

DISSENTING COMMENTARY ON CHAPTER 5

MR. MORTON'S CONCLUSIONS OR RECOMMENDATIONS FOR CHAPTER 5 – FRAMEWORK FOR REGULATORY DECISION MAKING

INTRODUCTION

Despite lengthy discussions amongst the Panel, I have been unable to reach a meeting of minds with the other members on an issue concerning the Framework for Regulatory Decision Making, and, as such, have prepared this Addendum to the Report. The remainder of the recommendations of the Panel contained in the draft report represent agreed Panel positions.

I am aware of the MCE's expectation that it would receive a single report from the Panel. Unfortunately, I have found my position on this issue to be sufficiently at odds with my fellow members as to prevent our reaching a consensus, at least in the context of the draft report.

Specifically, I disagree with the following conclusions and recommendations:

- that it is not appropriate for a global presumption to be adopted in the Law in favour of the regulator accepting a regulated entity's proposal. Equally, the majority of the Panel *concludes* that it is not appropriate for the Law or the Rules to mandate a consider-decide model. The complexity and differing characteristics of each element of the service provider's proposal are such that the Law cannot itself prescribe a single overriding test to be applied by the AER in assessing service provider proposals. These must be determined by the AEMC in the Rules developed for each of the alternative available forms of regulation. In some instances, this may involve relatively little discretion on the part of the AER, such as when parameters in the rate of return are prescribed in Rules or an objective methodology (by reference to observable market data, such as interest rates) for determining them is contained in the Rules. In other cases, such as in the estimation of forecast operating or capital expenditure, it may call for more discretion.
- that the AEMC have regard to the analysis of the issues related to propose-respond and receive-consider models in this report, the Panel's conclusions and the MCE's response in further developing its draft National Electricity Rule and any review of Chapter 8 of the Gas Code.

The purpose of this Addendum is to express my view on the preferred recommendation on this aspect of the report. Whilst I recognise that the majority view is a workable model, my view is that it is not the most desirable model. Instead, I maintain the view that a propose respond model should be retained in the NGL and included in the NEL, but on a more restricted basis than suggested by the Productivity Commission. In setting out my view of the desirable model, I explain why my views depart from those of the majority, which turn on:

- the consequences of regulatory error being sufficiently likely to be asymmetric for it to affect the approach to regulatory intervention;

- the most desirable regulatory response in light of the imprecision of regulation being a restricted propose respond model rather than a consider decide model.

In addition, I set out my response to some of the views that have been expressed in relation to the draft Report.

A key concern is that there is simply no “correct” answer to many of the issues that confront regulators in their decision making processes. Indeed, there is generally a range of entirely reasonable and well supported positions on many of the issues. Hence, whilst it is accepted that the Productivity Commission’s “propose respond” model contained elements that might lead to prices being higher than reasonably required to attract capital to the infrastructure sector, the fact is that there is simply no “correct” answer to many of these issues. It must also be remembered that what appears high to a regulator under one set of positions (that it would accept), may not appear high under an alternate set of reasonable positions.

ASYMMETRIC CONSEQUENCES OF REGULATORY ERROR

In my view, the distribution of the risks associated with regulatory error are likely to be asymmetric (at least in the context of the range around which regulatory decisions are made).

The asymmetry arises from two main causes. First, regulation has a tendency to limit upside, but not to place a floor under downside outcomes and this type of risk is not recognised in CAPM, the model generally used in regulators decisions on cost of capital. This issue has been addressed at length in the regulatory literature, and I do not address it further here.

Second, asymmetry arises because underinvestment in infrastructure (which might be expected if regulatory returns were too low) can, in general, be expected to have more severe consequences for the economy than excessive or otherwise inefficient investment that might occur if regulatory returns are too high. The reasons for this view are as follows:

- service providers are likely to be more sensitive to regulatory decisions than their customers;
- the consequences of underinvestment; and
- there are other mechanisms that can ameliorate the risk of excessive or otherwise inefficient investment.

Sensitivity to regulatory decisions

An access regulation decision under either the National Electricity Law and associated Rules or National Gas Law and associated Rules will generally affect a very high proportion of a service provider’s cash flows in relation to the regulated activity (in the limit this is 100% but may not always be so high). Accordingly, a regulatory decision will exert a considerable influence on the service provider.

In contrast, even though customers are more numerous, they are considerably less exposed to regulatory decisions and the errors they may contain. For example, it is rare for any customer of a regulated business to have more than 10% of its costs affected by any particular regulated service (and rare for more than 20% of its total cost structure to be affected by regulatory decisions).

Elasticity estimates indicate that customers are relatively insensitive to the prices of the services provided by energy networks. For example, whilst long run demand elasticity estimates vary, one of the more frequently cited estimates for electricity is between -0.25 (residential) and -0.4 (commercial and industrial).¹ This elasticity is to the price of the final product - consequently customers will, in general, be much less sensitive to the price of infrastructure services (considered in isolation) than these figures suggest.

Moreover, global elasticities comprise a range of demand elasticities across individual customers and classes of customers. Price sensitive customers are likely to minimise their exposure to energy network infrastructure charges, further lessening their specific sensitivity to the regulated rates, through:

- locational decisions; and
- regulatory regimes encouraging efficient price discrimination (and efficient price structures), consistent with the policy intent of the Trade Practices Amendment (National Access Regime) Bill 2005 which provides that access pricing should include price discrimination when it aids efficiency. I note that such discrimination is consistent with the Panel's recommendations in chapter 6 of the Report.

Therefore, all other things being equal:

- relatively small changes in the regulated price for regulated services will generally exert little impact on consumption. Hence, the benefits to the community from the setting of prices below optimal levels and thereby encouraging increased consumption are likely to be modest; and
- that same relatively small price change will result in a direct impact on the regulated business – which could be expected to directly affect the service provider's incentives to invest in the network if the small change results in insufficient returns being earned to justify investment. Any failure on the part of a service provider to undertake such investment is likely to directly affect the performance of the network over time, thereby adversely affecting all users to varying degrees.

¹ National Institute of Economic and Industry Research (2004), The price elasticity of demand for electricity in NEM regions, A report for the NEMMCO, p 3. the elasticities cited for industrial and commercial were -0.38 and -0.35 respectively.

Effects of underinvestment

The first impact from underinvestment in the network is likely to be that it becomes more vulnerable to low probability high impact events. Recent reliability incidents in the United States do not bear directly on economic regulation, but do serve to highlight the potential adverse impacts from inefficient investment levels in infrastructure services:² Concerns that the regulatory environment may have adversely affected service provider's incentive to sustain their investment in their networks have been expressed in Queensland³ and by a Parliamentary Committee in the United Kingdom:⁴

The (UK) regulator's concern to reduce costs to consumers should now be tempered by a greater emphasis on ensuring that electricity network owners have the financial resources to secure a viable, long term electricity supply.

The manifestation of underinvestment in infrastructure can be very subtle and take a long period of time to materialise. The fact that it is a characteristic of infrastructure industries that they can operate without apparent deterioration for long periods of time in the face of regulatory induced under-investment only serves to underscore these concerns. The experience of the UK water industry highlights that the problems from underinvestment that eventually arise are severe and very expensive to rectify.

Further examples of the subtlety of regulation induced distortions to investment can be seen in the gas pipeline infrastructure industry, where, we have seen in recent years:

- an increasing trend for pipelines (or expansions to existing pipelines) that are exposed to the risk of regulation to be built to meet initial market demand, rather than being sized in a way that creates initial spare capacity which in turn deprives the economy of the benefit of the realisation of scale economies; and
- a decreasing willingness for the industry as a whole to invest in R&D - the cessation of R&D could be partly reflective of a perverse outcome from the R&D undertaken by the industry in the early 1990's which *reduced* the replacement cost of gas pipeline infrastructure, and in turn, exerted a *downward* influence on regulated prices once gas pipelines became subject to regulation. In other words, the industry was undermining its own longer term financial performance by significantly *improving* the efficiency of its operations.

Of course, one cannot unequivocally state that these changes are solely in response to the regulatory environment. Nevertheless, both responses are rational responses to regulatory risk and highlight that it is the *perception* of regulatory risk that can

² U.S.-Canada Power System Outage Task Force (2004), Final Report on the August 14, 2003 Blackout in the United States and Canada: Causes and Recommendations, p 140.

³ See Electricity Distribution and Service Delivery for the 21st Century ("Somerville Report"), p51.

⁴ House of Commons Trade and Industry Committee, Resilience of the National Electricity Network: Third Report of Session 2003-04 Volume I, 10 March 2004, page 3. Available from: <http://www.publications.parliament.uk/pa/cm200304/cmselect/cmtrdind/69/69.pdf> as at 1 March 2006.

adversely affect investment. Accordingly, the significance of the rights created under the regulatory regime must be considered in the context of the perceptions those rights create for service providers.

The fact that gas pipeline infrastructure is becoming less exposed to the direct forms of regulation is not the point – the key issue is that the regulatory environment is likely to have contributed to changes that are adverse to the long term interests of the community. These effects, although subtle, are significant and potentially affect all regulated infrastructure.

The factors motivating network investment in a regulatory environment are more complex than simply ensuring an adequate return can be secured by investors.⁵ Nevertheless, a key to encouraging investment in regulated energy networks in the future is to provide potential investors with the confidence that the returns they can expect to earn under the regulatory environment will adequately compensate them for the risks associated with the investment at the time the investment occurred.

Allowing excessive returns and inefficient investment

In reviewing the economic consequences of prices being marginally higher than optimal, I believe (for the reasons set out below) that it is by no means clear that the model being proposed would lead to a systematic upward bias in pricing decisions.

From an economic perspective, the adverse impacts to the community from prices being marginally higher than the regulator believes to be optimal (such as could be expected where prices are set at the upper bound of a reasonable range, noting that optimal prices are simply not identifiable) whilst important (if they arise), are not large relative to the costs associated with underpricing, so long as excessive investment in network infrastructure is avoided.

There are three sources of resource allocation distortion from the charges imposed by service providers of gas and electricity networks being too high:

- customers will consume less of the product (electricity or gas) than they would if prices were set optimally (allocative efficiency losses);⁶
- productive efficiency losses, such as arising through the service provider undertaking excessive or unnecessary investment to deliver the service. A service provider who can gain a return from investing in infrastructure that is higher than the cost of securing the necessary funds could be motivated to invest even where the cost of the investment exceeds the benefit that the community receives from it;

⁵ See, for example, Burns, P. and Riechmann, C., Frontier Economics, Regulatory Instruments and their Effects on Investment Behaviour, World Bank Policy Research Working Paper 3292, April 2004, London and Bohlin, Garrone, Andersson, ‘Investment, Innovation and Telecommunication Regulation: What is the Role of the NRA?’ (2004) September available from http://www.pts.se/Archive/Documents/SE/Bolin_PTS-investering-innovation-040901.pdf

⁶ There can also adverse income effects associated of a transfer from the users of a service to the service provider

- dynamic efficiency losses arising from excessive investment in the infrastructure asset. This can arise from many sources, including:
 - other resources being attracted to compete for the provision of the service (such as through inefficient bypass); and
 - resources being committed to protect the excess returns (or rents) that are secured by the service provider.⁷

These adverse impacts are each important considerations in their own right. However, in my view, within the scope of the uncertainty and imprecision in which we are dealing, so long as substantial excess returns are avoided, these adverse impacts are unlikely to be as material as the consequences of underinvestment, for the following reasons:

- as outlined above, the sensitivity of demand to small price changes is relatively low. Consequently, the allocative efficiency losses are likely to be low from erring towards the upper end of a reasonable range (noting that it is not possible to articulate an optimal price);
- the combination of transparent infrastructure planning arrangements (such as the annual planning report produced by TNSPs) together with the *threat* of optimisation of clearly gold plated investments (where service providers are fully compensated under the regulatory regime for the asymmetric consequences of that threat) is likely to substantially ameliorate investment inefficiency concerns arising from prices being marginally above the optimal level;
- it is highly unlikely that pricing marginally above the optimal level would ever create an incentive for there to be bypass of a network due to the scale economies of this class of asset. Hence, bypass is generally not a viable alternative and efficiency losses are likely to be low; and
- while it is true that higher returns may encourage service providers to devote socially unproductive resources to protect those returns,⁸ the history of regulatory practice has been that greater resources are dissipated in responding to more aggressive regulatory decisions.

Ultimately of course, determining whether or not the costs of regulatory error are asymmetric is an empirical issue, and not one that has been tested in Australia. Nevertheless, in my view, this asymmetry is sufficiently likely to be present (at least in the zone bounded by what a reasonable person might expect is a reasonable proposal) for it to be a working assumption for the purposes of developing regulatory policy. On this issue, I understand that I depart from the other members of the Panel.

7 Posner, R. A., *The Social Costs of Monopoly and Regulation* *Journal of Political Economy*, 83, 1975, pp. 807-827. See also Tullock G., (1967) *The Welfare Costs Of Tariffs, Monopoly and Theft* *Western Economic Journal*, 5, 1967a, pp. 224-232.

8 A process generally referred to as rent dissipation.

I emphasise, however, that simply offering a service provider a higher financial return may do little for their incentive to “give less and take more”.⁹ Indeed, a key concern for the design of the regulatory framework is that the continued application of some form of regulation (involving price or revenue and service quality controls) is critical to Australia’s economic welfare. In determining the most desirable regulatory response, the asymmetric consequences of regulator error mean that it is prudent, in my view, to adopt as a guiding principle the objective of minimising the risk of the regulatory response having a long term adverse impact on the community.

EXPERIENCE TO DATE WITH THE PROPOSE RESPOND MODEL

The restricted propose respond model outlined in the Attachment C of the draft Report included a global presumption of acceptance established within the law to be assessed against criteria established by the AEMC (and included in the Rules). This is conceptually similar to the approach currently applying under the NGR subsequent to the GasNet ACT Determination in December 2003 and the MSP ACT Decision in July 2004.

Since this time there have been a number of gas distribution access arrangement reviews either commenced or finalised. These include:

- IPART assessment of AGLGN access arrangement – Final Decision April 2005;
- ERA assessment of Alinta Gas Network’s (AGN) Access Arrangement – Final Decision August 2005;
- QCA assessment of Envestra and Allgas proposed access arrangements – Draft Decision December 2005; and
- ESCOSA assessment of Envestra’s Draft Access Arrangement – March 2006.

These reviews have been undertaken under circumstances where there have been many different interpretations as to the implication of the inferred presumption of acceptance of a service provider’s proposal under the NGR. In particular, there has been uncertainty as to whether the presumption should be assessed at an individual parameter level or at some more aggregated level.

While this has created some uncertainty it is apparent that the application of the propose respond model with a presumption of acceptance has not resulted in delays in the assessment of access arrangements. The two completed processes (AGLGN in NSW and AGN in WA), were completed within seven and six months respectively from the time of the initial draft Decisions.

Further, these processes do not in any way suggest that prices have been systematically biased upwards as a result of the presumption of acceptance as regulators have continued to reject proposals that were considered to be based on

9 Whilst the main economic “harm” is actually caused by overinvestment that is likely to lead to excessively high standards of service, numerous other costs can arise from a poor alignment of incentives between an unregulated monopolist and its customer base.

unreasonable component values. For example, both AGLGN and AGN's initially proposed WACC values were rejected and materially reduced values for WACC were adopted in the final access arrangements.

Finally, these processes do not provide any evidence that the proposed model will increase the level of dispute - neither AGLGN nor AGN sought to appeal the regulators decision notwithstanding the significant reduction in WACC required in order for their proposed access arrangements to be accepted.

As such, recent experience with the preparation of access arrangements for gas distribution businesses suggests that a propose respond model subject to a reasonableness test is an entirely workable model.

Indeed, the key lesson for this experience is that the provision of additional guidance with respect to the structure and application of the model through the development of appropriate criteria and resolution of the scope of the presumption within the NGR is likely to reduce uncertainty and improve the efficiency and efficacy of the regulatory framework.

DESIRABLE REGULATORY APPROACH

In proposing an alternative regulatory approach, I set out:

- the inherent imperfections in the regulatory process;
- the proposed regulatory approach taking this into account; and
- my response to the concerns raised with maintaining a presumption in a restructured propose respond form.

Imperfections of the regulatory process

As indicated by the other members of the Panel, regulatory parameters cannot be measured with scientific precision. In my view, regulators are prone to succumbing to the illusion that greater precision is obtainable than can be delivered by the available instruments (or alternatively, taking the view that assuming precision, when this is not possible, is not harmful to investment). The finer the judgements that a regulator makes about regulatory parameters, the greater is the likelihood of errors arising from those judgements.

This creates the risk that regulators can all too readily impose their view on a service provider even though they are unable to demonstrate the intrinsic superiority of their specific position, notwithstanding the regulator's incentives being better (albeit imperfectly) aligned with the community than the service provider's interests.

Moreover, the regulatory process is susceptible to error. Virtually the entire stock of energy network infrastructure subject to regulation has had opening asset values assessed on the basis of straight line depreciation, an approach which results in

excessive depreciation of the asset for the purposes of establishing an initial asset base. This approach has since been found by the ACT to be deficient:¹⁰

... in our opinion the theoretical underpinning of DORC has progressed over the years to the point where it can now be recognised that straight line depreciation is too crude a tool to be used where there is the opportunity for a more sophisticated analysis. In our opinion, the materials before the ACCC, including its own Draft Statement of Principles, recognise that a net present value (NPV) approach is required for the most reliable result to be achieved, albeit, in our opinion, based upon costs rather than revenue.

Whilst applying straight line depreciation to new infrastructure is unlikely to be adverse to future investment in and of itself, the crucial point is that the regulatory process *is* vulnerable to systemic error (irrespective of whether such error is anyone's "fault").¹¹ These examples are made to highlight why, in my view, it is sensible to be cautious when addressing the adverse impacts from the misuse of market power that underpins the rationale for regulatory intervention.

These inevitable imperfections in any regulatory environment mean that the *perception* of regulatory risk can increase the cost of providing regulated infrastructure. Accordingly, an important benefit of the propose respond model is that it offers service providers increased confidence that they will be more able to influence their regulatory environment.

To the extent that the regulatory framework can ameliorate perceptions of regulatory risk, a substantial social benefit emerges. In my view therefore a key benefit of the propose respond model creating a presumptive right in legislation is that it is most likely to minimise regulatory impediments to investment, which, to the extent they exist, potentially impose an avoidable cost burden on the community. Naturally this cost burden is not amenable to quantification – however the impact of a small change is considerable in the context of the entirety of the annual investment in regulated infrastructure.

Recommended regulatory model

In my view, the combination of the asymmetric consequences of regulatory error, the inherent imperfections in the regulatory process and the desire to adopt an approach that minimises the risk of long term harm to the community from regulatory intervention creates an environment in which the most desirable regulatory process is one in which the regulator assesses the service provider's proposal and if it reasonably satisfies the criteria against which it is to be assessed, the proposal should be accepted. Accordingly, in my view, the NEL and NGL should establish a presumption in favour of accepting a regulated entities' proposal where the proposal reasonably meets the criteria in the NEL or NGL (as the case may be) and the relevant Rules.

¹⁰ Application by East Australian Pipeline Limited [2004] ACompT 8 para 38

¹¹ Similarly, the approach to the assessment of the weighted average cost of capital is far from settled as is evidenced by the views expressed by several leading Australasian experts in the field in relation to beta estimation – see for example, Gray, Hall, Bowman, Brailsford, Faff, and Officer, (2005), The performance of alternative techniques for estimating equity betas of Australian firms, Report Prepared for the Energy Networks Association.

Nature of presumption

The NGL and NEL should therefore require that the AER's first duty is to assess whether a proposal submitted by a service provider reasonably satisfies the defined decision making criteria, rather than to assess whether the AER believes that an alternative position better satisfies the criteria in its view. This approach does not usurp the regulator's role but focuses it on assessing the reasonableness of what is presented to it.

The concept of reasonableness should reflect that a proposal which a reasonable person (having regard to all the circumstances) would accept as meeting the criteria set out in the Rules should be accepted. This is consistent with the Australian Competition Tribunal's interpretation of the NGR.¹²

Criteria against which presumption is assessed

There are a range of different tests or criteria that ought properly be applied in the assessment of a proposal. There are many factors that bear upon the characterisation of the criteria, including the nature of the issue being assessed, the likelihood and consequences of wrongly prohibiting desirable conduct, the likelihood and consequences wrongly authorising undesirable conduct and the difficulties in distinguishing between these states.

However, the fact that a range of threshold tests is appropriate to the conduct of a regulatory review does not bear upon the separate but related question as to the desirability of a presumption in the application of the tests. I agree with the other members of the Panel that the AEMC is the appropriate body to develop such criteria. However, I believe that the basis upon which the compliance with the criteria established by the AEMC is assessed ought properly be the subject of a presumption (that a reasonable proposal be accepted) established in the NEL and NGL.

Just as there is an important distinction between the standard of proof (contrast a requirement to prove a fact on the balance of probability or beyond reasonable doubt) and the onus of proof (which party bears the onus of establishing a fact, which is normally the party asserting a fact), there is an important distinction between the characterisation of a criterion and whether in assessing compliance with it, a presumption is established. Similarly, in my view, there is a distinction between determining of the criteria to be applied by the AER (the role of the AEMC) and the way in which the test is applied (which should be the subject of the legislated presumption).

The key difference therefore between the views expressed here and those of the majority of the Panel is that rather than the Rules defining the test (criterion) as well as the way in which the test ought to be applied (application) my view is that the Rules should be restricted to the former, with the latter being safeguarded by the recognition of a presumption in the Law. This could naturally have implications for the way in which the Rules would be formulated.

¹² See discussion by Australian Competition Tribunal on this issue in *Application by Epic Energy South Australia Pty Ltd* [2003] ACompT 5 pages 4 and 5.

With this in mind, I turn to a consideration of the scope of the presumption.

Scope of presumption

To date, the greatest uncertainty associated with the practical implementation of the propose respond model arises in relation to the scope of the presumption. This issue was also raised in discussions with stakeholders.

In my view it is desirable to avoid conducting an assessment on a basis that requires a regulator to accept a proposal where every parameter (taken in isolation) may be within a reasonable range albeit at the extreme of such a range. Such an approach would oblige the regulator to accept a proposal, even though the proposal, taken as a whole, falls outside a reasonable estimate.

However, simply creating a model where the service provider's proposal is always granted a presumption (as suggested by the Productivity Commission model) does not prevent a procedurally astute service provider submitting an ambit claim at the commencement of the process and subsequently modifying it after the release of a draft decision to retain the benefit of the presumption. Recent history confirms that such an outcome can adversely affect the efficiency and efficacy of regulatory processes.

Accordingly, it is recommended that the benefit of the presumption should be lost (so that the regulator would be at liberty to assess the proposal against its view of what the constituent elements ought to be) where the service provider makes a proposal that does not meet the criteria for an identified component of the proposal. In other words, if, for example, the service provider submitted a proposal that sought greater revenue than fell within the bounds of a reasonable estimate, then the regulator could impose its view of the appropriate parameters in exercising its discretion as to the values the parameters should take.

This raises the issue as to the scope of the presumption. The key issue is to establish the ramifications of a situation where a service provider has one component of a proposal that does not meet the criteria established in the Rules – whether the loss of the presumption applies to the entire proposal or just the component that does not meet the criteria, and if the latter, how is that component identified.

It is accepted that a problem with the global presumption (suggested in Attachment C of the draft Report) is that a regulator's task could involve a difficult balancing of interests – such as whether a breach of the criteria established for, say, queuing, should impugn a pricing proposal.

In my view, this issue is best resolved through the Rules. Accordingly, the Rules would identify the components of a proposal that ought to be considered as discrete components for the purposes of potentially attracting a presumption. These components may well mirror the chapters of the NGR but would be determined by the AEMC. The Rules would also establish the relationships between the components – the reasonableness of a pricing proposal is likely to be considered last by the AER so that it can be addressed with the benefit of the other positions reached by the regulator on the other components of a proposal.

This creates an environment where the service provider has a strong incentive to make a submission to the regulator that is clearly capable of being accepted. Failure to do so risks the service provider losing the benefit of the presumption that it would otherwise be afforded under the regime.

The approach outlined here, which is a restricted form of the propose respond model, overcomes a major concern that the complete removal of the presumptive element to regulatory decision making would deny service providers a very important right that they currently enjoy under the NGR. A particular concern with the removal of this right is that the procedural enhancements that might be proposed in its place may not materially advance a service provider's rights beyond those already afforded by natural justice. The approach outlined here also provides a vehicle (through the AEMC rule making process) to resolve the only significant issue to arise from the practical application of the presumption under the NGR since the GasNet decision (namely the scope of the presumption).

As such, until it is shown to have failed (and I am not aware of any evidence to support such a proposition) I believe that the most appropriate action is to retain similar rights (in the form described here) in the NGL. Extending the benefit of a presumption in the NEL would be entirely consistent with adopting a common regulatory approach across gas and electricity network infrastructure.

Moreover, whilst it is possible that it may be appropriate for the AEMC to prescribe regulatory parameters for regulatory decision making in the future, it seems to me inappropriate for the AEMC to effectively prescribe critical values (such as the WACC) in the Rules, given that the impact of doing so will mean that the parameters are not tested under the new pricing principles or under the revised review processes.

I turn now to consideration of the issues raised in submissions criticising the propose respond model recommended by the Productivity Commission.

Response to concerns with the propose respond model

Uncertainty in ranges

Views have been expressed by many stakeholders (noted in the Panel's report) concerning the uncertainty that will emerge under a propose respond model due to the need to establish a range of possible values.

However, such concerns ignore the fact that the concept of ranges has formed an integral role in regulatory decision making over the past decade, so much so that the normal regulatory decision making process involves arriving at an estimate after first defining a reasonable range for the parameter in question.

It is therefore expected that the uncertainty associated with such a formulation (to the extent that it exists) will reduce over time. Indeed, the experience with the propose respond model to date suggests that the approach has not created significant uncertainty (other than in relation to the scope of the presumption).

After all, a decade ago there was similar uncertainty as to the shape that the regulatory environment might take over time. Accordingly, just as the experience with regulatory

precedent to date has been to clarify parameter values, so too can it be expected that a similar outcome will emerge from the adoption of a restricted presumption as has been suggested.

Whilst the revelation of the acceptable parameters may prove to be a more litigious process than in the past, the testing of any change to the regulatory environment (whether the interpretation of criteria or the extension of merits review) is likely to involve litigation. It is therefore not clear that the adoption of the restricted propose respond will actually increase disputes relative to the alternative.

Finally, the imprecision that is associated with the existence of ranges has been suggested as a weakness of the model. However, since the ranges are a reflection of genuine uncertainty and differences of informed opinion (imprecision), rather than providing a basis to criticise the restricted propose respond model, I suggest that this is exactly why the restricted propose respond model outlined herein represents a desirable approach in the circumstances. Again, recent history does not suggest that uncertainty is a threat to the practical efficacy of the model.

Bias

Stakeholders expressed the view that the propose respond model would lead to a bias in favour of service providers through service providers “cherry picking” parameter values. Again, it is repeated that there is simply no correct value for many of the parameters that inform a regulatory decision. The “bias” that is suggested simply reflects the position from which one begins, noting what appears high to a regulator under one set of positions (that it would accept), may not appear high under an alternate set of reasonable positions.

The Panel’s views concerning the evidentiary process that the AER may utilise in assessing a service providers’ proposal is significant in this regard. Conferring upon the AER the ability to formally test this material, including having a service provider’s experts examined by the AER as well as its advisers, will in my view strengthen the AER’s capacity to assess the reasonableness of a proposal that is presented to it and reduce the risk of the approach introducing a bias to regulatory outcomes.

Hence, the restricted propose respond model does not necessarily introduce a systematic bias to regulatory decision making. The “bias” that is intended to be introduced is simply one that minimises the risk of regulatory error adversely affecting the community.

Moreover, the fact that there is no evidence that regulators have felt constrained to reject proposals under the current NGR model in my view strongly rebuts the proposition that the general adoption of such a presumption would lead to a systematic bias in outcomes.

Workability of the proposed model

Views have been expressed that the propose respond model has significant practical limitations.

The adoption of the propose respond model requires additional regulatory decisions to be made relative to the consider decide model. This is clear from the very nature of the test – what is being asked is:

- whether a position that is put is reasonable (or complies with the decision making criterion) and if so that it be accepted; and
- if not, what is the nature of the position that should, if necessary, be imposed on the service provider.

However, the approach I outlined in the draft Report is very similar to the actual practice adopted by regulators in response to the GasNet decision (subject to the difficulty regarding the scope of the presumption outlined above). In my view therefore, the experience with the application of the NGC since the GasNet decision simply does not justify those concerns.

Whilst the details of the arrangements would be developed by the AEMC, one possible outcome would see the decision making process as follows:

- Step 1) Requirement for the service provider to submit a proposal consistent with the requirements of the Rules
- Step 2) Regulator to assess major components of proposal for reasonableness against criteria established in the Rules
- Step 3) Where an identified component of the proposal is determined to be inconsistent with the criteria, the regulator will reject that component and establish a reasonable replacement value within the draft decision for that component¹³
- Step 4) Service provider to submit a revised final proposal. Any changes from the original proposal would not enjoy the presumption of acceptance. Rather, such components would be assessed in accordance with the Rules (which may provide for a consider/decide model). If the revised final proposal satisfies the requirements outlined in the regulator's draft decision (or the regulator considers that additional information provided by the service provider justifies any variations from the draft decision), then the regulator would accept the revised proposal. Alternatively, the regulator will reject the revised final proposal and will draft and approve a revised arrangement consistent with the Rules
- Step 5) Merits review would be available to the service provider. In the first instance, the appeal body would assess whether the rejection of the components of the service provider's original proposal was reasonable. If not, the regulator would be required to accept the original proposal. If the rejection was justified, the issue before the appeal body would be whether the substituted decision is consistent with the Rules

¹³ It is logical to consider non-pricing components of a proposal first followed by final consideration of pricing in light of any changes to non-pricing elements

If, in the unlikely event, it is considered the model proposed here is unworkable due to the prospect of the loss of the benefit of the presumption, then I would prefer a model where there was no loss of presumption following a decision that a proposal does not comply with the criterion established under the Rules. I say that this is unlikely because the experience of the post GasNet decisions is that the model is workable.

Finally, I note that the issues with workability of any presumption will similarly arise under the model proposed by the other members of the Panel wherever the AEMC determines that a presumption should apply under the Rules.

Diversity

The restricted propose respond model suggested in this Addendum could lead to a greater diversity of proposals being submitted. However, there are several reasons why such a development should be manageable and even desirable:

- service providers are likely to be conservative in the proposals they put forward to minimise the risk that a benefit of the presumption could be lost (or that their submissions will be subjected to exhaustive cross examination);
- to the extent a more flexible approach emerges, it could encourage desirable evolution in regulatory forms and processes more quickly than what might otherwise occur, which, may, for example, encourage higher powered incentives emerging for service providers to pursue dynamic efficiency; and
- to the extent that it is necessary to do so, the development of Rules can limit the diversity of approaches that are submitted to the AER (although the adoption of such a model may have implications for the establishment of regulatory parameters through the Rules).

It is also relevant that the Gas Code always presented a range of options to service providers. There is no evidence that the range of choice promoted under the Gas Code excessively complicated the regulatory task.

Regulatory complexity

Regulation is not an easy task. The rights contained in the Gas Code may have complicated the regulatory task. However, this does not in itself provide a justification for the removal of those rights. The complexity of the regulatory task should be balanced against the benefits of alleviating the risk of regulatory error.

Moreover, it is also conceivable that the adoption of a restricted propose respond model will change the alignment of tensions in the regulatory process in a desirable way – due to the strong incentive for service providers to submit a proposal that is capable of being accepted. This is especially the case given the evidentiary processes that are being proposed that will assist the AER test the reasonableness of a proposal.

It is recognised that the AER has a very considerable workload that will only grow with the number of regulatory decisions it must make. Even if the model outlined here materially increased the regulatory task – and there does not appear to be evidence to

support such a proposition from recent history, then the appropriate policy response should be to increase the resources made available to the AER. It is certainly not a reason to potentially compromise the regulatory environment with a second best solution.

It is conceded that the model may need to evolve over time. For example, the model may need to become more complex to accommodate situations where prolonged regulatory processes result in a service provider's proposal no longer being assessed as being reasonable due to circumstances changing over the course of the regulatory process. This risk is likely to be asymmetric for service providers. Nevertheless, before complicating the model to address such deficiencies, I recommend that it be applied for a sufficiently long period to enable its efficacy to be assessed.

RECOMMENDATION

It is recommended that the NEL and NGL include a presumption in favour of the AER accepting a proposal submitted by a service provider where the proposal meets the requirements specified by the AEMC to a standard of reasonableness prescribed in the Law. The standard of reasonableness should reflect that a proposal which a reasonable person (having regard to all the circumstances) would accept as meeting the Rules should be accepted.

The AEMC in determining the criteria against which a proposal is assessed should establish the scope of the presumption by reference to the components of a proposal.

Where, in applying the criteria developed by the AEMC in relation to each identified component of a proposal, the AER concludes that the proposal does not satisfy the relevant requirements to the prescribed standard of reasonableness, then the AER may apply the relevant principles determined by the AEMC in making a draft or final determination for that component, but must have regard to the regulated entity's proposal, any relevant submissions made and any other information and analysis to which the AER may have regard in accordance with the Rules.

An intended consequences of this approach is it should preclude the AEMC making Rules that prescribe elements or parameters in a manner that removes service provider options and AER discretion (such as by prescribing parameters in the WACC).