# Economic Regulation of Network Service Providers Rule Change Requests – Melbourne Public Workshops 2 April 2012

***The summary below has been prepared by AEMC staff. It does not represent the views of the AEMC or the views of the participants that reported to the plenary session. The summary captures generally the matters discussed at the workshops and does not represent a consensus view of participants at the workshops.***

## Summary of discussions from workshop 1 – Capex/opex allowances

***Constraints on the AER***

- Discussion commenced with whether the Australian Energy Regulator (AER) has been constrained in practice.
- One participant stated that the constraint applies at the second stage of the process for the assessment of expenditure forecast proposals provided by network service providers (NSPs). It stated that there is a two stage process currently:
    - Stage one, whether the AER is satisfied or not with the NSP's proposal;
    - Stage two, if the AER is not satisfied and rejects the expenditure forecast proposal, what should the substitute be?
- One participant commented that it would be good to have only one stage. Stage one above needs to be removed. This would enable the AER with sufficient time to assess the proposal and make sure there is efficient investment upfront.
- Other participants sought to understand why the AER can't undertake the two stages jointly.
- One participant stated that the most effective way for eliminating the two stage process would be by changing the rule as proposed in the AER rule change requests. Or else, changing the regulatory process.
- However, participants doubted whether there is a need to make a rule change to reflect this request in terms of procedure. Time constraints could be dealt with by enhancing the regulatory process accordingly.
- Furthermore, it was noted that there shouldn't be any need to move away from the current process. The AER could start considering its adjustments from the beginning. More stakeholder engagement should be encouraged.
- It was suggested consumers need to be more involved. It was noted that it is very hard to get national level voice. One suggestion was to try to get one voice from both large and small consumer groups.

### *Driver of increasing prices*

- One participant noted evidence for inflated forecasts has been provided in the AER rule change proposal. There is evidence of the deficiency of the regulatory framework.

- However, NSPs generally expressed that meeting reliability standards could be one of the reasons for high prices.

- In response to the NSPs a participant noted that where reliability has been maintained at a certain level, there must be other reasons for increasing prices. It was suggested tracking back to previous periods and a jump in price in past five years will be noticed.

### *NSPs' proposal*

- A number of participants considered that the expenditure forecast proposal should be an input into the AER's assessment.

- Participants suggested that the AER assessment should start from the businesses' proposal.

- One participant stated that if there is a big difference between the proposed number and the estimate from the AER, the AER's ability to change the proposed number to the estimate is constrained.

- NSPs argued that the businesses have an incentive to provide a correct forecast. When directors sign the proposal, they need to consider the following factors:

    - The revenue requirement for the five years

    - Development plan

    - Governance matters

    - AER guidelines

- Therefore in providing the forecast expenditure proposal to the AER, management in each business must ensure there is no over-spending provided for.

- One participant commented that it is just the NSPs' point of view that the proposal aims to provide for efficient investment. There is no requirement on outcomes.

- There was also general discussion on whether efficient investment means one forecast number or a range. No agreement was achieved on this point.

- One participant noted a need to set up a restriction on the difference in expenditure forecasts provided for draft and final determinations. There was a case that the revised capex expenditure was doubled for the final determination.

### *Evidentiary proof*

- Some participants noted that it should be the NSPs' job to provide evidence to satisfy the AER.

- NSPs expressed the view that the AER is required to assess proposals and state whether it is satisfied or not.

- Another participant stated that the real problem is not with the evidentiary proof. It is about the two stage process.

***Techniques for assessment of expenditure proposals***

- Participants generally expressed the view that the AER should be able to assess the proposal using other analytical techniques. It has the freedom to use other tools to help with its assessment.

- It was noted that the following techniques could be used by the AER:

    - Self-benchmarking – using its historic data to inform the benchmark

    - External benchmarking

    - Sample spot-check

- One participant argued that a sampling “spot-check” is not ideal because it isn’t applied across the board. Broader sampling would mean a more effective process, but more time is needed for this.

- It was noted that a line by line assessment is not possible for the AER. As an economic regulator, it can’t take the role of managers of the network.

- It was noted that the senior teams in businesses also do not check the proposal on a line by line basis. It is the manager’s job to do a line by line check.

***Benchmarking***

- All participants were agreed that when benchmarking the AER must take into account certain circumstances of an NSP. This issue that had been disputed in submissions appeared to be resolved.

***Publishing material***

- It was observed that material needs to be available in advance before a final determination. If it has significant impact on the determination, further discussion opportunity should be provided before the final determination. However, the practical difficulties in this were also observed.

- If the information is material, for example, a new data set or a new methodology, stakeholders need to be able to take this into account and respond.

## Summary of discussions from workshop 2 – Capex incentives

***Reasons why a NSP may need to spend more than its capital expenditure allowance***

- NSPs stated that they may overspend for three broad reasons:

    - higher than expected peak demand;

    - a problem not originally identified occurring, eg a particular fleet of assets breaking down; and

    - to meet higher reliability standards (which may be rewarded through rewards under the service target performance incentive scheme).

- Other relevant factors mentioned included:

- demand is always going to change from forecast. The regulator may also get the forecast wrong;

- NSPs may focus on the overall capital expenditure (capex) allowance for the regulatory control period rather than the annual allowances. NSPs noted that it would not be clear to them whether they would overspend until later on in the regulatory control period;

- a NSP's forecast may be developed on probabilistic scenarios, but that NSP deals with the problems or requirements at the time;

- actual depreciation (as opposed to forecast) drives under expenditure; and

- the uncertainty regime may not be appropriate in the circumstances, for a number of reasons, including that the uncertainty regime is designed as being applicable only really for shipwreck-type circumstances due to thresholds; and the way that the regulator implements the regime. Against this, it was suggested that NSPs may avoid the uncertainty regime because they will get cost recovery anyway under the roll forward approach.

- There was some discussion on the relevance of ownership in relation to expenditure. It was suggested that privately-owned NSPs generally do not overspend unless they have safety or reliability issues.

- The lack of supervision of expenditure above allowances was discussed; and whether the NER should and could provide back up where governance arrangements fall over. The AEMC clarified that the NER did not extend to regulating corporate governance. NSPs considered there was scrutiny of over expenditure when the AER came to set the forecasts for the next period.

- The AER's concerns with the current efficiency benefit sharing scheme (EBSS) framework is that it requires a scheme to be symmetrical which provides stronger incentives to defer capex from one regulatory control period to the next.

***Possible solutions***

- A number of possible solutions, including their advantages and disadvantages, were discussed.

- Carry forward mechanism: One NSP noted that a carry forward mechanism for capex could work but is not as easy to apply as it is for operating expenditure. It had concern over ex-post reviews. The trigger for the uncertainty regime was too high in distribution.

- Ex-post reviews:

  - In Western Australia NSPs can obtain pre-approval of capex above the forecast. This provides the NSP with greater certainty. In addition some types of capex are subject to an investment adjustment mechanism which allows revenues to be adjusted if certain types of capex take place. Growth capex is subject to this mechanism for example. There is some time involved in implementing these mechanisms and the regulator in WA only has to oversee one NSP.
  - Query the level of evidence necessary to establish whether capital expenditure was efficient. The implementation issues were acknowledged. Pre-approvals should be further investigated.

    - NSPs did not support ex-post reviews. They suggested that privately-owned NSPs would not overspend under this regime, even when it was efficient to do so. It was noted that ex-post reviews are provided for in Great Britain and the US.

- AER's proposed 60/40 sharing mechanism:

    - NSPs suggested that this option was blunt and didn't take into account other mechanisms such as the service target performance incentive scheme. They noted that the AER had the power to strengthen capex incentives in distribution through the development of an efficiency benefit sharing scheme.

- Ofgem's menu regulation: this may be worth exploring but involves a different approach to regulation. It involves negotiation which is not the way things have gone in Australia.

- An EBSS for capex has been applied successfully in gas in Victoria. However, it was withdrawn by the ESC in electricity distribution due to concerns around difficulty in determining the reasons for under-expenditure ie whether it was through efficiency or through non-sustainable deferral. Given the lumpy nature of capex it is also difficult to use past trends to determine future requirements. For these reasons, governments were not sure whether an EBSS would work.

- Some other factors to be considered in addressing this issue:

    - how to ensure that the NER does not create incentives for inefficient deferral;

    - the incentive regime should provide for flexibility;

    - the role of the RIT-T in ensuring efficient and prudent investment;

    - any incentive scheme needs to be clear at the outset. NSPs said it was crucial that they knew what their incentives were at the start of a regulatory control period to make decisions about whether to invest or not in certain projects.

***Role of consumers in the capex process***

- The difficulty for consumers to engage in the process was noted.

- One NSP noted that it tries to get customers involved before it submits its regulatory proposal. This is particularly the case for large customers. The RIT-T is also a mechanism by which customers can get involved in the transmission context.

***Uncertainty regime***

- NSPs suggested that applying the capex reopener and contingent project regimes to distribution was problematic due to the fact that capital projects for distribution are smaller and more numerous than in transmission

- The contingent project regime is similar to the pre-approval regime in Western Australia. The pre-approval regime there has been for major projects and has mainly been used in transmission but there have been a couple of projects identified in distribution. The threshold for pre-approval in Western Australia is $30 million plus CPI for transmission and $10 million plus CPI for distribution. There have not been many applications so these have been easy to manage in WA.

- It was suggested that capex reopeners and contingent projects were more suited to transmission due to the project specific nature of transmission capex. NSPs suggested that an allowance for different scenarios could be put aside in distribution rather than basing on individual projects. Similarly,  a “contingent program” regime for distribution was suggested. This was an interesting concept that should be explored further.

- The impact of changes in distribution pricing during the regulatory control period on retailers pricing structures was noted.

***Other incentive schemes***

- NSPs noted the AER already had discretion to develop a wide range of incentive schemes under the NER and had not used the extent of its existing powers referring to the capex EBSS in distribution. They broadly preferred that incentive schemes be tested against the National Electricity Objective and did not consider it appropriate that the AER be given this discretion. One NSP did not object to the AER having this discretion as long as new schemes were consulted on fully.

- If the AER is given this power, NSPs thought that they should be able to propose incentive schemes in the framework and approach stage of the regulatory determination process.

- It was suggested that pilot schemes could result in duplication.

***Actual or forecast depreciation***

- Some NSPs expressed concern about the distortionary impact that using actual depreciation has on incentives between short and long lived assets. They suggested that the use of actual depreciation creates a stronger incentive for NSPs to invest in short lived assets. This was not an intended consequence of the NER and is particularly relevant as increasingly, investment is in IT infrastructure. Some NSPs therefore preferred that forecast depreciation be locked into the NER.

- Other participants still considered that there be flexibility in the NER, along the lines that the AER has suggested in its rule change request; although some suggested even further flexibility and whether the NER should permit different incentives on different asset types.

***Related party margins***

- Most participants agreed that there was an issue with related party margins that would not be addressed by any mechanisms to address expenditure above allowed forecasts. However, NSPs considered it was important that the NER did not prohibit related party margin costs.

- One participant stated that it might be better for the AER to undertake an ex-post review of the methods for determining related party margins.

- Governments asked how do benefits from efficient activities provided by a NSP using a related party get returned to consumers.

## Summary of discussions from workshop 3 – Rate of return

Workshops 3 and 7 on rate of return issues were structured in a similar way. About half of each workshop was a discussion of the overall framework for setting the rate of return, while the second part of each workshop discussed the approach to setting the cost of debt.

***Part A – The framework for setting the rate of return***

- There was general agreement with the AEMC's characterisation of the current frameworks for electricity transmission and gas in the Directions Paper. The Chapter 6A transmission framework was seen as inflexible to deal with changing market circumstances, while the gas framework has many desirable qualities such as flexibility and the application of the forward-looking cost of funds for a hypothetical efficient benchmark firm. There was some concern that the AEMC's assessment that lack of guidance on parameters in the gas framework results in "open-ended" debate may be too harsh. Although, it was recognised that the gas framework, despite the flexibility in practice often operated with the framework that the AER applied in the electricity sector.

- A number of factors were not considered, nor could have been foreseen, when the AEMC implemented the Chapter 6A rules. A number of material factors have contributed to the current difficulties, such as the GFC and the MCE's subsequent decision to avail merits review of rate of return.

- The interdependence of parameters can be considered at two levels – by the AER and by the Tribunal. It was recognised that there are two aspects to the interdependence of WACC parameters. The first is the technical interrelationship, such as between the gamma and the market risk premium. The second aspect is the off-setting considerations, such as where the regulator may allow a more generous estimate of one parameter to recognise the lower estimate made in another parameter.

- The gas rules provides a better scope for the AER to consider the rate of return in its totality rather than focusing on individual parameters in detail as is the case with the Chapter 6 and 6A rules. The gas rules provide the regulator with more opportunity to undertake a number of "reasonableness checks" to ensure that the overall rate of return is consistent with market practice. Given the Tribunal's focus is on the precision of individual parameter estimations, this overall reasonableness check may not occur at the appeals stage.

- It was suggested that the overall evidence of broader evaluation of the rate of return is an open legal question about how the Tribunal is limited. Experience suggested that the AER was not hamstrung to raise the interrelationships of parameters at the Tribunal stage once the grounds for appeal have been identified. It was suggested that such issues should not be addressed as part of specific appeals, but through broader discussions, such as a WACC review.

- Some energy users did not support a framework that is based on the hypothetical efficient benchmark firm. It should be recognised that there are different degrees of precision for the values for different parameters.

- There was general agreement on the attributes the AEMC suggested for a good rate of return framework. Consumer groups noted that the attributes should also include some consideration of consumer resources and how they interact in the process. The framework should also provide an appropriate degree of certainty for consumers.

- It was suggested that the AER's role is not to be a consumer advocate. There was a need for a broader consumer involvement in the rate of return determination process.

- Electricity NSPs generally favoured a common framework for transmission and distribution based on the current Chapter 6 rules with some modifications.

- It was noted that establishment of a common rate of return framework should ensure that different parameter values can be adopted depending on the risk/incentive arrangements that may be applied by the regulator to a network business as part of the determination.

- There was some support for a common rate of return framework that allowed different parameter values to be adopted for different network businesses if it was warranted. However, there was some preference for codification of the post-tax CAPM approach to WACC across all electricity and gas network businesses. The framework should still allow for the rate of return to be cross-checked for reasonableness.

- The use of ranges for parameter estimates was discussed. It was recognised that estimation of some parameters in the WACC was not an exact science and different values can result depending on the subjective judgement of the regulator. There was support to make better use of ranges, so long as the regulator still applied integrity and rigour to individual parameter estimations. The regulator should still be required to make a point estimate for each parameter at the time of the determination.

***Part B – cost of debt***

- Discussion commenced with the question on whether it was the framework for determining the cost of debt that was the problem or the way in which the regulator has applied the existing rules.

- It was noted that Tribunal decisions on debt risk premium (DRP) since the rule change requests were lodged may be instructive. For example, the Envestra appeal decision. It was also noted that the premise of the AER that it is constrained by the current rules on DRP is not borne out in its recent draft decision for the Powerlink and Aurora Energy determinations. Discussion focused around whether the Tribunal decisions and the AER's approach in the Powerlink and Aurora Energy decisions means that the benchmark for DRP estimation may not be a problem and that the AER has the ability to consider a broader sample of corporate bonds..

- It was noted that benchmark specification is a measurement issue. There was a range of views among NSPs and consumer groups about what the benchmark should be. NSPs supported the use of a 10 year benchmark as it more closely reflected the debt tenor they seek to reflect investment in their long-lived assets. Consumer groups questioned whether this benchmark was right and pointed to market evidence.

- There was broad support for further investigation of using the trailing average approach to estimating cost of debt as proposed by the EURCC rule change request. However, it was noted that there were many practical and implementation issues to be considered before making such a significant change in approach. It was also suggested that the AEMC should carefully consider the implications of allowing this approach as it raises a fundamental question of regulatory design. An analogy was drawn that demand forecasting is a difficult task, but the regulator does not adopt a trailing average approach to demand forecasting. The trailing average approach with annual adjustments to prices for cost of debt may run counter to the incentive properties inherent in an ex ante regulatory framework.

- It was suggested that when raising debt for investment, investors have no certainty whether they will get a positive return on their investments. Different NSPs will have different practices of risk management for their investors. Some had preference for a trailing average approach as it meant that refinancing risk could be managed more regularly.

- Questions were also raised around the treatment of risk free rate in determining the DRP. That is whether the risk free rate would also be smoothed or would the spot rate be used? Concerns were expressed by some NSPs that it was not appropriate to smooth the risk free rate because it is not possible to hedge against the underlying interest rates. Any smoothing of the risk free rate would cause it to diverge from the prevailing spot interest rates.

- Discussion at the workshop concluded with the EURCC's proposal to determine the cost of debt for government-owned NSPs differently to privately-owned NSPs. Consumer groups representing energy users as well as EURCC expressed strong disagreement with the AEMC's rejection of the EURCC's proposal on this issue. Views were expressed challenging AEMC's basis for its conclusions with respect to: input/output market distortions, application of competitive neutrality principles, recovery of government fees are another form of tax; distortions in network pricing signals, and implications for future divestiture of government-owned assets.

## Summary of discussions from workshop 4 – Regulatory process

***Late submissions***

- Some consumer groups support the AER's proposal to limit NSP submissions. They consider that this would incentivise NSPs to provide its best regulatory proposal, and improve consumer group engagement. They suggest that there has been evidence of material differences (and therefore increased prices) between the revised regulatory proposals and the AER's requirements in the AER draft regulatory determination, which could be attributed to gaming, as NSPs have sufficient time to prepare their regulatory proposals.

- NSPs disagreed with the claims of gaming and questioned whether there was any evidence to substantiate those claims. One NSP provided an example where a NSP submission was provided which resulted in a reduction in capex/opex allowance.

- Some gas service providers considered that any proposed changes to the regulatory determination process should not be made to the current gas regime, as they consider the current regime is appropriate.

***Voluminous information***

- NSPs regard the reason for voluminous information is as a result of the regulatory information notice (RIN) (for distribution) or information guidelines (for transmission) issued from the AER. As it is a legal instrument, NSPs make sure they comply with the provision of information on time in accordance to the RIN or information guideline requirements. In addition to the RIN and information guidelines, the AER also requests additional information after NSPs submit their regulatory proposals. However, NSPs queried whether the volume of material requested by the AER under the RIN is always necessary or useful.

- One NSP has improved the way they present their information to the AER. This was as a result of feedback that this NSP received from the AER.

***Confidential information***

- Assessing confidentiality claims can be resource intensive and constrained by the current regulatory determination timeframe. General consensus that there can be improvement in transparency and processing of confidentiality claims in NSP regulatory proposals.

- Some NSPs are improving how confidential information is presented to the AER. NSPs are proposing the development of protocols to address how confidential information is dealt with. The protocols could include alternative approaches to addressing confidential information such as a limited disclosure agreement with interested stakeholders.

- The non-confidential information provided as part of the RIN requirements may not be seen by all stakeholders. Generally, only the regulatory proposal is published by the AER.

- NSPs considered that the AER could provide more information to stakeholders and should consider an information portal to allow for the sharing of that information.

***Delaying final regulatory determination***

- Delaying the making of the final regulatory determination did not receive much support. This is because there would be a flow-on effect on the annual pricing proposal process, which follows after the regulatory determination process. The current time period for a DNSP to submit its pricing proposal is limited enough.

- For jurisdictional regulators, their current retail pricing schedule is contingent on the AER regulatory determination process. Delays to the AER process would impact on the jurisdictional timeframe.

***Commencing regulatory determination process earlier***

- General support for commencing the regulatory determination process earlier.

- NSPs support the proposal to extend the time so that they can have sufficient time to prepare their revised regulatory proposals, and engage with other stakeholders if a cross-submissions stage was introduced. To facilitate this, the process should be commenced earlier (say three months). Commencing the process earlier could mean that the process is finished earlier and allow for more time for DNSPs to prepare their annual pricing proposals, following the final regulatory determination.

- General consensus that the current process for the making of regulatory determinations more detailed and structured than prior to the operation of Chapter 6 and Chapter 6A and that it was now necessary to look at expanding and improving the current regulatory determination process.

***Improvement of the consumer engagement process***

- One way to facilitate an improved consumer engagement process is for a formation of a national consumer peak group.

- Another consideration is the inclusion of a mandatory issues paper stage. It was noted that some jurisdictional regulators already do this, which is seen to provide an additional consultation opportunity for consumers. The ACCC has also previously had an issues paper stage. The benefit of an issues paper is that it provides a map of the consultation process, and contains distilled information with reduced complexity that is “consumer friendly”. This idea received general support, including from consumer groups.

- Even though the issues paper is currently optional, the current timeframe is too limited to facilitate an issues paper stage. If it was to be implemented, then the current timeframe would need to be extended.

- The AER currently makes use of a consumer consultative group as a way to engage with consumers during the regulatory determination process. In contrast, consumer groups considered NSPs need to be more proactive and engage with them further, especially prior to the regulatory proposal. Early consumer engagement could address local specific considerations. The distribution network planning rule change and the Power of Choice Review may address some of these issues.

### *Cross-submissions stage*

- The cross-submissions stage is similar to the process used by the NZ Commerce Commission. In NZ, submissions are limited to issues raised by the regulated business. Some NSPs consider this as a way to bring forward new evidence.

- An issue with the cross-submissions stage is how much time should be afforded to such a process.

### *Framework and approach paper*

- A cause for voluminous information in the RIN may be related to capex and opex forecast expenditure information. The framework and approach paper could reduce this by including an agreed method for calculating forecast opex and capex. This proposal would also allow all stakeholders to be engaged on this significant issue, and the regulator would be able to know upfront the NSP's underlying calculation method when it receives the regulatory proposal.

- NSPs questioned the benefit of including a capex and opex forecast calculation method in the framework and approach paper, given that NSPs already provide this information to the AER. A consumer representative pointed out that the difference between current NSP practice and the proposal is the proposal includes other stakeholders such as consumers in the process.

- Some NSPs regard service classification in distribution as being stable once it has been established. Similarly, incentive schemes may become more homogenous following the transition from the jurisdictional arrangements to the AER. These reasons could support making the framework and approach paper an optional stage. The framework and approach paper may be required when there is a foreseeable change such as when a non-contestable service ought to become contestable.

- Opinions varied on the degree of certainty that should be placed on the framework and approach paper. One NSP prefers more certainty in the framework and approach paper such as locking in the control mechanism for standard control services. Another suggestion is for the AER to indicate in the framework and approach paper how the AER would assess capex; however, this may be difficult for the AER to establish from the start unless it has knowledge of the calculation method for capex and opex. Another NSP considered that some certainty in the paper is necessary but should not result in a mini regulatory determination process.

- General consensus that the control mechanism should remain locked in the framework and approach paper and the formulaic expression used in the control mechanism can be departed from. However, the trigger for changing the formulaic expression was a moot point.

- Consumer groups considered that the framework and approach paper, including on incentive schemes, should be retained as it is beneficial to the public. This is in spite of an apparent lack of consumer submissions during the process, especially with respect to incentive schemes.

### *Material errors*

- Addressing material errors may at times be constrained. Once the merits review process commences, the regulator may be operating outside of its jurisdiction to correct the material error. Another constraint relates to the narrow scope of the Chapter 6 provisions for revocation and substitution of the revenue determination, which could prevent the correction of errors outside of that scope.

- General consensus was that further evidence needs to be provided to support the AER proposal to expand the scope for material errors in the rules.

## Summary of discussions from workshop 5 – Capex/opex allowances

***Constraints on the AER***

- As with workshop 1, discussion commenced with general disagreement from participants of whether the AER has been constrained in practice.
- In addition to comments made in workshop 1, a comment was made that there is a shortage of AER resources that may affect the way it applies the rules.
- Some participants argued that it is appropriate for the AER to have constraints. The AER should not move too far away from the proposal.
- One participant suggested the using of ex post processes to provide mechanism to deal with unders and overs in respect of the original forecast. A ”claw back” mechanism has been considered in other states.
- It was noted that apart from the issue of whether it is a two stage process, two questions need to be answered:
    - Is there a problem?
    - Where is the problem?

***Driver of the increasing prices***

- It was suggested the AER should take into account affordability. At moment the prices are increasing dramatically. Network charges are also increasing significantly.
- A response was that the AER has provided downward pressure on NSPs’ revenues.
- One participant noted that the rules can’t be a substitute for governance or the actual behaviour of the regulator.

***Businesses’ proposal***

- There were similar discussions as in workshop 1. It was observed that the AER’s problem is with the second stage of the process for assessment. It needs to know how it should proceed if it obtained a very different estimate from an NSP’s forecast. NSPs stated that businesses have an incentive to provide the correct forecast in their proposal, therefore the possibility to get a significantly different estimate is small.
- It was noted that more information could be taken into account by the AER in assessing expenditure forecasts. However, the AER is constrained in making adjustments at the second stage of the process.
- In respect of applying benchmarking, it was accepted that the AER can’t use benchmarking by itself to determine a substitute allowance, and that the AER must consider the NSP’s proposal.

***Evidentiary proof***

- Following some discussion it was decided that this is not a significant issue, since the AER, as a decision maker under administrative law, will always issue decisions supported by reasoning.

***Techniques for assessment/line by line assessment***

- As discussed in workshop 1, it was noted that the AER should be able to have other tools for its assessment. It was also noted that the AER will not be able to do a line by line assessment of the entire proposal.

***Benchmarking***

- One participant commented that the provisions in the current rules in respect of the AER taking into account the individual circumstances of an NSP are not very clear in respect of what that means for benchmarking.

- Participants also questioned whether there was a need to benchmark regarding specific elements/criteria and also questioned who is going to set out these criteria.

- Some participants suggested removing the word "circumstances" or removing the provision entirely. However there was no general agreement.

***Publishing material***

- The issue of whether the AER should publish analysis undertaken between the draft and final determinations prior to the final determinations was discussed. While there was no agreement on how this should be resolved, many participants felt there should be a process for new analysis such as this to be published in advance of the final determination.

## Summary of discussions from workshop 6 – Capex incentives

***The AER's proposed 60/40 sharing mechanism***

- The AER came up with its 60/40 sharing mechanism proposal to address the issue that some NSPs have regularly overspent their allowance.

- It was noted that there are already strong incentives in the NER to defer expenditure to the next regulatory control period and an EBSS for capex could increase the strength of this incentive.

***Reasons why a NSP may spend more than its allowance***

- A number of reasons why a NSP may spend more than its allowance were discussed. They included:

    - NSPs may spend more than efficient levels of capex where there are differences in NSPs' regulated and true costs of capital.  Approaches to corporate governance may also be relevant;
    - the AER and/or the NSP did not get the demand forecast right;
    - there are practical issues around getting capital projects to come in on forecast. Conditions are dynamic and constantly changing;
    - exogenous events; or
    - the NSP makes a decision to invest based on the incentives provided under the service target performance incentive scheme.

- Businesses that have large capital projects in competitive markets will prioritise their investments to ensure that they do not spend more than they have budgeted for at the end of a period.

- Rather than just focusing on over spending the focus should be on strengthening the incentive to underspend.

- NSPs considered that the lack of scrutiny of overspending has been overstated. The AER has full sight of over or under expenditure by NSPs at the time it determines NSPs revenues/prices.

***Possible solutions for dealing with capex incentive problems***

- In discussing possible solutions for dealing with capex incentives, a number of points were raised, including:
  - NSPs considered that the AER should have attempted to develop an EBSS for capex.
  - One stakeholder noted that deferral within period is not necessarily a bad thing and that an annual target/continuous incentive would remove the incentive to defer. Efficient deferral should be rewarded.
  - The distribution network planning framework and the RIT-D may have a role to play in ensuring efficient investment.
  - Ex-post reviews may create an incentive for NSPs to exercise constraint. NSPs consider that ex-post reviews could add up to six months to the regulatory cycle.
  - The Ofgem capex rolling incentive mechanism now works on a two year basis to incentivise companies to respond to these incentives.

***Role of consumers in the capex process***

- There is a role for NSPs to improve negotiation with consumers, particularly representatives of residential and small business customers.

***Uncertainty regime***

- The application of capex reopeners and contingent projects in distribution is problematic as there are fewer large projects and more smaller projects than in transmission. An application to the AER under the uncertainty regime would be similar to a determination in itself. For transmission the contingency projects regime works well and it removes risk for NSPs.

- The materiality threshold of one per cent of the annual revenue requirement applied to distribution for cost-pass throughs proposed by the AER is a large project in distribution. On the other hand, the threshold should not be set too low such that the AER is not continually assessing applications.

- As an alternative, NSPs could be provided with a menu of options for demand and exogenous events when their allowances are set to encourage them to forecast accurately.

- The impact that the uncertainty regime has on the ability of retailers to set and structure their prices was noted.

- A NSP should be able to seek cost pass throughs for material exogenous events (with guidance on what is material). The NSP can manage non material events through re-prioritising capex. The threshold would need to be set at an appropriate level. There may also need to be a review mechanism for these decisions.

***Other incentive schemes***

- Large energy users agreed with the AER having broad discretion to develop incentive schemes. There would be a consultation process to develop any new scheme.

- NSPs considered that the AER had enough discretion already but if additional discretion was provided then the financial incentives needed to be carefully considered. Paper trials should be considered.

***Related party margins***

- The issue in part concerns the fact that all capex incurred is rolled forward from one regulatory control period to the next without any supervision or scrutiny.

***Actual or forecast depreciation***

- Views expressed included:
  - NSPs may not respond to the different incentives created between short and long lived assets by using actual depreciation.
  - there are additional administrative costs associated with using actual depreciation (forecast depreciation is already calculated for the purposes of determining a NSPs revenues). Forecast depreciation should be locked into the rules.

- The difference in incentives between short and long lived assets created by using actual depreciation will become more of a material issue with a move towards smarter networks.

## Summary of discussions from workshop 7 – Rate of return

***Part A – The framework for setting the rate of return***

- There was general agreement from participants that the Chapter 6A framework has proved to be too rigid. Electricity NSPs considered that while Chapter 6 is a much better framework, there are areas that can be improved. Views on the gas framework were also consistent with comments from workshop 3, in that the flexibility provided in the gas framework to determine the rate of return is very desirable. It allows for prevailing conditions in the market for funds to be taken into account. It also benefits from allowing consideration of more than one model for determining the cost of equity, unlike the electricity rules.

- It was also noted that while the AER's approach to date in applying the gas framework largely involved imposing WACC methodologies established under the electricity frameworks, it was commendable to the extent that its decisions on those methodologies were transparent.

- Electricity NSPs expressed the need for the rate of return framework to factor in the need for investment certainty. It was suggested that investment certainty should be one of the key attributes that AEMC consider. However, it was also recognised that providing investment certainty in the rate of return involves a trade-off with flexibility. There was strong support from electricity NSPs for a modified Chapter 6 framework for TNSPS and DNSP that:
  - considered prevailing conditions in the market for funds;
  - recognised interrelationships between parameters; and

    - provided the flexibility to use other cost of equity models to test for reasonableness of the estimates.

- Consumer and energy user groups expressed the view that the current frameworks were not delivering efficient rates of return that a business would expect in a competitive environment. They were of the view that the rates of return allowed by the AER were far in excess of what was being achieved by businesses in other unregulated sectors, facing greater risks. Consumer groups advocated greater use of benchmarking of WACCs through the use of other financial ratios that are publicly available for competitive businesses.

- It was that noted that there are two features of the Chapter 6A framework that may warrant some consideration. These were:

    - the WACC determined for TNSPs provides a point in time estimate. This allows for the WACC to be considered holistically where many parameters are not industry specific and exhibit stability; and

    - the WACC reviews conducted every 5 years effectively set up the methods that can be used in other frameworks, such as gas. This also assists in more effective consumer engagement in terms of better use of their resources by engaging in one process periodically rather than on a determination by determination basis.

- Consumer groups and energy users in this session echoed similar sentiments expressed in workshop 3 about the need for better consumer engagement in the rate of return determination. It was suggested that consumer engagement can be enhanced by having periodic WACC reviews and by codifying certain methodologies in the rules to mitigate resourcing issues from determination-by-determination debates as is currently the case with Chapter 6 and the gas rules.

- There were some suggestions that determination-by-determination consideration of rate of return does not necessarily have to involve a full WACC review. It can take an incremental form where the regulator only considers new evidence from its previous decision for a NSP. It was also suggested that under this approach, there may be some role for periodic WACC guidance papers from the regulator. However, this guidance should be informative, not determinative.

- It was stated that ideally, the incremental approach to rate of return determination is its preferred model. However, it was noted that there were some practical issues with this approach such as the timing of Tribunal decisions on appeals and the overlap of the timetable of regulatory decisions. This meant that it would be difficult to establish a precedent to apply to future decisions with any certainty.

- There was some discussion about the application of the current persuasive evidence test. The was a view that the current requirement of persuasive evidence is open to extremely wide interpretation and without any specific guidance from the Tribunal so far, it remained a key issue. It was recognised that there was a need to clarify the policy intent of the application of the persuasive evidence test.

***Part B – cost of debt***

- Discussion commenced with consumer groups highlighting their view that the cost of debt allowances for NSPs are not meant to be a source of profit. It should only provide compensation for their debt costs. The current approach is too generous because the benchmark used is not appropriate. They noted that market data showed that NSPs were raising debt at levels significantly lower than the allowances provided in their determinations.

- NSPs noted that a point in time spot DRP cannot be accurately compared to the allowances determined at the time of their determinations. NSPs refinance a majority of their debt around the time of their determinations, and spot interest rate margins do not reflect this.

- While NSPs were supportive of consideration of the EURCC's trailing average approach to DRP, they were concerned with the precise way in which it would be applied and how it would affect their ability to refinance their existing debt to adjust for any risks from changing the approach. Consideration of transitional provisions was suggested.

- In addition, NSPs favoured the application of a trailing average approach to the DRP component of cost of debt and not the risk free rate. Discussion also included whether any changes to the way the risk free rate is measured for cost of debt would have any implications for the risk free rate used for cost of equity estimation.

- The final point of discussion focussed on the AEMC's position on the cost of debt for government-owned NSPs. Consumer groups and energy users, including the EURCC expressed disappointment at the AEMC not endorsing their proposal in this respect. Government-owned NSPs strongly argued in favour of the AEMC's position and noted that they were subject to competitive neutrality principles and incurred debt neutrality fees as part of their debt raising costs through their respective state government treasuries. Discussion focused on stand-alone credit ratings of government-owned NSPs compared to their implied credit ratings.

## Summary of discussions from workshop 8 – Regulatory process

***Late submissions***

- A key issue for consumer groups is that the NSP may be providing additional information in the form of submissions, leaving consumer groups with insufficient time to respond to or assess this information. Consumer groups are seeking transparency in the process and being provided adequate time to consider the NSP information. They are of the view that NSPs have the incentive to delay providing information until late in the regulatory determination process.

- NSPs considered that the AER proposal to limit submissions from NSPs is too restrictive. The current rules place restrictions on the content of revised regulatory proposals. It should not be assumed that late information is as a result of NSPs providing new information after the draft regulatory determination, but could be due to legitimate reasons such as material changes. For example, the AER has previously sought stakeholders comment on changes to the debt risk premium. If NSPs were gaming the process by providing late information that the AER would not have time to consider for the purposes of having that information considered in the merits review process, the Tribunal may refuse to grant leave to the NSP.

- NSPs supported additional time for them to prepare their revised regulatory proposals and submit on the AER draft regulatory determination. They consider there is a difference between making submissions and providing revised regulatory proposals, given that they serve different purposes.

- The regulator has received information from NSPs which have been legitimate at times and consulted upon these. However, there has also been other information that is questionable.

***Confidential information in regulatory proposals***

- A greater amount of confidentiality claims in NSP regulatory proposals than expected, especially broad claims, can be resource intensive. The AER proposal could discourage blanket claims, as well as improving stakeholder engagement, within the current allowable timeframe.

- Blanket claims of confidentiality from a service provider have been evident in other jurisdictions. The rules could be used to promote efficient engagement on confidential information.

- Consumer groups supported the proposal in the AEMC's directions paper that NSPs be required to explain their reasons for making confidentiality claims on their regulatory proposals. They consider that the burden of proof needs to be placed on NSPs as opposed to the AER. The regulator and consumer groups are limited in both time and expertise to assess such claims. Limited disclosure of information to interested parties may be a possible solution.

- One NSP has a large amount of information that they consider to be confidential. However, they consider that the making of blanket confidentiality claims is not in their interest as it may result in the claim for confidentiality not being accepted and genuine confidential information being disclosed.

- NSPs considered that there can be areas of improvement in the process for making confidentiality claims in regulatory proposals, and to assist in restricting confidentiality claims. They are looking to proposing a set of non-rules based solutions. This might take the form of a protocol to the AER which could include a standard non-disclosure form, and the adoption of the ACCC approach in addressing confidentiality claims in the telecoms industry which they regard to have been effective. Further education is also being provided to NSP staff on what information is genuinely confidential.

***Delaying final regulatory determination***

- The current timeframe for DNSPs to submit to the AER its revised regulatory proposal is short and the AER has a limited timeframe to make its final regulatory determination. In contrast, the current timeframe in transmission is more flexible.

- Delaying the making of the final regulatory determination is not a suitable option to address the above problem. For instance, DNSPs need to submit their annual pricing proposals within a limited timeframe after the final regulatory determination is made. Retailers will then need to follow the approved pricing proposals. If this time was delayed, customers may experience a price shock for the delayed period. On the other hand, NSPs considered that if the circumstances required a more robust solution in the final regulatory determination, then a delay may be justified.

***Commencing regulatory determination process earlier***

- NSPs were supportive of commencing the regulatory determination process and completing the final regulatory determination earlier. With respect to the latter point, DNSPs would have more time to prepare their annual pricing proposals following the final regulatory determination.

- Starting the process earlier may result in less accurate data, such as determining the rolling forward capital base, and a need to true-up once the actual costs become known. On the other hand, the accuracy of the data may easily be updated.

***Improvement of the consumer engagement process***

- NSPs support the Victorian DPI proposal to include a mandatory issues paper, which should increase stakeholder engagement in the regulatory determination process. NSPs also considered that it would guide NSPs on the AER's intent and key issues.

- Some jurisdictional regulators always publish an issues paper as part of their regulatory determination process. These issues papers would summarise key elements to be considered. Some consumer groups have found this useful in other jurisdictions.

- Although an issues paper has never been utilised during the regulatory determination process, the AER has hosted pre-determination conferences.

- Consumer groups did not have a problem with the implementation of a mandatory issues paper. However, they consider meaningful engagement could be improved by the AER holding a forum on the key issues concerning the regulatory proposal. They also propose that NSPs engage with consumer groups earlier in the process to develop a level of trust (e.g. in relation to consideration of non-network solutions, and on how NSPs forecast their capex and opex).

***Cross-submissions stage***

- NSPs consider that a cross-submissions stage after consultation on the draft regulatory determination would enable NSPs and other stakeholders to respond to each other but that there would need to be more time in the regulatory determination process if this stage was to be included.

- The regulator is considering whether a cross-submissions stage can be implemented.

***Framework and approach paper***

- NSPs propose that the framework and approach paper should be made optional. For NSW, the elements covered in the framework and approach paper may become stable over time and not require further changes in the future.

- In Victoria, there has been an experience of changes to incentive mechanisms such as the Advanced Metering Infrastructure program. This would justify the retention of incentive schemes being covered in the framework and approach paper.

- With respect to the trigger for amending service classifications, NSPs prefer the existing “good reasons” threshold because it provides a level of certainty that the AER’s proposed “unforeseen circumstances” threshold lacks. Another point is that the circumstances may be foreseeable but only develop over time, e.g. a change in competition.

- There was consensus in workshop 4 on the point that the control mechanism should remain fixed in the framework and approach paper and supported that the formulaic expression of that mechanism should be able to be changed following the framework and approach paper.

- There is an initial difficulty of assessing capex and opex forecasts as each NSP has a different approach. To address this problem, the framework and approach paper could be used to determine the calculation method for forecasting opex and capex on a case by case basis. This could result in making the framework and approach paper mandatory.

- From a consumer perspective, consumer groups consider that the difference between expenditure and demand forecasts and actuals are not very well done. However, they consider that it would be reasonable for NSPs to engage with them to improve the transparency and accuracy of these forecasts.

***Material errors***

- In workshop 4, there may be a constraint in addressing material errors in circumstances where the merits review has already commenced or as a result of the limited scope of Chapter 6.

- NSPs have not seen evidence that the scope for material errors in either Chapter 6 or 6A are inappropriate, noting that NSPs have previously requested the AER to exercise its existing powers but decided not to do so. They note that Chapter 6 is narrow and based on the terms "material error" and "deficiency", while Chapter 6A is broad and excludes the term "deficiency". If the term "deficiency" is introduced into Chapter 6A, then the narrower definition of such errors and deficiencies in Chapter 6 would need to be adopted into Chapter 6A.

- NSPs also considered that the ACCC had previously exercised its powers under the National Electricity Code to address material errors. If the AER took the same approach as the ACCC on addressing material errors, then merits reviews on material errors could be avoided.

***"Stop the clock" mechanism***

- The stop the clock mechanism proposed by NSPs has been used in regulatory processes in other industries. It was found to have been an effective mechanism.