on *Distribution Network Service Providers* and customers of the effect of differences between actual and forecast expenditure.

(7) the desirability of a *capital expenditure sharing incentive scheme* containing a method for adjusting capital expenditure incurred during the relevant period relative to the forecast capital expenditure accepted or substituted by the *AER* in respect of that period for the purposes of applying the scheme, with such method designed to reduce the impact on *Distribution Network Service Providers* and customers events that are not within the full control of *Distribution Network Service Providers*.  For example:

(i) a method that defines in advance the adjustments that will be made to actual or forecast expenditure where specified events occur in a *regulatory control period*;

(ii) a method for considering whether certain classes of projects should be excluded from the operation of the scheme;

(iii) a method for authorising adjustments to the forecast expenditure, actual expenditure, or to the calculated *efficiency benefit sharing scheme* amounts where necessary to ensure that the calculated *efficiency benefit sharing scheme* amounts are consistent to the extent practicable with rewarding or penalising *Distribution Network Service Providers* for the actual change in efficiency, with the method for making such adjustments defined in advance of the regulatory period to which the expenditure relates.

(c) The *AER* must, when designing a *capital expenditure sharing incentive scheme*, take into account the characteristics of distribution projects, including the typical size and drivers of such projects and the regulatory obligations applicable to different classes of distribution projects [(including, without limitation, the role of the *regulatory investment test for distribution*)].

(d) A *capital expenditure sharing incentive scheme* must provide that parameters or values under the scheme may vary between *Distribution Network Service Providers* or classes of *Distribution Network Service Providers* over time.

~~(1) *Distribution Network Service Providers* should be rewarded for undertaking efficient capital expenditure and penalised for undertaking inefficient capital expenditure;~~

~~(2) the rewards and penalties should be commensurate with the efficiencies or inefficiencies in capital expenditure, but a reward for efficient capital expenditure need not correspond in amount to a penalty for the same amount of inefficient capital expenditure; and~~

~~(3) penalties should not be imposed on *Distribution Network Service Providers* that undertake capital expenditure in an efficient manner, in terms of both its amount and timing.~~

~~(d) In *developing* a *capital expenditure sharing scheme*, the *AER* must also take into *account*:~~

~~(1) the interaction of the scheme with other incentives that *Distribution Network Service Providers* may have in relation to undertaking efficient operating or capital expenditure; and~~

~~(2) any applicable *regulatory obligations or requirements* associated with the provision of *standard control services*.~~

(e) In deciding:

(1) whether to apply a *capital expenditure sharing scheme* to a *Distribution Network Service Provider* for a *regulatory control period*; and

(2) the nature and details of any *capital expenditure sharing scheme* that is to apply to a *Distribution Network Service Provider* for a *regulatory control period*,

the *AER* must:

~~(3) make that decision in a manner that contributes to the achievement of the *capital* expenditure *incentive objective*; and~~

(3) take into account:

(i) both the *capital expenditure sharing scheme principles*, and the matters referred to in paragraph (b ~~d~~), as they apply to the *Distribution Network Service Provider*; and

(ii) the circumstances of the *Distribution Network Service Provider*.

**S6.2.2A Reduction of amounts by which the value of the regulatory asset base may be increased where certain requirements are satisfied ~~for efficiency of past capital expenditure~~**

...

(c) The overspending *requirement* is satisfied where ~~the sum of~~:

(1) all actual capital expenditure incurred in the five *regulatory years* prior to a *regulatory proposal* being submitted under clause 6.8.2(a) ~~during the previous control period (excluding the last two *regulatory years* of that previous control period); and~~;

~~(2)~~ ~~the actual capital expenditure incurred during the last two *regulatory years* of the *regulatory control period* preceeding the previous control period,~~

exceeds the sum of:

(2) the forecast capital expenditure accepted or substituted by the *AER* for the period in which the capital expenditure referred to in subparagraph (c)(1) (the **review period**) was incurred, subject to any adjustment pursuant to clauses 6.6.5(f) ~~and 6.6A.2(h)~~; and

(3) any capital expenditure that is recovered by way of such part of an *approved pass through amount* as is permitted to be passed through to *Distribution Network Users* during that period less any capital expenditure that is included in a *negative pass through amount* that is required to be passed through to *Distribution Network Users* during that period,

excluding any forecast or actual expenditure that:

(4) represents a margin payable or paid by the *Distribution Network Service Provider* in circumstances where the margin is referable to arrangements that, in the opinion of the *AER*, do not reflect arm's length terms; or

(5) ~~is constituted by the capitalisation of operating expenditure in circumstances where that capitalisation is inconsistent~~ comprises expenditure which was treated as capital expenditure and that ~~capitalisation~~ treatment was ~~is~~ inconsistent with the capitalisation policy submitted to the *AER* under clause S6.1.1(8) in relation to that review period or any part of it.

…

(f) Where the *overspending requirement* is satisfied, and subject to paragraphs (f1), (g) *and* (h), the *AER* may determine that the amount of the capital expenditure as a result of which the previous value of the regulatory asset base would otherwise be increased in accordance with clause S6.2.1(e) should be reduced ~~by such amount as the *AER* is satisfied correspondences to capital expenditure incurred during that period that does not reasonably reflect the *capital expenditure criteria*~~.

(f1) The *AER* may only make a determination under paragraph (f) where the *AER* is satisfied that the amount by which the capital expenditure will be reduced under paragraph (f) is capital expenditure that would not have been incurred by a prudent operator in the circumstances of the *Distribution Network Service Provider*

(g) The amount determined by the *AER* under paragraph (f):

(1) must not be greater than the amount calculated in accordance with paragraph (c);

~~(2)~~ ~~must be determined in a manner that is consistent with the *capital expenditure incentive objective*;~~ and

(2) must be determined taking into account the *Capital Expenditure Incentive Guidelines* that were in operation at the beginning of the relevant *regulatory control period* in which the capital expenditure being assessed was incurred.

(h) In making a determination under paragraph (f), the *AER* must:

(1) have regard to the matters in clause S6.2.2(1) to (7)~~*capital expenditure factors*~~; and

(2) only take into account information and analysis that the *Distribution Network Service Provider* could reasonably be expected to have considered or undertaken at the time that it undertook the relevant capital expenditure.

### S6.1.1 Information and matters relating to capital expenditure

A *building block proposal* must contain at least the following information and matters relating to capital expenditure:

…

(8) the policy that the *Distribution Network Service Provider* applies in determining whether expenditure is to be treated as capital expenditure (capitalisation policy) ~~capitalising operating expenditure~~.

### S6.2.2A Reduction of amounts by which the value of the regulatory asset base may be increased where certain requirements are satisfied ~~for efficiency of past capital expenditure~~

(e) The capitalisation *requirement* is satisfied where the amount of the capital expenditure as a result of which the previous value of the regulatory asset base would otherwise be increased in accordance with clause S6.2.1(c) includes ~~capital~~ expenditure that, under the ~~is constituted by the capitalisation of operating expenditure in circumstances where that~~ ~~capitalisation is inconsistent with~~ *Distribution Network Service Provider's* capitalisation policy submitted to the *AER* under clause S6.1.1(8) in relation to that review period or any part of it, should have been treated as operating expenditure.

…

(j) Where the *capitalisation requirement* is satisfied, and subject to paragraph (k), the *AER* may determine that the amount of the capital expenditure as a result of which the previous value of the regulatory asset base would be otherwise be increased in accordance with clause S6.2.1(e) should be reduced by any or all ~~such~~ of the ~~capitalised operating~~ amount of expenditure referred to in paragraph (e) which should have been treated as operating expenditure ~~as is included in the forecast operating expenditure accepted or substituted by the *AER* for the review period~~.

(j1) Where the *AER* makes a determination pursuant to paragraph (j), the *AER* must also make any consequential adjustments to any estimate of actual capital or operating expenditure amounts for the relevant *regulatory period* which reflect the *AER's* determination that expenditure which was treated by the *Distribution Network Service Provider* as capital expenditure should not have been treated as capital expenditure in accordance with the *Distribution Network Service Provider's* capitalisation policy and should have been treated as operating expenditure.

**Drafting note:** consequential amendment to clause S6.2.2A

~~(c)(6)~~ ~~is constituted by the capitalisation of operating expenditure in circumstances where that capitalisation is inconsistent~~ comprises expenditure which was treated as capital expenditure and that treatment was inconsistent with the capitalisation policy submitted to the *AER* under clause S6.1.1(8) in relation to that review period or any part of it.

# 8. Regulatory Process

### 6.10.2 Publication of draft determination and consultation

…

(c) Any person, other than the Distribution *Network Service Provider,* may make a written submission to the AER on the draft distribution determination within the time specified in the invitation referred to in the paragraph (a)(5), which must not be earlier than ~~30 *business days*~~ ~~40 *business days*~~ 55 *business days* after the making of the draft distribution determination.

### 6.10.3 Submission of revised proposal and submission on draft distribution determination

(a) ~~in addition to making written submissions, t~~The *Distribution Network Service Provider* may, not more than ~~30 *business days*~~ 45 *business days* after the publication of the draft distribution, submit to the AER:

(1) a revised regulatory proposal ~~to the AER~~; and

(2) a written submission on the draft distribution determination.

(b) A *Distribution Network Service Provider* may only make the revisions referred to in paragraph (a)(1) so as to incorporate the substance of any changes required to address matters raised by the draft distribution determination or the *AER's* reasons for it.

…

(e) The AER ~~may~~, ~~but need not,~~ must invite written submissions on any revised regulatory proposal and the written submission on the draft determination received under clause 6.10.3(1)(a) within the time specified in the invitation referred to in clause 6.10.2(c).

### 6.10.4 Submissions on specified matters

~~If the *AER* invites submission on a revised *regulatory proposal* under clause 6.10.3(e),~~ The *AER* ~~may~~ must invite further written submissions ~~on the submissions received under clauses 6.10.2(c) or 6.10.3(e)~~ by *publishing* an invitation which specifies:

(a) ~~the matters in respect of which submissions are invited~~ that the *Distribution Network Service Provider* and any person may make submissions on new matters raised by other persons in submissions made under clauses 6.10.2(c) and 6.10.3(e); and

(b) the time for making submissions, which must not be earlier than 15 *business days* after the date on which the invitation was published.

### 6.11.2 Notice of distribution determination

The *AER* must as soon as practicable, but not later than ~~2 months~~ 10 weeks before the commencement of the relevant *regulatory control period*, *publish*:

(1) notice of the making of the distribution determination; and

(2) the distribution determination itself; and

(3) the *AER's* reasons for making the distribution determination in its final form including the constituent decisions i.e. the decisions made in accordance with rule 6.12 on which the distribution determination is predicated.

### 6.18.2 Pricing proposals

(a) A Distribution Network *Service Provider* must:

(1) submit to the *AER*, as soon as practicable, and in any case within ~~15~~ 20 *business days*, after *publication* of the distribution determination, a *pricing proposal* (the **initial *pricing proposal***) for the first *regulatory year* of the *regulatory control period*; …

### 6.8.1 AER's framework and approach paper

(a) The *AER* must *prepare* and publish a *framework and approach paper* in anticipation of every distribution determination.~~make and *publish* a document (a *framework and approach paper*) that applies in respect of a distribution determination for a matter listed in paragraph (b) in accordance with this clause if:~~

~~(1) there is no *framework and approach paper* that applies in respect of that distribution determination for that matter; or~~

~~(2) there is a *framework and approach paper* that would apply in respect of that distribution determination for a matter, but the *AER* considers it necessary or desirable to make and publish an amended or *replacement framework and approach paper* in so far as it relates to that matter.~~

(b) A *framework and approach paper* must set out:

(1) the *AER's* decision (together with its reasons for the decision) on the following matters:

(i) the form (or forms) of the control mechanisms;

(ii) as to whether or not Part J of Chapter 6A is to be applied to determine the pricing of *transmission standard control services* provided by any *dual function assets* owned, controlled or operated by the *Distribution Network Service Provider*.

**Note**

See cl. 6.25(6).

(2) the *AER's* proposed approach (together with its reasons for the decision) to the following matters:

(i) the classification of *distribution services* under this Chapter;

(ii) the formulae that give effect to the control mechanisms referred to in subparagraph (1)(i);

(iii) the application to the *Distribution Network Service Provider* of any *service target performance incentive scheme*;

(iv) the application to the *Distribution Network Service Provider* of any *efficiency benefit sharing scheme*;

(v) the application to the *Distribution Network Service Provider* of any *capital expenditure sharing scheme*;

(vi) the application to the *Distribution Network Service Provider* of any *demand management and embedded generation connection incentive scheme*;

(vii) the application to the *Distribution Network Service Provider* of any *small-scale incentive scheme*.~~;~~

(viii) the ~~methodology~~ forecast expenditure assessment techniques that the *AER* will use ~~is to be used~~ as part of its assessment ~~assess for the preparation~~ of forecasts of operating expenditure and capital expenditure that are to be included in the *Distribution Network Service Provider's building block* ~~*regulatory*~~ *proposal*~~, which may be the *standard expenditure forecasting methodology* or some different methodology~~.

(c) A *framework and approach paper* is to be prepared in consultation with the relevant *Distribution Network Service Provider* and with other interested stakeholders.

(d) Where a distribution determination applies to a *Distribution Network Service Provider* and none of the *AER*, the *Distribution Network Service Provider* or an interested stakeholder submits that it is necessary or desirable to amend or replace the approach that has been taken in that distribution determination to a matter listed in paragraph (b), the *AER* is not required to consult on that matter and the approach to that matter in the *framework and approach paper* is that set out in the distribution determination that applies to the *Distribution Network Service Provider* in the regulatory period preceding the regulatory period in respect of which the *framework and approach paper* is being prepared.

(e) The *AER* must commence preparation of, and consultation on, the *framework and approach paper* at least 32 months before the commencement of the distribution determination in respect of which the *framework and approach paper* is to apply.

~~(c)~~ ~~If there is a *framework and approach paper* that would apply in respect of the distribution determination for a matter listed in paragraph (b) then, no later than 32 months before the end of the *regulatory control period* that precedes that for which the distribution determination is to be made, the *AER* must *publish* a notice inviting submissions on whether it is necessary or desirable to amend or replace that *framework and approach paper* in so far as it related to that matter,~~

~~(d)~~ ~~If there is a *framework and approach* paper that would apply in respect of the distribution determination for a matter listed in paragraph (b) and the *AER* considers that it may be necessary or desirable to make an amended or replacement *framework and approach paper* that applies in respect of that matter, then, no later than 31 months before the end of the *regulatory control period* that precedes that for which the distribution determination is to be made, the *AER* must:~~

~~(1) make and *publish* its decision to that effect; and~~

~~(2) give its reasons for that decision.~~

~~(d1)~~ ~~In *making* a decision under paragraph (d), the *AER* must have regard to any submissions made in response to the invitation under paragraph (c).~~

(f) ~~Where paragraph (a) applies then, a~~ At least 25 months before the commencement of the distribution determination in respect of which the *framework and approach paper* is to apply~~end of the current *regulatory control period*~~, the *AER* must~~, after consulting with the relevant *Distribution Network Service Provider* and other persons as the *AER* considers appropriate,~~ make, amend or replace the *framework and approach paper*, as the case may be; and

(1) give a copy of it to the relevant *Distribution Network Service Provider*; and

(2) *publish* it,

as soon as is reasonably practicable.

(g) Subject to clauses 6.12.3 and 6.25(d), a *framework and approach paper* is not binding on the *AER* or a *Distribution Network Service Provider*.

(h) The *AER* may make and *publish* a *framework and approach paper* that applies in respect of a distribution determination for a matter that is not listed in paragraph (b) and, if it does so, this clause 6.8.1 applies as if that matter were listed in paragraph (b).

**6.12.3 Extent of AER's discretion in making distribution determinations**

(a) Subject to this clause and other provisions of this Chapter 6 explicitly negating or limiting the *AER's* decision, the *AER* has a discretion to accept or approve, or to refuse to accept or approve, any element of a regulatory proposal.\

~~(b) The classification of services must be as set out in the relevant *framework and approach paper* unless the *AER* considers that, in the light of the *Distribution Network Service Provider's regulatory proposal* and the submissions received, there are good reasons for departing from the classification proposed in that paper.~~

(b) The classification of *distribution services* must be as set out in the relevant *framework and approach paper* unless the AER is satisfied that material which has become available after the publication of that paper justifies a departure ~~considers that unforeseen circumstances justify departing~~ from the classification as set out in that paper.

~~(c) The control mechanism must be as set out in the relevant framework and approach paper.~~

(c) The form of the control mechanism must be as set out in the relevant *framework and approach paper.*

(c1) The formulae that give effect to the control mechanisms referred to in paragraph (c) must be as set out in the relevant *framework and approach paper* unless the *AER* is satisfied that material which has become available after the publication of that paper justifies a departure ~~considers that unforeseen circumstances justify departing~~ from the formulae as set out in the paper.

**6.11.1 Making of distribution determination**

~~Subject to rule 6.14(a), the *AER* must consider any submissions made on the draft distribution determination, or on any revised regulatory proposal submitted to it under clause 6.10.3, and must make a distribution determination in relation to the *Distribution Network Service Provider.*~~

(a) The *AER* must make a distribution determination in relation to the *Distribution Network Service Provider.*

(b) In making a distribution determination in relation to the *Distribution Network Service Provider,* and subject to rule 6.14, the *AER* must have regard to each of the following:

(1) the information included in or accompanying the *regulatory proposal;*

(2) written submissions received under this Part E; and

(3) any analysis undertaken by or for the *AER* that is published prior to the making of the distribution determination ~~or as part of the distribution determination.~~

(c) The *AER* must use its best endeavours to *publish,* a reasonable time prior to the making of the distribution determination, any analysis undertaken by or for it on which it proposes to rely, or to which it proposes to refer, for the purposes of the distribution determination.

(d) If the *AER* does not publish any analysis in accordance with paragraph (c), the *AER* must, in the distribution determination, identify the analysis that was not published and provide reasons why the *AER* was unable to make that analysis available prior to the making of the distribution determination.

## 10.2 Drafting Amendments to National Electricity Rules (Chapter 6A)

# 4&5. Cost of capital estimation framework & Return on debt estimation

### 6A.6.2 Return on capital

#### Calculation of return on capital

(a) The return on capital for each *regulatory year* must be calculated by applying a rate of return for the relevant *Transmission Network Service Provider* for that *regulatory year* that is determined in accordance with this clause 6A.6.2 (the *allowed rate of return*) to the value of the regulatory asset base for the relevant *transmission system* as at the beginning of that *regulatory year* (as established in accordance with clause 6A.6.1 and schedule 6A.2).

#### Allowed rate of return

(b) The *allowed rate of return* for a *Transmission Network Service Provider* ~~must correspond to~~ is to be commensurate with the benchmark efficient financing costs of an ~~benchmark efficient~~ entity ~~with~~ facing a similar degree of risk as that which applies ~~to the *Transmission Network Service Provider*~~ in respect of the provision of *prescribed transmission services* (the *allowed rate of return objective*).

(c) The *allowed rate of return* for a *regulatory year* must be determined:

(1) as a weighted average of the return on equity for the *regulatory control period* in which that *regulatory year* occurs (as estimated under paragraph (e)) and the return on debt for that *regulatory year* (as estimated under paragraph (f)) where the weights applied to compute the average reflect the relative proportions of equity and debt finance that would be employed by an efficiently financed benchmark efficient entity with a similar degree of risk as that which applies to the *Transmission Network Service Provider* in respect of the provision of *prescribed transmission services*;

(2) on a nominal ~~post tax~~ vanilla basis that is consistent with the estimate of the value of imputation credits referred to in clause 6A.6.4; and

(3) taking into account relevant estimation methods, financial models, market data and other evidence.

(d) In determining the *allowed rate of return*, regard must be had to~~:~~

~~(1) the desirability of using an approach that leads to the consistent application of any estimates of financial parameters that are relevant to the estimates of, and that are common to, the return on equity and the return on debt; and~~

~~(2)~~ any interrelationships between estimates of financial parameters that are relevant to the estimates of the return on equity and the return on debt.

#### Return on equity

(e) The return on equity for a *regulatory control period* must be estimated:

(1) in a way that is consistent with the *allowed rate of return objective*; and

(2) taking into account the prevailing conditions in the market for equity funds

### Return on debt

(f) 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 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 (l~~i~~).

(g) A *Revenue Proposal* must include a methodology for estimating the return on debt which the *Transmission Network Service Provider* considers is consistent with the *allowed rate of return objective* and the *return on debt methodology principles*.

(h) The *AER* must accept the methodology for estimating the return on debt that included in a *Revenue Proposal* if the *AER* is satisfied that the proposed methodology is consistent with the *allowed rate of return objective* and the *return on debt methodology principles*.

(i) If the *AER* is not satisfied as referred to in paragraph (h), the methodology for estimating the return on debt must be the same as the methodology that applied to the *Transmission Network Service Provider* in the immediately preceding *regulatory control period*.

(j) Subject to paragraph (f), the methodology adopted to estimate the return on debt may, without limitation, be designed to result in the return on debt reflecting:

(1) the return that would be required by debt investors in a benchmark efficient entity if it raised debt at the time or shortly before the making of the *revenue determination* for the *regulatory control period*;

(2) the average return that would have been required by debt investors in a benchmark efficient entity if it raised debt over an historical period prior to the time when the *revenue determination* for that *regulatory control period* is made; or

(3) some combination of the returns referred to in subparagraphs (1) and (2).

(k) In determining whether the methodology adopted to estimate the return on debt for a *regulatory year* is estimated in a way that is consistent with the *allowed rate of return objective*, regard must be had to the following ~~factors~~ principles (the *return on debt methodology principles*):

~~(1)~~ ~~the likelihood of any significant differences between the costs of servicing debt of a benchmark efficient entity referred to in subparagraph (c)(1) and the return on debt over the *regulatory control period*;~~

~~(2)~~ ~~the impact on electricity consumers, including due to any impact on the return on equity of a benchmark efficient entity referred to in subparagraph (c)(1);~~

~~(3)~~ ~~the incentive effects of inefficiently delaying or bringing forward capital expenditure; and~~

~~(4)~~ ~~the impact of changing the methodology for estimating the return on debt across *regulatory control periods*.~~

(1) that the return on debt should allow for recovery by a *Transmission Network Service Provider* of the expected cost of debt financing over the life of the assets used to supply

*prescribed transmission services* (including to the extent that the life of these assets may extend over more than one *regulatory control period*); and

(2) that the methodology adopted to estimate the return on debt should reflect the efficient financing costs of a prudent operator in the circumstances of the *Transmission Network Service Provider*.

(l) A methodology referred to in paragraph (f)(2)(ii) must provide for any change in ~~the *Transmission Network Service Provider's annual building block requirement* for the *regulatory year* that would result from a change to the *allowed rate of return* for that *regulatory year*, as a result of~~ the return on debt ~~for that~~ as between different *regulatory years* within the same *regulatory control period* ~~being different from that estimated under subparagraph (f),~~ to be effected through the automatic application of a formula that is specified in the *revenue determination*.

### Rate of return Guidelines

(m) The *AER* must, in accordance with ~~the *transmission consultation procedures*~~ this clause 6.5.2 make and publish guidelines (the *Rate of Return Guidelines*), ~~except that the first *Rate of Return Guidelines* must be made in accordance with paragraph (m) and not the *transmission consultation procedures*~~.

(n) Subject to paragraph (o), a *Rate of Return Guideline* only applies to a *revenue determination* in respect of which the *framework and approach paper* was published after publication of the *Rate of Return Guideline*.

(o) A *Rate of Return Guideline* may only apply to a *revenue determination* in respect of which the *framework and approach paper* was published prior to publication of the *Rate of Return Guideline* if the *Transmission Network Service Provider* to which the *revenue determination* will apply consents to such application.

(p) A *revenue determination* to which a *Rate of Return Guideline* applies must be consistent with the *Rate of Return Guideline* unless there are reasons and evidence in support of a departure from the *Rate of Return Guideline*.

(q) The *Rate of Return Guidelines* must set out:

~~(1) the methodologies that the AER proposes to use in estimating the allowed rate of return, including how those methodologies are proposed to result in the determination of a return on equity and a return on debt in a way that is consistent the allowed rate of return objective; and~~

~~(2) the estimation methods, financial models, market data and other evidence the AER proposes to take into account in estimating the return on equity, the return on debt and the value of imputation credits referred to in clause 6.5.3.~~

(1) in relation to the return on equity:

(i) the financial models which the *AER* proposes to use in determining the return on equity;

(ii) for each parameter in the applicable financial models, either a value which the *AER* proposes to use or the information and data sources which it proposes to use to derive such a value;

(iii) the way in which the *AER* proposes to use the financial models, information and data sources to derive a value for the return on equity; and

(iv) an estimate of the return on equity which would apply as at the date of publication of the *Rate of Return Guidelines*, based on the *AER's* proposed use of the financial models, information and data sources;

(2) in relation to the return on debt:

(i) the form of debt finance which will be used to determine benchmark efficient debt financing costs of an entity with a similar nature and degree of risk as that which applies to a *Transmission Network Service Provider* in respect of the provision of *prescribed transmission services*;

(ii) the information and data sources which the *AER* proposes to use to determine the return on debt applicable to the relevant form of debt finance as at any point in time; and

(iii) an estimate of the return on debt which would apply as at the date of publication of the *Rate of Return Guidelines*, based on the *AER's* proposed form of debt finance and proposed information and data sources;

(3) the relative proportions of equity and debt finance that would be employed by an efficiently financed entity with a similar nature and degree of risk as that which applies to the *Transmission Network Service Provider* in respect of the provision of *prescribed transmission services* (as referred to in clause 6.5.2(c)(1)); and

(4) the value of imputation credits referred to in clause 6.5.3.

(r) A *Rate of Return Guideline* must be accompanied by a statement of reasons setting out:

(1) the evidence relied upon by the *AER* in formulating the guideline; and

(2) reasons and evidence supporting:

(i) for the first *Rate of Return Guideline*, any change in approach from the Statement of WACC Parameters, in respect of any of the matters referred to in clause 6A.6.2(p) which are addressed in the Statement of WACC Parameters;

(ii) for any subsequent *Rate of Return Guideline*, any change in approach from the previous *Rate of Return Guideline*, in respect of any of the matters referred to in clause 6A.6.2(p).

(s) For the purposes of paragraph (r), Statement of WACC Parameters means the 'Statement of the revised WACC parameters (transmission)' issued by the *AER* on 1 May 2009, pursuant to clause 6A.6.2 of the *Rules*.

(t) The AER must publish the first *Rate of Return Guideline* by [29 ~~August~~ December 2013] and there must be *Rate of Return Guideline* in force at all times after that date.

(u) For the purpose of making the first *Rate of Return Guideline*, the *AER* must:

(1) by no later than [29 March 2013], publish a consultation paper that sets out its preliminary views on the material issues that are to be addressed by the *Rate of Return Guidelines*;

(2) publish an invitation for written submissions on the consultation paper, with such submissions to be made within the time specified in the invitation (which must not be earlier than ~~30~~ 60 business days after the invitation for submissions is published);

(3) by no later than ~~31 July~~ 15 August 2013, publish a draft of the *Rate of Return Guidelines*; and

(4) publish an invitation for written submissions on the draft *Rate of Return Guidelines*, with such submissions to be made within the time specified in the invitation (which must not be earlier than ~~30~~ 60 business days after the invitation for submissions is published).

(v) The *AER* must~~, in accordance with the *transmission consultation procedures*,~~ review the *Rate of Return Guidelines*:

(1) at intervals not exceeding ~~three~~ four years, with the first interval starting from the date referred to in paragraph (t~~l~~); and

(2) at the same time as it reviews the *Rate of Return Guidelines* made under clause 6.5.2.

(w) A review of the *Rate of Return Guidelines* under paragraph (v) must be conducted in accordance with the *transmission consultation procedures,* subject to:

(1) the reference in clause 6A.20(c) to 30 *business days* being read as a reference to 60 *business days*; and

(2) the reference in clause 6A.20(e) to 80 *business days* being read as a reference to 180 *business days*.

(x) For the avoidance of doubt, nothing prevents the *AER* from publishing the *Rate of Return Guidelines* made under this clause 6A.6.2 in the same document as the *Rate of Return Guidelines* made under clause 6.5.2.

# 6. Capital and operating expenditure forecasting

### 6A.5.6 Expenditure forecast ~~methodology~~ assessment techniques

(a) The *AER* must, in accordance with the *transmission consultation procedures,* develop and *publish* ~~a methodology~~ the assessment techniques that it may use in determining whether it is satisfied that the total of the forecast operating expenditure or forecast capital expenditure of a *Transmission Network Service Provider* included in a *Revenue Proposal* reasonably reflects the *operating expenditure criteria* or the *capital expenditure criteria,* as relevant ~~for the preparation of forecasts of operating expenditure and capital expenditure that as included in *Transmission Network Service Provider's Revenue Proposals*~~ (~~the *standard*~~ *forecast expenditure assessment techniques* ~~*methodology*~~).

(b) Subject to paragraph (c), the *AER* may, from time to time and in accordance with the *transmission consultation procedures,* amend the ~~*standard*~~ *forecast expenditure* ~~*forecasting methodology*~~ *assessment techniques.*

(c) The *AER* may make administrative or minor amendments to the ~~*standard*~~ *forecast expenditure* ~~*forecasting methodology*~~ *assessment techniques* without complying with the *transmission consultation procedures.*

(d) The *AER* must *publish* the first ~~*standard*~~ *forecast expenditure* ~~*forecasting methodology*~~ by [28 June 2013] and there must be ~~a *standard*~~ forecast *expenditure* ~~*forecasting methodology*~~ assessment techniques in force at all times after that date.

### 6A.10.1B Notification of expenditure forecasting methodology

(a) A *Transmission Network Service Provider* must advise the *AER* of the expenditure forecasting methodology that the *Transmission Network Service Provider* proposes to adopt in developing the forecast operating expenditure and forecast capital expenditure for its *Revenue Proposal* at the same time or as soon as practicable after, the *AER* commences preparation of, and consultation on, the relevant *framework and approach paper* under clause 6A.10.1A(e).

(b) Subject to any claim for confidentiality, the *AER* may *publish* details of expenditure forecasting methodology provided to it pursuant to paragraph (a) and consult on that methodology as part of the *framework and approach paper.*

### 6A.6.6 Forecast operating expenditure

....

(c) Subject to paragraph (c1), 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 forecast operating expenditure for the *regulatory control period* reasonably reflects each of the following (the *operating expenditure criteria*):

(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*;

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

### 6A.7.5 Small-scale incentive scheme

(a) The *AER* may, in accordance with the *transmission consultation procedures*, develop and *publish* an incentive scheme or schemes (*small-scale incentive scheme*) that provides *Transmission Network Service Providers* with incentives to provide *prescribed transmission services* in a manner that contributes to the achievement of the *national electricity objective*.

(b) In developing a *small-scale incentive scheme*, the *AER* must have regard to the following requirements:

(1) *Transmission Network Service Providers* should be rewarded for efficiency gains in respect of their *transmission systems*, and penalised for efficiency losses in respect of their *transmission systems*;

(2) the rewards and penalties should be commensurate with the efficiency gains or efficiency losses in respect of a *Transmission system*, but a reward for efficiency gains need not correspond in amount to a penalty for efficiency losses, however, if it is anticipated that the operation of the scheme will result in penalties exceeding rewards, the scheme must provide for inclusion in forecast operating expenditure an amount that compensates the *Transmission Network Service Provider* for the expected net cost under the scheme;

(3) penalties should not be imposed on *Transmission Network Service Providers* that act in an efficient manner, in terms of both the degree and timing of that action;

(4) the benefits to electricity consumers that are likely to result from efficiency gains in respect of a *transmission system* should warrant the rewards provided under the scheme, and the detriments to electricity consumers that are likely to result from efficiency losses in respect of a *transmission system* should warrant the penalties provided under the scheme;

(5) the scheme should be consistent with other incentives that *Transmission Network Service Providers* may have under the *Rules* and under any other incentive schemes; ~~and~~

(6) the scheme should not be inconsistent with any applicable *regulatory obligations or requirements* associated with the provision of *prescribed transmission services*~~.~~;and

(7) that the benefits arising from the scheme should exceed the costs of which the development, implementation and administration of the scheme, which, for the avoidance of doubt, includes the costs incurred by the AER and *Transmission Network Service Provider*.

(c) The *AER* may, from time to time and in accordance with the *transmission consultation procedures*, amend or replace any *small-scale incentive scheme*.

(d) Where the *AER* applies a *small-scale incentive scheme* to a *Transmission Network Service Provider* for a *regulatory control period*:

(1) the aggregate rewards or penalties for a *regulatory year* in that *regulatory period* that are provided or imposed under that scheme and any other *small-scale incentive schemes* that apply to that *Transmission Network Service Provider* must not exceed 0.5% of the *maximum allowed revenue* for the *Transmission Network Service Provider* for that *regulatory year* unless the *Transmission Network Service Provider* consents to the contrary, in which case that aggregate must not exceed 1% of the *maximum allowed revenue* for the *Transmission Network Service Provider* for that *regulatory year*; and

(2) *small-scale incentive scheme* must cease to provide rewards or impose penalties in respect of a *regulatory year* after the expiry of such a period as is determined by the *AER*, being a period that is not more than two *regulatory control periods* after the commencement of that scheme.

(e) Notwithstanding anything else contained in this clause, the *AER* may require a *Transmission Network Service Provider* to participate in a trial of a small-scale incentive scheme under which, for the duration of that trial, the *Transmission Network Service Provider* is not required to bear any penalty and is not entitled to earn any reward.

**6A.6.6 Forecasting operating expenditure**

…

(e) In deciding whether or not the *AER* is satisfied as referred to in paragraph (c), the *AER* must have regard to the following (the *operating expenditure* factors)…

(4) relevant benchmarking material that takes into account differences in the environments of different *Transmission Network Service Providers,* including ~~the most recent~~ *annual benchmarking reports* ~~that has been~~ published under rule 6A.31 and the benchmark operating expenditure that would be incurred by an efficient *Transmission Network Service Provider* over the relevant *regulatory control period*;

**6A.6.7 Forecast capital expenditure**

…

(e) In deciding whether or not the *AER* is satisfied as referred to in paragraph (c), the *AER* must have regard to the following (the *capital expenditure factors*)…

(4) relevant benchmarking material that takes into account differences in the environments of different *Transmission Network Service Providers,* including ~~the most recent~~ *annual benchmarking reports* ~~that has been~~ *published* under rule 6A.31 and benchmark capital expenditure that would be incurred by an efficient *Transmission Network Service Provider* over the relevant *regulatory control period*;

**Definition of materially**

**Materially**

For the purposes of the application of clause 6A.7.3, an event (other than a *network support event*) results in a *Transmission Network Service Provider* incurring *materially* higher or *materially* lower costs if the change in the total of operating and capital expenditure ~~costs~~ (as opposed to the revenue impact) that the *Transmission Network Service Provider* has incurred and is likely to incur in any *regulatory year* of a *regulatory control period*, as a result of that event either in isolation or together with any other *pass through event* which occurs in the same *regulatory year* as the first event, exceeds 1% of the *maximum allowed revenue* for the *Transmission Network Service Provider* for that *regulatory year*.

**6A.7.3 Cost pass through**

**Positive pass through**

….

(c1) Where the *Transmission Network Services Provider* is seeking the approval of the *AER* to pass through to *Transmission Network Service Users* a *positive pass through amount* in respect of more than one *positive change event* where those events has occurred during the same *regulatory year*, the *Transmission Network Service Provider* is required to submit the written statement referred to in paragraph (c) to the *AER* within 90 *business days* of the later of the *positive change events* occurring.

**Negative pass through**

...

(f2) Where the *Transmission Network Service Provider* is required to submit to the *AER* a written statement pursuant to paragraph (f) and that statement is in respect of more than one *negative change event* where those events have occurred during the same *regulatory year*, the *Transmission Network Service Provider* is required to submit the written statement referred to in paragraph (f) to the *AER* within 90 *business days* of the latest of the *negative change events* occurring.

# 7. Capital expenditure incentive mechanisms

### 6A.5A Capital expenditure incentive mechanisms

~~(a) The *capital expenditure incentive objective* is to ensure that, where the value of a regulatory asset base is subject to adjustment in accordance with the *Rules*, then the only capital expenditure that is included in an adjustment that increases the value of that regulatory asset base is capital expenditure that reasonably reflects the *capital expenditure criteria*.~~

(b) The *AER* must, in accordance with the *transmission consultation procedures*, make and *publish* guidelines (the *Capital Expenditure Incentive Guidelines*) that set out:

(1) any *capital expenditure sharing schemes* developed by the *AER* in accordance with clause 6A.6.5A, and how the *AER* has taken into account the *capital expenditure sharing scheme principles* in developing those schemes;

(2) the manner in which it proposes to make determinations under clause S6A.2.2A(a) if the *overspending requirement* is satisfied;

(3) the manner in which it proposes to determine whether depreciation for establishing a regulatory asset base as at the commencement of a *regulatory control period* is to be based on actual or forecast capital expenditure;

(4) the manner in which it proposes to assess capital expenditure that represents a margin that is paid by a *Transmission Network Service Provider* in circumstances where the margin is referable to arrangements that, in the opinion of the *AER*, do not reflect arm's length terms; ~~and~~

(4a) the manner in which it proposes to make determinations under clause S6A.2.2A(j) where the *capitalisation requirement* is satisfied; and

(5) the manner in which it proposes to approach what *capital expenditure incentive scheme,* combination of *capital expenditure incentive schemes,* or combination of *capital expenditure incentive schemes* and any other incentive scheme, should apply to a *Transmission Network Service Provider* in a *regulatory period* ~~how each scheme and proposal referred to in subparagraphs (1) to (4), and all of them taken together, are consistent with the *capital expenditure incentive objective*.~~

(c) The *AER* must publish the first *Capital Expenditure Incentive Guidelines* by [30 August 2012] and there must be *Capital Expenditure Incentive Guidelines* in force at all times after that date.

### S6A.2.2A Reduction of amounts by which the value of the regulatory asset based may be increased where certain requirements are satisfied ~~for efficiency of past capital expenditure~~

…

(g) The amount determined by the *AER* under paragraph (f):

(1) must not be greater than the amount calculated in accordance with paragraph (c);

~~(2) must be determined in a manner that is consistent with the *capital expenditure incentive objective*,~~ and

(2) must be determined taking into account the *Capital Expenditure Incentive Guidelines* that were in operation at the beginning of the relevant regulatory control period in which the capital expenditure being assessed was incurred.

…

(k) ~~A determination made under paragraph (i) or (j) must be consistent with the *capital expenditure incentive objective* and, i~~In making ~~such~~ a determination under paragraph (i), the *AER* must take into account the *Capital Expenditure Incentive Guidelines* that were in operation at the when the arrangements that gave rise to the margin being payable or paid by the *Transmission Network Service Provider.*

…

(l) In making a determination under paragraph (j) the *AER* must take into account the *Capital Expenditure Incentive Guidelines* that were in operation when the relevant capital expenditure was incurred. ~~Nothing in this clause *S6A.2.2A* is to be taken to preclude the *AER* from:~~

~~(1)~~ ~~requiring a *Transmission Network Service Provider* to provide such information; or~~

~~(2)~~ ~~from undertaking such analysis, as the *AER* considers appropriate to enable it to make a statement, with supporting reasons, as referred to in clause 6A.14.2(1).~~

**S6A.2.2B Depreciation**

(a) Pursuant to clause 6A.14.1(5D), the *AER* must decide, for a draft decision under rule 6A.12 or a final decision under rule 6A.13, whether depreciation for establishing the regulatory asset base for a *transmission system* as at the commencement of the following *regulatory control period* is to be based on actual or forecast capital expenditure.

~~(b)~~ ~~The decision referred to in paragraph (a) must be consistent with the *capital expenditure incentive objective*.~~

(b) In making the decision referred to in paragraph (a), the *AER* must have regard to:

(1) the incentives that the *Transmission Network Service Provider* has in relation to undertaking efficient capital expenditure, including as a result of the application of any ~~*service target performance*~~ *incentive scheme* or any other incentives under the *Rules*;

(2) the substitution possibilities between assets with relatively short economic lives and assets with relatively long economic lives and the relative benefits of such asset types;

(3) any determination made by the *AER* under clause S6A.2.2A(j) ~~the extent to which any capital expenditure incurred by the *Transmission Network Service Provider* has exceeded the corresponding amount of forecast capital expenditure accepted or substituted by the *AER* and the amount of that excess expenditure is not efficient;~~

(4) the *Capital Expenditure Incentive Guidelines* that were in operation at the time the framework and approach paper which applies to the final decision being made was published; and

(5) the *capital expenditure factors*.

**6A.6.5A Capital expenditure sharing scheme**

(a) A *capital expenditure sharing scheme* is a scheme developed for *Transmission Network Service Providers* that is designed to share the benefits of efficiency gains and efficiency losses in a manner that promotes the *national electricity objective* ~~provides *Transmission Network Service Providers* with an incentive to undertake efficient capital expenditure during a *regulatory control period*.~~

~~(b)~~ ~~If the *AER* develops a *capital expenditure sharing scheme* in accordance with this clause, the *capital expenditure sharing scheme* must be consistent with the *capital expenditure incentive objective*.~~

(b) In developing and implementing a *capital expenditure sharing scheme*, the *AER* must have regard to ~~take into account~~ the following principles (the *capital expenditure sharing scheme principles*):

(1) that efficiency gains and efficiency losses should be measured by way of comparison between all capital expenditure incurred during the relevant period relative to the forecast capital expenditure accepted or substituted by the *AER* in respect of that period, with those expenditure amounts appropriately adjusted by a method in contained in the scheme pursuant to paragraph (c);

(2) the need to ensure that benefits to electricity consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme;

(3) the need to provide *Transmission Network Service Providers* with a continuous incentive of equal strength in each *regulatory year*;

(4) the need for the scheme to operate symmetrically, that is, that where there is an efficiency gain or efficiency loss of equal size (in absolute terms) this will accrue the same reward or penalty (in absolute terms);

(5) the desirability of the scheme providing an incentive of appropriate strength given:

(i) any other incentives that *Transmission Network Service Providers* may have under other incentive schemes or other incentives under the *Rules* and the need for these taken together to provide *Transmission Network Service Providers* with an incentive to operate in a manner consistent with the *national electricity objective*;

(ii) the *regulatory obligations or requirements* applying to the *Transmission Network Service Providers* or classes of *Transmission Network Service Providers*; and

(iii) the residual risk created by the scheme for *Transmission Network Service Providers*;

(6) the desirability of the scheme providing for a quantitative limit being set on the impact on *Transmission Network Service Providers* and customers of the effect of differences between actual and forecast expenditure.

(7) the desirability of a *capital expenditure sharing incentive scheme* containing a method for adjusting capital expenditure incurred during the relevant period relative to the forecast capital expenditure accepted or substituted by the *AER* in respect of that period for the purposes of applying the scheme, with such method designed to reduce the impact on *Transmission Network Service Providers* and customers events that are not within the full control of *Transmission Network Service Providers*. For example:

(i) a method that defines in advance the adjustments that will be made to actual or forecast expenditure where specified events occur in a *regulatory control period*;

(ii) a method for considering whether certain classes of projects should be excluded from the operation of the scheme;

(iii) a method for authorising adjustments to the forecast expenditure, actual expenditure, or to the calculated *efficiency benefit sharing scheme* amounts where necessary to ensure that the calculated *efficiency benefit sharing scheme* amounts are consistent to the extent practicable with rewarding or penalising *Transmission Network Service Providers* for the actual change in efficiency, with the method for making such adjustments defined in advance of the regulatory period to which the expenditure relates.

(c) The *AER* must, when designing a *capital expenditure sharing scheme,* take into account the characteristics of transmission projects, including typical size and drivers of such projects and the regulatory obligations applicable to different classes of transmission projects (including without limitation the role of the *regulatory investment test for transmission*).

(d) A *capital expenditure sharing incentive scheme* must provide that parameters or values under the scheme may vary between *Transmission Network Service Providers* or classes of *Transmission Network Service Providers* over time.

~~(1) *Transmission Network Service Providers* should be rewarded for undertaking efficient capital expenditure and penalised for undertaking inefficient capital expenditure;~~

~~(2) the rewards and penalties should be commensurate with the efficiencies or inefficiencies in capital expenditure, but a reward for efficient capital expenditure need not correspond in amount to a penalty for the same amount of inefficient capital expenditure; and~~

~~(3) penalties should not be imposed on *Transmission Network Service Providers* that undertake capital expenditure in an efficient manner, in terms of both its amount and timing.~~

~~(d) In developing a *capital expenditure sharing scheme*, the *AER* must also take into account:~~

~~(1) the interaction of the scheme with other incentives that *Transmission Network Service Providers* may have in relation to undertaking efficient operating or capital expenditure; and~~

~~(2) any applicable *regulatory obligations or requirements* associated with the provision of *prescribed transmission services*.~~

(e) In deciding:

(1) whether to apply a *capital expenditure sharing scheme* to a *Transmission Network Service Provider* for a *regulatory control period*; and

(2) the nature and details of any *capital expenditure sharing scheme* that is to apply to a *Transmission Network Service Provider* for a *regulatory control period*,

the *AER* must:

~~(3) make that decision in a manner that contributes to the achievement of the *capital expenditure incentive objective*; and~~

(3) take into account:

(i) both the *capital expenditure sharing scheme principles*, and the matters referred to in paragraph (b ~~d~~), as they apply to the *Transmission Network Service Provider*; and

(ii) the circumstances of the *Transmission Network Service Provider*.

**S6A.2.2A Reduction of amounts by which the value of the regulatory asset base may be increased where certain requirements are satisfied ~~of efficiency of past capital expenditure~~**

...

(c) The *overspending requirement* is satisfied where ~~the sum of~~:

(1) all actual capital expenditure incurred in the five *regulatory years* prior to a *Revenue Proposal* being submitted under clause 6A.10.1 ~~during the previous control period (excluding the last two *regulatory years* of that previous control period); and~~

~~(2) the actual capital expenditure incurred during the last two *regulatory years* of the *regulatory control period* preceding the previous control period,~~

exceeds the sum of:

(2) the forecast capital expenditure accepted or substituted by the *AER* for the period in which the capital expenditure referred to in subparagraphs (c)(1) and (2) (the **review period**) was incurred, subject to any adjustment pursuant to clauses 6A.7.1(f) and 6A.8.2(h); and

(3) any capital expenditure that is recovered by way of such part of an *approved pass through amount*, or a *network support pass through amount*, as is permitted to be passed through to *Transmission Network Users* during that period less any capital expenditure that is included in a negative pass through amount, or in a network support pass through amount, that is required to be passed through to *Transmission Network Users* during that period,

excluding any forecast or actual capital expenditure that:

(5) represents a margin payable or paid by the *Transmission Network Service Provider* in circumstances where the margin is referable to arrangements that, in the opinion of the *AER*, do not reflect arm's length terms; or

(6) ~~is constituted by the capitalisation of operating expenditure in circumstances where~~ comprises expenditure which was treated as capital expenditure and that treatment was ~~capitalisation is~~ inconsistent with the capitalisation policy submitted to the *AER* under clause S6A.1.1(9) in relation to that review period or any part of it.

…

(f) Where the *overspending requirement* is satisfied, and subject to paragraphs (f1), (g) and (h), the *AER* may determine that the amount of the capital expenditure as a result of which the previous value of the regulatory asset base would otherwise be increased in accordance with clause S6A.2.1(f) should be reduced. ~~by such amount as the *AER* is satisfied corresponds to capital expenditure incurred during that period that does not reasonably reflect the *capital expenditure criteria*.~~

(f1) The *AER* may only make a determination under paragraph (f) where the *AER* is satisfied that the amount by which the capital expenditure will be reduced under paragraph (f) is capital expenditure that would not have been incurred by a prudent operator in the circumstances of the *Transmission Network Service Provider*.

(g) The amount *determined* by the *AER* under paragraph (f):

(1) must not be greater than the amount calculated in accordance with paragraph (c);

~~(2) must be determined in a manner that is consistent with the *capital expenditure incentive objective*~~, and

(2) must be determined taking into account the *Capital Expenditure Incentive Guidelines* that were in operating at the beginning of the relevant *regulatory control period* in which the capital expenditure being assessed was incurred.

(h) In making a *determination* under paragraph (f), the *AER* must:

(1) have regard to the matters in clause S6A.2.2(1) to (6) ~~*capital expenditure factors*~~; and

(2) only take into account information and analysis that the *Transmission Network Service Provider* could reasonably be expected to have considered or undertaken at the time that it undertook the relevant capital expenditure.

**S6.1.1 Information and matters relating to capital expenditure**

A *Revenue Proposal* must contain at least the following information and matters relating to capital expenditure:

…

(9) the policy that the *Transmission Network Service Provider* applies in determining whether expenditure is to be treated as capital expenditure (capitalisation policy) ~~in capitalising operating expenditure~~.

**S6A.2.2A Reduction of amounts by which the value of the regulatory asset base may be increased where certain requirements are satisfied ~~of efficiency of past capital expenditure~~**

(e) The *capitalisation requirement* is satisfied where the amount of the capital expenditure as a result of which the previous value of the regulatory asset base would otherwise be increased in accordance with clause S6A.2.1(f) includes ~~capital~~ expenditure that, under the ~~is constituted by the capitalisation of operating expenditure in circumstances where that capitalisation is inconsistent with~~ *Transmission Network Service Provider's* capitalisation policy submitted to the *AER* under clause S6A.1.1(9) in relation to that review period or any part of it, should have been treated as operating expenditure.

(j) Where the *capitalisation requirement* is satisfied, and subject to paragraph (k), the *AER* may determine that the amount of the capital expenditure as a result of which the previous value of the regulatory asset base would otherwise be increased in accordance with clause S6A.2.1(f) should be reduced by any or all ~~such~~ of the ~~capitalised operating~~ amount of expenditure referred to in paragraph (e) which should have been treated as operating expenditure ~~as is included in the forecast operating expenditure accepted or substituted by the *AER* for the review period.~~

(j1) Where the *AER* makes a determination pursuant to paragraph (j), the *AER* must also make any consequential adjustments to any estimate or actual capital or operating expenditure amounts for the relevant *regulatory period* which reflect the *AER's* determination that expenditure which was treated by the *Transmission Network Service Provider* as capital expenditure should not have been treated as capital expenditure in accordance with the *Transmission Network Service Provider's* capitalisation policy and should have been treated as operating expenditure.

**Drafting note: consequential amendment to clause S6A.2.2A**

(6) ~~is constituted by the capitalisation of operating expenditure in circumstances where that capitalisation is inconsistent~~ comprises expenditure which was treated as capital expenditure and that treatment was inconsistent with the capitalisation policy submitted to the *AER* under clause S6A.1.1(9) in relation to that review period or any part of it.

# 8. Regulatory Process

### 6A.12.2 Publication of draft determination and consultation

…

(c) Any person, other than the *Transmission Network Service Provider*, may make a written submission to the AER on the draft decision within the time specified in the invitation referred to in the paragraph (a)(4), which must not be earlier than ~~40 *business days*~~ 55 *business days* after the making of the draft decision.

### 6A.12.3 Submission of revised proposal, framework or pricing methodology and submission on draft decision

(a) ~~In addition to making written submissions, t~~The *Transmission Network Service Provider* may, not more than ~~30 business days~~ 45 *business days* after the publication of the draft decision, submit to the AER:

(1) a revised regulatory proposal;

(2) a revised proposed *negotiating framework*;~~ or~~

(3) a revised proposed pricing methodology; or

(4) a written submission on the draft decision.

(b) A *Transmission Network Service Provider* may only make the revisions referred to in paragraphs (a)(1)(2) and (3) so as to incorporate the substance of any changes required to address matters raised in, the draft decision or the *AER's reasons for it*.

….

(f) Subject to the provisions of the Law and the *Rules* about the disclosure of confidential information, the *AER* must *publish:*

(1) any revised *Revenue Proposal;*

(2) any revised proposed *negotiating framework*; or

(3) any revised proposed *pricing methodology*

(as the case may be), that is submitted by the *Transmission Network Service Provider* under paragraph (a), together with the accompanying information, including any written submission on the draft decision, as soon as practicable after the receipt by the AER.

(g) The *AER* ~~may~~ must invite written submissions on the *Revenue Proposal,* revised proposed *negotiating framework* or revised proposed *pricing methodology* and any written submission on the draft decision received under clause 6A.12.3(a) within the time specified in the invitation referred to in clause 6A.12.2(c).

### 6A.12.4 Submissions on specified matters

~~If the *AER* invites further submissions on a revised *Revenue Proposal,* revised proposed *negotiating framework* or revised proposed *pricing methodology* under clause 6A.12.3(g),~~ The *AER* ~~may~~ must invite further written submissions ~~on the submissions received under clauses 6A.12.2(c) or 6.12.3(g)~~ by *publishing* an invitation which specifies:

(a) ~~the matters in respect of which submissions are invited~~ that the *Transmission Network Service Provider* and any person may make submissions on new matters raised by other persons in submissions made under clauses 6A.12.2(c) and 6A.12.3(g); and

(b) the time for making submissions, which must not be earlier than 15 *business days* after the date on which the invitation was published.

### 6A.13.1 Making of final decision

~~(a) Subject to rule 6A.16(a), the *AER* must consider any submissions made on the draft decision, or on any revised *Revenue Proposal*, revised proposed *negotiating framework* or revised proposed *pricing methodology* submitted to it under clause 6A.12.3, and must make a final decision in relation to the *Transmission Network Service Provider*.~~

(a) The *AER* must make a final decision in relation to the *Transmission Network Service Provider*.

(a1) In making a final decision in relation to the *Transmission Network Service Provider*, and subject to rule 6A.16, the *AER* must have regard to each of the following:

(1) the information included in or accompanying the *Revenue Proposal*, proposed *negotiating framework* and proposed *pricing methodology;*

(2) written submissions received under this Part E; and

(3) any analysis undertaken by or for the *AER* that is published prior to the making of the final decision ~~or as part of the final decision.~~

(a2) The *AER* must use its best endeavours to *publish*, a reasonable time prior to the making of the final decision, any analysis undertaken by or for it on which it proposes to rely, or to which it proposes to refer, for the purposes of that decision.

(a3) If the *AER* does not publish any analysis in accordance with paragraph (a2), the *AER* must, in the final decision, identify the analysis that was not published and provide reasons why the *AER* was unable to make that analysis available prior to the making of that decision.

(b) The *AER's* final decision must be made in accordance with, and must comply with, the relevant requirements of rule 6A.14.

### 6A.10.1A AER's framework and approach paper

(a) The *AER* must prepare and publish a *framework and approach* paper in anticipation of every *revenue determination.* ~~make and publish a document (a *framework and approach paper*) that applies in respect of a *revenue determination* for a matter listed in paragraph (b) in accordance with this clause if:~~

~~(1) there is no *framework and approach paper* that applies in respect of that *revenue determination* for that matter; or~~

~~(2) there is a *framework and approach paper* that applies in respect of that *revenue determination* for that matter, but the *AER* considers it necessary or desirable to make and *publish* an amended or replacement *framework and approach paper* in so far as it relates to that matter.~~

(b) A *framework and approach paper* ~~that applies in respect of a *revenue determination*~~ must set out the *AER's* proposed approach (together with its reasons for the proposed approach), ~~in the forthcoming *revenue determination*,~~ to the following matters:

(1) the application to the *Transmission Network Service Provider* of any *service target performance incentive scheme*;

(2) the application to the *Transmission Network Service Provider* of any *efficiency benefit sharing scheme*;

(3) the application to the *Transmission Network Service Provider* of any *capital expenditure sharing scheme*;

(4) the application to the *Transmission Network Service Provider* of any *small-scale incentive scheme*; and

(5) the ~~methodology~~ forecast expenditure assessment techniques that the AER will use ~~is to be used~~ as part of its assessment ~~for the preparation~~ of forecasts of operating expenditure and capital expenditure that are to be included in the *Transmission Network Service Provider's Revenue Proposal*, ~~which may be the *standard expenditure forecasting methodology* or some different methodology.~~

~~(c)~~ ~~If there is a *framework and approach paper* that would apply in respect of the *revenue determination* for a matter listed in paragraph (b) then, no later than 32 months before the end of the *regulatory control period* that precedes that for which the *revenue determination* is to be made, the *AER* must *publish* a notice inviting submissions on whether it is necessary or desirable to amend or replace that *framework and approach paper* in so far as it relates to that matter.~~

~~(d)~~ ~~If there is a *framework and approach paper* that would apply in respect of the *revenue determination* for a matter listed in paragraph (b) and the *AER* considers that it may be necessary or desirable to make an amended or replacement *framework and approach paper* that applies in respect of that matter, then, no later than 31 months before the end of the *regulatory control period* that precedes that for which the *revenue determination* is to be made, the *AER* must:~~

~~(1)~~ ~~make and *publish* its decision to that effect; and~~

~~(2)~~ ~~give its reasons for that decision.~~

(c) A *framework and approach paper* is to be prepared in consultation with the relevant *Transmission Network Service Provider* and with other interested stakeholders.

(d) Where a *revenue determination* applies to a *Transmission Network Service Provider* and none of the *AER*, the *Transmission Network Service Provider* or an interested stakeholder submits that it is necessary or desirable to amend or replace the approach that has been taken in that the *revenue determination* to a matter listed in paragraph (b), the *AER* is not required to consult on that matter and the approach to that matter in the *framework and approach paper* is that set out in the *revenue determination* that applies to the *Transmission Network Service Provider* in the regulatory period preceding the regulatory period in respect of which the *framework and approach paper* is being prepared.

(e) The *AER* must commence preparation of, and consultation on, the *framework and approach paper* at least 32 months before the commencement of the *revenue determination* in respect of which the *framework and approach paper* is to apply.

~~**(d1)**~~ ~~**In making a decision under paragraph (d), the *AER* must have regard to any submissions made in response to the invitation under paragraph (c).**~~

(f)~~(e)~~ ~~Where paragraph (a) applies then,~~ At least 25 months before the commencement of the *revenue determination* in respect of which the framework and approach paper is to apply ~~end of the current *regulatory control period*~~, the *AER* must, ~~after consulting with the relevant *Transmission Network Service*~~

~~*Provider* and such other persons as the *AER* considers appropriate,~~ make, amend or replace the *framework and approach paper*, as the case may be, and:

(1) give a copy of it to the relevant *Transmission Network Service Provider*; and

(2) *publish* it,

as soon as is reasonably practicable.

(f) A *framework and approach paper* is not binding on the *AER* or a *Transmission Network Service Provider*.

(g) The *AER* may make and *publish* a *framework and approach paper* that applies in respect of a *revenue determination* for a matter that is not listed in paragraph (b) and, if it does so, this clause 6A.10.1A applies as if that matter were listed in paragraph (b).

## 10.3 Drafting Amendments to National Gas Rules

# 4-5. Cost of capital estimation framework and return on debt estimation

**Rule 9B Rate of return consultative procedure**

(1) If the *Law* requires a *decision* maker to comply with the *rate of return consultative procedure* in making, amending, replacing or reviewing the *rate of return guidelines*, the *decision* maker must proceed in accordance with this rule.

(2) The *decision* maker must proceed as follows:

(a) the *decision* maker must publish a notice on its website and in a newspaper circulating generally throughout Australia:

(i) describing the proposed *rate of return guidelines*, amendments or review, and giving the address of a website on which the details of such guidelines, amendments or review, and the reasons for them, are published; and

(ii) inviting written submissions on the proposed rate of return guidelines, amendments or review within no less than ~~30~~ 60 *business days* of the date of the notice;

(b) the *decision* maker may publish such issues, consultation and discussion papers, and hold such conferences and information sessions in relation to the proposed *rate of return guidelines*, amendments or review as it considers appropriate; and

(c) the *decision* maker must, within ~~80~~ 180 *business days* of the date of the notice referred to in subrule (2)(a) and after considering relevant submissions made within the time allowed in the notice and other matters the decision maker considers relevant, make its final *decision*.

(3) The final *decision* must:

(a) be in writing;

(b) state the terms of the *decision* and the reasons for it; and

(c) include a summary of each issue raised in submission, that the *decision* maker reasonably considers to be material, together with the *decision* maker's response to each such issue.

(4) The *decision* maker may extend the time within which it is required to make its final *decision* if:

(a) the consultation involves questions of unusual complexity or difficulty; or

(b) the extension of time has become necessary because of circumstances beyond the *decision* maker's control.

(5) After making a final *decision*, the decision maker must, without delay:

(a) publish the final *decision* on the decision maker's website; and

(b) make the final *decision* available for inspection during business hours at the *decision* maker's public offices.

## Rule 87 Rate of return

(1) The return on the projected capital base for each regulatory year of the *access arrangement period* is to be calculated by applying a rate of return that is determined in accordance with this rule 87 (the *allowed rate of return*).

(2) The *allowed rate of return* ~~is to correspond to~~ is to be commensurate with the benchmark efficient financing costs of an ~~benchmark efficient~~ entity ~~with~~ facing a similar degree of risk as that which applies ~~to the service provider~~ in respect of the provision of reference services (the *allowed rate of return objective*).

(3) The *allowed rate of return* for a *regulatory year* is to be determined:

(a) as a weighted average of the return on equity for the *access arrangement period* in which that regulatory year occurs (as estimated under paragraph (e)) and the return on debt for that regulatory year (as estimated under paragraph (f)) where the weights applied to compute the average reflect the relative proportions of equity and debt finance that would be employed by an efficiently financed benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of reference services;

(b) on a nominal ~~post-tax~~ vanilla basis that is consistent with the estimate of the value of imputation credits referred to in clause 6A.6.4; and

(c) taking into account relevant estimation methods, financial models, market data and other evidence.

(4) In determining the *allowed rate of return*, regard must be had to~~:~~

~~(a)~~ ~~the desirability of using an approach that leads to the consistent application of any estimates of financial parameters that are relevant to the estimates of, and that are common to, the return on equity and the return on debt; and~~

~~(b)~~ any interrelationships between estimates of financial parameters that are relevant to the estimates of the return on equity and the return on debt.

### Return on equity

(5) The return on equity for an *access arrangement period* must be estimated:

(a) in a way that is consistent with the *allowed rate of return objective*; and

(b) taking into account the prevailing conditions in the market for equity funds.

### Return on debt

(6) The return on debt for a regulatory year must be estimated:

(a) in a way that is consistent with the *allowed rate of return objective*; and

(b) using a methodology under which:

(i) the return on debt for each regulatory year in the access arrangement period is the same; or;

(ii) the return on debt for a regulatory year (other than the first regulatory year in the access arrangement period) is estimated using a methodology which complies with ~~subparagraph (i)~~ subrule (12).

(7) An *access arrangement proposal* must include a methodology for estimating the return on debt which the service provider considers is consistent with the *allowed rate of return objective* and the *return on debt methodology principles*.

(8) The *AER* must accept the methodology for estimating the return on debt that is included in an *access arrangement proposal* if the *AER* is satisfied that the proposed methodology is consistent with the *allowed rate of return objective* and the *return on debt methodology principles*.

(9) If the *AER* is not satisfied as referred to in subrule (8), the methodology for estimating the return on debt must be the same as the methodology that applied to the service provider in the immediately preceding *access arrangement period*.

(10) Subject to subrule (6), the methodology adopted to estimate the return on debt may, without limitation, be designed to result in the return on debt reflecting:

(a) the return that would be required by debt investors in a benchmark efficient entity if it raised debt at the time or shortly before the time when the AER's decision on the access arrangement for that *access arrangement period* is made;

(b) the average return that would have been required by debt investors in a benchmark efficient entity if it raised debt over an historical period prior to the time when the AER's decision on the access arrangement for that access arrangement period is made; or

(c) some combination of the returns referred to in subparagraphs (a) and (b).

(11) In determining whether the methodology adopted to estimate the return on debt for a regulatory year is ~~estimated in a way that is~~ consistent with the *allowed rate of return objective*, regard must be had to the following ~~factors~~ principles (the *return on debt methodology principles*):

~~(a) the likelihood of any significant differences between the costs of servicing debt of a benchmark efficient entity referred to in subrule (3)(a) and the return on debt over the access arrangement period;~~

~~(b) the impact on gas consumers, including due to any impact on the return on equity of a benchmark efficient entity referred to in subrule (3)(a);~~

~~(c) the incentive effects of inefficiently delaying or bringing forward capital expenditure; and~~

~~(d) the impact of changing the methodology for estimating the return on debt across access arrangement periods.~~

(a) that the return on debt should allow for recovery by a service provider of the expected cost of debt financing over the life of the assets used to supply reference services (including to the extent that the life of these assets may extend over more than one *access arrangement period*); and

(b) that the methodology adopted to estimate the return on debt should reflect the efficient financing costs of a prudent operator in the circumstances of the service provider.

(12) A methodology referred to in subrule (6)(b)(ii) must provide for any change in ~~total revenue for the regulatory year that would result from a change to the allowed rate of return for that regulatory year, as a result of~~ the return on debt ~~for that~~ as between different regulatory years within the same *access*

*arrangement period* ~~being different from that estimated under subrule (6),~~ to be effected through the automatic application of a formula that is specified in the access arrangement.

## Rate of return Guidelines

(13) The *AER* must, in accordance with the *rate of return consultative procedures,* make and publish guidelines (the *rate of return guidelines*), except that the first *rate of return guidelines* must be made in accordance with subrule ~~(13)~~ (20) and not the *rate of return consultative procedures*.

(14) Subject to subrule (15), a *rate of return guideline* only applies to an access arrangement final *decision* in respect of which the *access arrangement proposal* was submitted at least three months after publication of the *rate of return guideline*.

(15) A *rate of return guideline* may only apply to an access arrangement final *decision* in respect of which the *access arrangement proposal* was not submitted at least three months after publication of the *rate of return guideline* if the service provider to which the access arrangement final *decision* will apply consents to such application.

(16) An access arrangement final decision to which a *rate of return guideline* applies must be consistent with the *rate of return guideline* unless there are reasons and evidence in support of a departure from the *rate of return guideline*.

(17) The *rate of return guidelines* must set out:

~~(a) the methodologies that the AER proposes to use in estimating the allowed rate of return, including how those methodologies are proposed to result in the determination of a return on equity and a return on debt in a way that is consistent the allowed rate of return objective; and~~

~~(b) the estimation methods, financial models, market data and other evidence the AER proposes to take into account in estimating the return on equity, the return on debt and the value of imputation credits referred to in rule 87A.~~

(a) in relation to the return on equity:

(i) the financial models which the *AER* proposes to use in determining the return on equity;

(ii) for each parameter in the applicable financial models, either a value which the *AER* proposes to use or the information and data sources which it proposes to use to derive such a value;

(iii) the way in which the *AER* proposes to use the financial models, information and data sources to derive a value for the return on equity; and

(iv) an estimate of the return on equity which would apply as at the date of publication of the *rate of return guidelines*, based on the *AER's* proposed use of the financial models, information and data sources;

(b) in relation to the return on debt:

(i) the form of debt finance which will be used to determine benchmark efficient debt financing costs of an entity with a similar nature and degree of risk as that which applies to a service provider in respect of the provision of reference services;

(ii) the information and data sources which the *AER* proposes to use to determine the return on debt applicable to the relevant form of debt finance as at any point in time; and

(iii) an estimate of the return on debt which would apply as at the date of publication of the *rate of return guidelines*, based on the *AER's* proposed form of debt finance and proposed information and data sources;

(c) the relative proportions of equity and debt finance that would be employed by an efficiently financed entity with a similar nature and degree of risk as that which applies to the service provider in respect of the provision of reference services (as referred to in subrule (3)(a)); and

(d) the value of imputation credits referred to in rule 87A.

(18) A *rate of return guideline* must be accompanied by a statement of reasons setting out:

(a) the evidence relied upon by the *AER* in formulating the guideline; and

(b) reasons and evidence supporting any change in approach from any previous *rate of return guideline*, in respect of any of the matters referred to in subrule (17).

(19) The AER must make the first *rate of return guideline* by [29 ~~August~~ December 2013] and there must be *rate of return guideline* in force at all times after that date.

(20) For the purpose of making the first *rate of return guideline*, the *AER* must:

(a) by no later than [29 March 2013], publish a consultation paper that sets out its preliminary views on the material issues that are to be addressed by the *rate of return guidelines*;

(b) publish an invitation for written submissions on the consultation paper, with such submissions to be made within the time specified in the invitation (which must not be earlier than ~~30~~ 60 business days after the invitation for submissions is published);

(c) by no later than ~~31 July~~ 15 August 2013, publish a draft of the *rate of return guidelines*; and

(d) publish an invitation for written submissions on the draft *rate of return guidelines*, with such submissions to be made within the time specified in the invitation (which must not be earlier than ~~30~~ 60 business days after the invitation for submissions is published).

(21) The *AER* must, in accordance with the rate of return *consultative procedures*, review the *rate of return guidelines*:

(a) at intervals not exceeding ~~three~~ four years, with the first interval starting from the date referred to in subrule ~~(12)~~ (19); and

(b) at the same time as it reviews the *rate of return guidelines* made under clauses 6.5.2 and 6A.6.2 of the National Electricity Rules.

(22) The *AER* may, from time to time and in accordance with the rate of return *consultative procedure*, amend or replace the *rate of return guidelines*.

~~(16) The rate of return guidelines are not mandatory (and so do not bind the AER or anyone else) but, if the AER makes a decision in relation to the rate of return (including in an access arrangement draft decision or an access arrangement final decision) that is not in accordance with them, the AER must state, in its reasons for the decision, the reasons for departing from the guidelines.~~

**Attachment B**

# Case studies – application of *ex post* review mechanisms

**Western Australia**

The Economic Regulation Authority (ERA) is required by the Western Australian Electricity Access Code 2004 (Code) to assess ensure that only prudently incurred capital expenditure is factored into the setting of price controls – that is, that "no more than" prudent amounts be included in the RAB. However, the Code provides little guidance or restriction as to how the test should be applied.

During the second access arrangement review for Western Power, the ERA's application of the ex post prudence test resulted in an across the board disallowance of 15 per cent of the capital expenditure incurred in the previous period.

This application of an ex post prudence test provides a telling example of the significant risks and costs that can be created where an ex post prudence test is applied in an inappropriate manner, and so underscores the necessity for the appropriate design and application of an ex-post prudence test.

Professor Yarrow and Dr. Decker undertook and assessment of the ERA's approach to applying an ex-post prudence test and concluded it was a poor application of the test and did not accord with the Code objective or good regulatory principles or practice[71]:

> *"In response to the two questions asked, and on the basis of the reasoning above, we conclude the ERA' s application of the NFIT provisions (sections 6.51A to 6.55 of the Electricity Networks Access Code 2004) and its reasoning for the proposed asset write down of 15 per cent is:*
>
> *(a) not consistent with the Code objectives.*
>
> *(b) not consistent with good regulatory principles and practice in other, comparable jurisdictions."*

Professor Yarrow and Dr. Decker compared the approach undertaken by the ERA in applying an ex-post prudence test to that of other jurisdictions and found a number of important deficiencies[72]:

> "*It will be apparent from what has been said in the discussion of practice in other jurisdictions regarding capex disallowances (in section 5 above) that the ERA's approach in the Draft Decision is out of line with approaches elsewhere. Four points stand out in this respect:*
>
> - *The normal standard against which actual performance is compared is based on notions of reasonableness rather than best possible practice (or, 'frontier' efficiency). The ERA reasoning appears to us to tend to rely on the latter notion, although it is impossible to be definite because the relevant standard is not actually discussed and specified (which is itself a significant fault in the reasoning).*
> - *When they occur, disallowances in other jurisdictions tend to be based on findings of substantial failures relating to specific projects. They are not based on sweeping, across-the-board judgments about the efficiency of capex programmes as a whole.*
> - *With the exception of US disallowances of investments in electricity power plant, particularly nuclear power plant, ex post adjustments to regulatory asset bases have tended to be much smaller, in proportionate terms, than the adjustment indicated by the ERA.*

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[71] *Report on the ERA's draft decision on proposed revisions to the access arrangement for the south west interconnected network*, p. 27, 1 September 2009, G. Yarrow and C. Decker

[72] *Report on the ERA's draft decision on proposed revisions to the access arrangement for the south west interconnected network*, pp. 26 - 27, 1 September 2009, G. Yarrow and C. Decker

- *It is generally recognised that ex post disallowances made in regulatory contexts where there is no source of compensatory payments in the regulatory system (such as a higher allowable return on capital, or capex incentive schemes that provide for the possibility of supernormal returns) are liable to lead to deficient investment incentives and hence to inefficiently low levels of investment. The ERA Draft Decision does not address the compensation issue."*

**NEM experience**

In its final Statement of Principles for the Regulation of transmission revenues (SORP), the ACCC decided not to use an ex prudence tests for capital expenditure in future periods, choosing instead to rely on an ex-ante regime (that is, financial incentives) to encourage efficiency.[73] In this decision, the ACCC indicated it was concerned about potential distortions that might arise from applying an ex-post prudence test.

However, prior to this change in approach, the ACCC did apply an ex post prudence test to capital expenditure. Its approach for applying the ex post prudence test was specified most clearly in the SORP (this was addressed in the SORP as part of the transition to the new approach). The overarching test for prudency was the amount that would be invested by a prudent TNSP acting efficiently in accordance with good industry practice. The ACCC further explained 'good industry practice' was having regard to "*...TNSP's investment decisions considering the information available to the TNSP at the time the decisions were taken...*"[74] and whether a prudent TNSP would have made the same decisions. This implies a 'no hindsight' test applied.

The starting point for assessing the prudency of TNSP's capital expenditure was to be the Regulatory Test. After considering that this alone could not be relied upon, the ACCC identified three, arguably desirable, considerations:

- Whether there was a justifiable need for the investment
- Whether the TNSP proposed the most efficient investment to meet that need, and
- 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 one instance where the ACCC applied the ex-post prudence test and that resulted in a material disallowance was with respect to TransGrid's MetroGrid project. While this case study demonstrates many of the difficulties with applying an ex post prudence test, it provides a clear illustration of how difficult it is for a decision maker not to apply the benefit of hindsight when looking back on a business's past expenditures. It also provides a good example of how care is required to properly quantify the "imprudent" portion of cost and hence for the need for clear guidance on this matter.

The relevant facts of the case were that:

- TransGrid determined that it needed to upgrade the reliability of the Sydney CBD (by adding additional resilience against contingencies, namely a shift from an 'N-1' standard for the Sydney CBD to a 'modified N-2' standard).
- After the conduct of the Regulatory Test, the cost of the project changed materially.

[73] ACCC, Decision, *Statement of principles for the regulation of electricity transmission revenues – background paper*, 8 December 2004, p.44
[74] NSW and ACT Transmission Network Revenue Cap, TransGrid 2004/05 to 2008/09 final decision, p. 71, 27 April 2005, ACCC

The ACCC – on the advice of Mountain Associates – made the following two findings.

- First, given the material change to the cost of the project, TransGrid should have deferred the project to undertake further assessment of whether the project as implemented was the best one. That is, the previous 'N-1' should be maintained, with demand management procured to ensure that the 'N-1' standard was continued.

- Secondly, the amount of "imprudence" in the project cost was deemed to be the saving in financing costs that would have flowed if the project was deferred to allow the additional assessment, net of the cost of procuring sufficient demand management to meet the 'N-1' standard.

Turning first to whether hindsight was exercised, it is not obvious from the discussion presented by the ACCC and its adviser that hindsight was exercised, and there are assertions that this was not the case. However, when the findings are examined critically, material exercises of hindsight are obvious.

- First, as a general matter, this project was only singled out because there had been a cost increase compared to the forecast, which itself is an exercise of hindsight that is common to all applications of the ex post prudence test.

- More importantly, the ACCC's and its adviser's assertion that the N-1 standard should have been maintained while further assessments were undertaken was the 'hindsight' that the sort of event that justified the move from an N-1 to a 'modified N-2' standard had not occurred over the intervening period. In short, if the sort of high impact, low probability event that justified the higher standard had occurred – and thus MetroGrid had avoided serious economic consequences – it is inconceivable that Mountain Associates and the ACCC would have suggested it would have been prudent for the reliability upgrade to be deferred while further assessments were undertaken[75].

Turning to the question of how the imprudent portion of the expenditure was quantified, it is notable that neither the ACCC nor its adviser disagreed with the appropriateness of the move to a modified N-2 standard. Moreover, neither found that there was a better project than MetroGrid for meeting this higher standard. Notwithstanding, the ACCC (on the advice of Mountain Associates) reduced TransGrid's RAB by the cost saving that would have occurred if the project had been deferred.

Against this background, the extent of imprudence that the ACCC determined clearly was excessive for two reasons.

- First, the asserted cost saving to customers is only part of the story – if the project had been deferred, the lower cost to customers would have come with a commensurately lower level of reliability. The net impact on customers from an imprudent investment is the difference between the additional costs borne and the additional service received, the latter of which the ACCC ignored.

- Secondly, the ACCC's acceptance that the move to the 'modified N-2' was desirable implies an acceptance that the benefits to customers from the higher reliability standard would exceed the cost. A consequence of this acceptance is that the ACCC should only have found that MetroGrid was imprudent if a lower cost means of meeting the higher standard existed. The ACCC's suggestion of deferring the upgrade ACCC would never be prudent because it would mean that customers would lose more from the reliability reduction than the cost that would be saved. Indeed, the fact that that the ACCC identified there was no superior alternative to MetroGrid for

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[75] It is important to note the TransGrid further challenged whether such a delay was prudent given the costs already incurred for the project and the costs that would have been incurred by a delay; for example, the costs of breaking or delaying contracts that were already in place.

> meeting the 'modified N-2' standard means there was no logical basis for it concluding that there was any imprudence.

Thus, the key lesson from the TransGrid example is that the exercise of hindsight is difficult to prevent and may well be present in subtle forms. The second lesson is that care is required to quantify any imprudence correctly and guidance on this matter is required to ensure a holistic assessment.

**UK experience**

Ofgem provides itself with the option to undertake ex-post prudency tests of capital expenditure incurred. Importantly, while many of the key features of the Australian approach to regulation are modelled on the UK approach, a key difference in this respect is that the UK does not include the requirement for network businesses to undertake an economic test prior to a specific investment being undertaken. In that respect, it might be argued that the ex-ante safeguards against inefficient expenditure are lower in the UK than compared to Australia.

Another key difference between Australia and the UK is that in the UK there are no separate rules setting out the powers of the regulator. Therefore, the approach taken to regulation in the UK is largely clarified by statements from the regulator or its actual practice.

In the UK Ofgem appears reluctant to disallow expenditure on an ex-post basis except in the most extreme cases. As noted by Professor Yarrow and Dr Decker there is a strong preference of UK regulators to rely on ex-ante incentives:[76]

> "*UK sectoral regulators have tended to have a strong aversion to ex post disallowances of capital expenditures, reflecting factors such as:*
>
> - *A recognition that the regulatory asset base is the crystallisation of past 'settlements' between customers/consumers and investors which should not, in ordinary circumstances, be disturbed, and*
> - *The focus of the (RPI-X) regulatory regime on forward looking approaches to capex evaluation.*"

There is only once instance where Ofgem has made an ex-post disallowance of expenditure. Importantly, however, this was a reaction to a known perverse incentive with a generous upside and did not relate to 'obligated' levels of capacity[77]. In its decision on for the National Grid gas business Ofgem disallowed £19m of £73m expenditure already incurred relating to the delivery of baseline capacity at the St Fergus entry terminal. The basis for the disallowance was that National Grid ignored important information at the time it made its investment and did not review its initial investment decision in light of new information[78].

Notably, the disallowance in this instance was reasonably small (0.64% of National Grid's closing RAB and 1.9% of capital expenditure during the period) and related to a specific project where concerns were identified. Further, the approach by Ofgem displayed elements of good regulatory practice in that, to the extent possible, the following features were sought:

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[76] *Report on the ERA's draft decision on proposed revisions to the access arrangement for the south west interconnected network*, pp. 12- 13, 1 September 2009, G. Yarrow and C. Decker

[77] The disallowed investment related to an incentive scheme that allowed for returns of up to 6% above the cost of capital over a period of between five and ten years. See: *Report on the ERA's draft decision on proposed revisions to the access arrangement for the south west interconnected network*, 1 September 2009, G. Yarrow and C. Decker

[78] Transmission Price Control Review: Final Proposals, 4 December 2006, p.33, Ofgem

- Ofgem has accepted that it should face the burden of proof to demonstrate that an investment was inefficient when applying the ex post test to incurred expenditure, which is a different stance to what it takes when assessing proposed capital expenditure

- The test applied to the information that was available at the time the decisions to invest were made by the company, rather than with the benefit of hindsight

- The test was applied only to large individual projects that have passed materiality thresholds.

**US experience**

In the US, there is no systematic or general provision for regulatory, ex-post prudence reviews of transmission investment. Project-specific transmission plans are approved by Independent System Operators (ISOs)/Regional Transmission Operators (RTOs) prior to the investment being undertaken. FERC and state authorities then approve the initial cost estimates of individual projects. FERC regulates all US wholesale transmission functions, outside the Electric Reliability Council of Texas (ERCOT). Once the project is completed and in use, the actual costs incurred in relation to the project are included in the regulated tariffs.

The actual investment costs incurred are assumed to be prudent, unless they are challenged during the tariff review process before FERC. Anyone, including FERC, can file a complaint under section 206 of the Federal Power Act to challenge the inclusion of actual expenditure in tariffs. Such a complaint requires a demonstration that the expenditure was unnecessary or imprudent, such that the recovery of those costs would lead to transmission rates that are unjust and unreasonable. The burden of proof is the responsibility of the challenger.

In practice there have been very few challenges to the inclusion of the full actual cost of transmission projects in the rate base. In recent years there have been a number of notable cases where the actual costs of transmission projects have significantly exceeded the cost estimates at the time of regulatory approval. However this has led to additional prescription in some ISO/RTO’s cost estimation requirements, and enhanced requirements for reporting on differences between estimated and actual costs during the construction process, rather than to ex post prudency reviews and disallowances of actual project costs.