George Maltabarow
Managing Director

570 George Street
Sydney NSW 2000
All mail to GPO Box 4009
Sydney NSW 2001
T +61 2 9269 2112
F +61 2 9264 2982
www.ausgrid.com.au

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Mr James Cox
Chief Executive Officer
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB POST OFFICE NSW 1230

Dear Mr Cox

Draft Report – Changes in Regulated Electricity Retail Prices from 1 July 2011

IPART's draft report makes some rather unsubstantiated claims indicating customers may be paying more than necessary for electricity because of an inherent bias in the framework in favour of higher network prices and inefficient outcomes.

Our submission responds directly to these claims and the recommendations made in response to them.

Based on its concerns with the extent of the price increases, IPART recommends taking action to limit future increases in network costs to more appropriate levels and this can be achieved by reviewing key aspects of the regulatory framework. IPART provides four "problems" it perceives with the existing framework:

- An unusually high burden of proof on the regulator;
- An unbalanced appeal process;
- An overly prescriptive approach to determining network business returns;
- A requirement to include all capital expenditure spent in the asset base.

There are serious flaws in the analysis put forward by IPART and this submission addresses a number of misconceptions and unsubstantiated conclusions in that analysis.

1. *IPART's assertion that there is an unusually high burden of proof on the regulator*

The IPART's draft report alleges that *"the AER must approve a DNSP's opex and capex forecast unless the AER can prove that the proposal does not reflect the reasonable efficient costs".*[1] IPART's recommendation is that the Rules should be amended so that the AER has an obligation to ensure that network expenditure is prudent and efficient.

IPART has misinterpreted the decision making framework that applies to distribution networks. There is no burden of proof on the AER as such. This is a legal concept and has no currency under the Rules. The AER does not have to 'prove' anything. The AER's obligation is to determine whether or not it is satisfied that the proposed expenditure reasonably reflects the efficient costs of a prudent operator in the circumstances of the DNSP.

This is clearly demonstrated in previous AER decisions. An analysis of the most recent decisions by the AER reveals there has been no determination where the AER has been satisfied with the forecast proposed by a distribution network service provider. Instead the AER has, in every instance, substituted its own operating and capital expenditure forecast that has been materially lower that what businesses originally proposed (on average 10% lower for capital expenditure and 8% lower for operating expenditure).

A summary of recent decisions and the AER's substation on operating and capital expenditure is attached. The fact that the AER has substituted its own forecast in every decision it has made, this would suggest that the burden of proof is not as high as IPART asserts.

This threshold for substitution was very carefully considered when it was developed as part of the transmission framework by the AEMC.

> "The decision-making process set out in the Revenue Rule will also reduce the incentive for TNSPs to submit forecasts which represent ambit claims. Such exaggerated forecasts would be likely to fail to satisfy the decision criteria to be applied by the AER and therefore to run the risk of being rejected and replaced by the AER with a less favourable forecast.
>
> The introduction of more objective, operationally focussed decision criteria for the AER's assessment of whether or not it is satisfied with the basis of the forecasts, removes to a considerable degree the subjectivity associated with criteria such as reasonable or best estimates of expenditure requirements. While informed opinions may differ on what are efficient costs, costs of a prudent operator or realistic expectations of forecast demand and input costs in the circumstances facing the regulated entity, those matters can be tested readily by reference to objective evidence drawn from history, the performance and experience of comparable businesses and the assessments of electricity industry experts. Under the Revenue Rule, the AER is required to exercise judgement in deciding whether it is satisfied that the forecasts reflect the specified criteria, having regard to the specified factors.[2]

In Ausgrid's view, there is no basis or foundation for any assertion that that regulator is disadvantaged by information asymmetry or that the framework is biased towards the regulated business. Ausgrid does not agree that any review of this decision making framework is warranted, but should a review proceed Ausgrid will be strongly cautioning the MCE and AEMC against any changes to the framework based on the line of analysis which has been put forward by IPART.

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[1] IPART's draft report, p83.

[2] OpCitp 52 and 53

We do accept that the Rules require a higher standard of decision making and accountability than that which had been permissible under the previous Code (pre-reform) framework. This was one of the intended outcomes of the new framework for transmission and distribution. The previous Code framework provided a very low level of accountability for regulators' decisions. It did not require regulators to justify specific decisions and allowed regulators to make decisions which were justified as "on balance" of the various factors. The Code framework was generally seen as allowing for decisions which were opaque and pre-determined without any effective accountability, and leaving decisions open to criticism that they were "back solved" to meet short term outcomes (such as lower prices to customers).

The current framework provides the AER with all of the tools and powers it needs to carry out its role effectively. At the same time as this framework was put in place under the Rules, the National Electricity Law was amended confer broad-ranging information gathering powers upon the AER. These powers enable the AER to seek any information it requires from a business or any other person to enable it to carry out its functions including assess expenditure forecasts.

There are strong incentives placed upon businesses to comply with these requirements in addition to the usual enforcement mechanisms. If the information required is not provided by the business then the AER can make assumptions, including adverse assumptions, when making the determination for that business. In addition, any failure to provide information may result in the business being refused leave to review the merits of the decision.

2. *IPART's assertion of an unbalanced appeal process*

IPART asserts that the legislative provisions limit merits review to specific matters contested by the business and creates a bias in favour of the DNSP who cannot be worse off under a merits review process.

These claims are based on an incorrect understanding of the limited merits review framework which applies under the NEL.

The law does not prevent the decisions which are the subject of review being expanded beyond any error identified by the DNSP. A user or consumer intervener to a review may raise new grounds that are not related to the original application for review. In addition the AER may raise matters not raised by the DNSP or intervener[3] and may also raise a possible outcome or effect of the reviewable regulatory decision that it believes should be considered.

The second reading speech introducing the bill confirms this:

> The Australian Energy Regulator is also able to raise related consequential matters in a review to ensure that the Tribunal takes account of the broader issues affecting the decision[4].

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[3] Sections 71M and 71O National Electricity Law.
[4] Hansard, Legislative Assembly, South Australia 27 September 2007, p967

It is also not true that the distributors can appeal the AER's decision at will. Limited merits review means that review is only available if the original decision contains errors of fact, if the AER's incorrectly exercised its discretion, or where the decision was unreasonable, having regard to all the circumstances.

Because the merits review framework is limited in that it requires the identification of the specific decision the subject of error and review, it follows as a matter of logic that an error in one decision does not necessarily affect other decisions made by the regulator in its determination.

Limited merits review means there is no review as of right, leave must first be obtained from the Tribunal. Leave to apply for a review requires a demonstration that there is a serious issue to be heard and determined and, in relation to revenue decisions, a monetary threshold of $5mil or 2% of the annual average revenue applies. In addition, strict timeframes apply such that an application for review must be made within 15 business days of the decision being made by the AER.

A high level analysis of the merits review appeals shows that, in the vast majority of cases, the Tribunal has found in favour of the DNSP only where a clear identifiable error has been conceded by the AER or established before the Tribunal.

3. *IPART's assertion that a prescriptive WACC leads to excessive returns*

IPART's report alleges that the prescriptive nature of the Rules with respect to the setting of WACC 'can lead to excessive returns'. Also such prescription limits the AER's ability to adjust WACC for changes in market conditions.[5]

These statements are incorrect. The Rules specifically allow the AER in its determination to depart from the WACC parameter the AER has previously prescribed where a material change in circumstances would make the previously determined WACC parameter inappropriate.

IPART's statements also ignore the potential downside risks faced by DNSPs during the five year period if the outturn cost of debt and equity is higher than the allowed WACC set by the AER.

4. *IPART's assertion that the NER forces the regulator to include all capital expenditure spent in the asset base and customers should only pay for prudent expenditure.*

IPART's report alleges that the AER must include all capital expenditure incurred in the regulatory asset base at the beginning of the next period and advocates that customers should pay only for prudent capital expenditure and the AER should undertake a review of investment after it is made to ensure this is the case.

Ex Post reviews were common in pre-reform regulatory frameworks, but regulators and policy makers have since moved away from this approach. The AER's submission to the AEMC in respect of transmission regulation best outlines some of the problems with IPART's approach.

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[5] IPART's draft report, pp84.

> this [ex post] approach creates significant uncertainty as TNSPs face the threat of optimisation after the expenditure has been spent; is highly intrusive as it requires the regulator to 'second guess' past investment decisions and also requires an assessment of the efficiency with which assets were developed; and is not consistent with the NEL and AEMC's objectives.

Instead, policy makers and the national regulator consider that a preferable approach is to adopt an ex-ante framework. This provides both improved incentives for efficient investment and regulatory certainty, which is in the long term interests of customers.[6]

Moving back to an ex post assessment of prudence in many cases would result in higher prices for customers, where investment above the regulatory allowance is prudent. In any regulatory period a distribution business is only compensated for the financing and capital return for efficient and prudent expenditure determined by the regulator during that regulatory period. This occurs whether the DNSP has invested prudently and efficiently or not. If the DNSP was rewarded ex post for expenditure above an allowance deemed prudent and efficient, it would result in higher network prices relative to the current regulatory arrangements.

Review of National Electricity Rules

We note that IPART is recommending a review of the National Electricity Rules to address some of the concerns raised in the report. However, many of the report's recommendations were considered and rejected in previous reform developments in favour of arrangements that better promote the National Electricity Objective.

Ausgrid looks forward to IPART's final report. In the meantime, if you have any questions or require further clarification, please do not hesitate to contact me or Ms Catherine O'Neill, Executive Manager – Regulation & Pricing on 02 9269 4171.

Yours sincerely

GEORGE MALTABAROW
Managing Director

[6] AER submission to the AEMC's review of Electricity Transmission and Pricing Rules, page 5

Business	AER rejected /substituted proposed expenditure	Reduction in opex	Reduction in capex	Appeal opex/capex	Result of appeal
EnergyAustralia	Yes	$358 million (12.0%)	$465 million (5.6%)	Opex - Maintenance and step change costs ($170 million)	AER admitted error in element of decision before the hearing (resulting in $4 million additional opex). Tribunal upheld other elements of AER decisions.
Integral Energy	Yes	$5 million (0.3%)	$14 million (0.5%)	No	
Country Energy	Yes	$159 million (7.2%)	163 million (4.2%)	No	
Actew AGL	Yes	$18 million (5.0%)	$23 million (7.7%)	No	
Transgrid	Yes	$52 million (6.4%)	$109 million (4.4%)	Opex – maintenance costs	Tribunal found error with AER decision, resulting in $14 million additional opex.
TransEnd	Yes	$29 million (10.2%)	$106.2 million (14.9%)	No	
Energex	Yes	$17 million (1.1%)	$287 million (4.7%)	No	
Ergon	Yes	$93 million	$1285 million	(a) Labour cost	(a) Tribunal over-turned AER's decision on basis that

Business	AER rejected /substituted proposed expenditure	Reduction in opex	Reduction in capex	Appeal opex/capex	Result of appeal
		(4.9%)	(20.5%)	escalators (b) Non-system capex	Ergon proposal was within reasonable range (b) The AER admitted error in determining a substitute value of zero. AER agreed that proposed value should be included.
ETSA	Yes	$48 million (4.4%)	$1572 million (12.7%)	No	
Citipower	Yes	$37 million (14.0%)	$182 million (19%)	Information not publically available	
PowerCor	Yes	$128 million (13.8%)	$281 million (17.5%)	Information not publically available	
Jemena	Yes	$57 million (16.7%)	$148 million (25.4%)	Information not publically available	
SPAusNet	Yes	$105 million (10.9%)	$117 million (7.6%)	Information not publically available	
United Energy	Yes	$90 million (14.1%)	$63 million (7.7%)	Information not publically available	