COAG Energy Council
Senior Committee of Officials

BULLETIN

BINDING RATE OF RETURN GUIDELINE

June 2018

SENIOR COMMITTEE OF OFFICALS RESPONSE TO SUBMISSIONS ON BINDING RATE OF RETURN LEGISLATION

INTRODUCTION

In July 2017, the COAG Energy Council agreed to amend the National Electricity Law (NEL) and National Gas Law (NGL) to implement a binding instrument relating to the calculation of the rate of return on capital and the value of imputation credits used in economic regulatory decisions made by the Australian Energy Regulator (AER) and the Economic Regulation Authority, Western Australia (WA ERA).

The COAG Energy Council agreed to introduce the final legislative amendments on 15 June 2018.

Under the current arrangements, the AER and WA ERA's rate of return guidelines are non-binding, meaning they can, and do, use different approaches to the rate of return for each network business determination.

The legislative amendments will have the effect of elevating the framework for setting the rate of return that applies in determining the revenue of regulated electricity network and gas pipeline businesses into the laws. Consistent with this approach, the legislative amendments will remove heads of power for the Australian Energy Market Commission (AEMC) to make rules regarding the determination of a rate of return.

The amendments will implement a binding instrument that sets out a single approach to the calculation of rate of return parameters for all network businesses; and which is developed through a single, industry-wide process every four years. These new arrangements will enhance regulatory certainty for regulated businesses, the regulator and other stakeholders.

The policy intent

The purpose of the legislative package is to enhance regulatory certainty for regulated businesses, investors, consumers and the regulator regarding the rate of return component of the network's determinations and reduce the regulatory burden for all stakeholders in terms of the time and costs involved in debating rate of return issues.

The policy intent is achieved by:

- Giving the AER and the WA ERA the power to implement a legislative instrument that sets out the approach they will use to determine the rate of return and the value of imputation credits, providing more certainty to network businesses about their rate of return.
- Reasserting the primacy of the National Electricity Objective (NEO) and National Gas Objective (NGO) and the Revenue and Pricing Principles (RPPs) to ensure the primary focus in making the instrument is on the long term interests of consumers, including providing networks with an efficient rate of return.
- Refocussing engagement on rate of return issues to a single, periodic, industry wide process to reduce the regulatory burden on stakeholders and regulators.
- Making the regulators' process more robust to enable early resolution of contested issues, so as to increase confidence in the regulator's decisions. In developing the instrument, and in addition to existing consultation requirements, regulators will be required to seek input from:
  - a specially appointed consumer reference group to ensure effective consumer consultation;
  - experts with appropriate qualifications or experience, with nominations to be sought at the commencement of the process; and
  - an independent expert panel, comprising at least three members, who will assess and publicly report on the regulators draft guideline.

In presenting the draft and final instrument, regulators will also be required to provide explanatory information detailing the reasons for their decision, including how they had regard to estimation methods, conditions in equity markets and the RPPs.

The binding instrument will apply to determinations currently underway. The amendments also include transitional arrangements to make clear that consultation for the review of the current non-binding guidelines constitutes consultation for the purpose of the binding instrument.

Stakeholder feedback

On 2 March 2018, the Senior Committee of Officials (SCO) released draft amendments to the national energy laws to implement the binding instrument for stakeholder feedback. Consultation closed on 13 April 2018 and 15 submissions were received. A further stakeholder forum was held on 29 May 2018.

The feedback received through these processes was used to inform the final legislative package.

A detailed summary of issues raised and how they have been addressed is provided at **Attachment A**.

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Attachment A

ISSUES RAISED IN CONSULTATION

Main issues raised in consultation	Changes to the legislation after consultation
Judicial review of the rate of return instrument	
• **That proposed sections 18R/30M invalidly remove judicial review and is bad practice.** • **That the introduction of broad discretion and little guidance for the regulators effectively ruled out the ability to bring judicial review challenges.**	• The draft legislation has been amended to introduce greater guidance for the regulators and to provide stakeholders with certainty the regulators will be required to consider the revenue and pricing principles in addition to the NEO/NGO. ▪ Changes have been made to ensure sections 18R/30M will not prevent an instrument being challenged for non-compliance with achieving the NEO/NGO or having regard to the revenue and pricing principles. ▪ Sections 18R/30M will however operate to prevent judicial review on process grounds after the instrument has been made, ensuring it cannot be invalidated on minor or frivolous grounds.
Delegated power and the role of the AEMC	
• **Some stakeholders expressed a preference for retaining the existing rules and the AEMC's existing rule-making function.** ▪ **In particular, retention of the allowed rate of return objective (ARORO), and within that, the benchmark efficient entity (BEE); and the weighted average cost of capital (WACC).** ▪ **There were concerns that the loss of these concepts and overall limited guidance for the regulators would give regulators too much discretion and open the door for a move away from the established incentive-based economic regulatory model.** • **Others favoured removal of these rules and the conferral of a broad discretion on the regulators.**	• The AEMC's rule making powers will be removed. This is consistent with the instrument being of legislative character, and the transferral of power to make the instrument from the AEMC to AER/ERA. ▪ It also ensures there is no risk of rules being made that are inconsistent with the instrument. • Elements of the current rules have been moved into the draft legislation to provide more guidance for the AER/ERA, including: ▪ The concept of a weighted average of an allowed rate of return on debt and allowed return on equity has been included (see 18I/30D). ▪ What explanatory information the AER/ERA must provide with the instrument has been amended to ensure they explain how they had regard to: ➢ prevailing market conditions in the market for equity funds. ➢ estimation methods, financial models, and market data. ➢ the reasons for how the rate or value is calculated and how the AER/ERA has determined the rate or value.

Main issues raised in consultation	Changes to the legislation after consultation
	➢ if the AER/ERA deviates from how it has previously calculated the rate of return and the reasons why it has done this. ➢ Why the AER/ERA is satisfied the approach taken will contribute to the NEO/NGO to the greatest degree.
Re-opening the instrument early	
• **Some stakeholders supported provisions to reopen the instrument and sought more detail in the legislation about the circumstances in which the instrument could be re-opened.** • **Other stakeholders thought provisions to enable the instrument to be reopened early were unnecessary.**	• The final legislation does not include a re-opener. • The overall policy intent of the binding instrument is to provide regulatory stability and certainty. Allowing the potential for it to be re-opened could be counterproductive. • The instrument will be in force for 4 years and the inclusion of a re-opener within this short window is likely to create unnecessary regulatory uncertainty. • The potential effects of a financial market shock can be accounted for in the AER's rate of return methodology.
The role of the concurrent evidence sessions	
• **Some stakeholders sought greater prescription about how the concurrent evidence sessions would work and which experts would be invited to participate.**	• The draft legislation has been changed to require that: ▪ The AER/ERA must call for nominations of eligible experts, but may seek the opinions or evidence of any eligible expert. ▪ Experts should have relevant experience, as determined by the AER/ERA, for example one or more of the following fields; finance, economic regulation, consumer affairs, institutional investment. ▪ If practicable, it must seek opinions or evidence from at least 3 eligible experts.
The role of the independent panel	
• **That the expert panel should have the relevant expertise to consider regulatory decisions.** • **That the panel should be able to review the instrument and recommend amendments to it.**	• The draft legislation has been changed to require that: ▪ The panel members must have relevant expertise as determined by the AER/ERA for example, finance, economics, law, consumer affairs and institutional investment. ▪ the AER/ERA should use all reasonable endeavours to minimise and manage any conflict of interest a panel member may have in relation to making the instrument. • While the expert panel will review draft instruments and provide a public report, the AER/ERA is not bound to follow its advice. To

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	require this would be akin to reintroducing a form of merits review.
Separate instruments for electricity and gas	
• **Gas networks support the regulator making separate binding instruments for electricity and gas businesses.**	• This was always the intention. The draft legislation has been amended to clarify this with the addition of the following words: ▪ "To remove any doubt, it is declared that the instrument may include different rates of return on capital and values of imputation credits for the purposes of this Law and the National Gas Laws".
Time of application of first instrument	
• **That the 2013 guideline should continue to apply for the regulatory determinations currently under development.** • **The AER noted it has the ability to depart from the 2013 guideline, as provided for in the rules, and would probably apply the outcome of the current review of the non-binding guideline to regulatory determinations currently under development.**	• Council decided at its July 2017 meeting that the new arrangements will apply as soon as possible, so as to enhance regulatory certainty, improve engagement and reduce the substantial time and cost of continually debating the rate of return. • The draft legislation has been amended to ensure that if the review of the non-binding guideline is completed before the legislation to establish a binding instrument commences, the revised non-binding guideline will automatically become the first binding instrument.
Transitional arrangements for WA	
• **Some Western Australian stakeholders were concerned the WA ERA would not be required to consult with stakeholders in the development of the first instrument.**	• No amendments will be made to the draft legislation. Western Australia will deal with transitional issues at the jurisdictional level. • Specifically, for the first process for making the binding rate of return instrument, the WA ERA will be exempt from the requirement to consult with stakeholders before publishing its draft rate of return guideline. • All other procedural requirements, including independent panel review, will align with those for the AER.

List of submissions

- Australian Energy Regulator (AER)
- ATCO
- Consumer Challenge Panel (CCP)
- Australian Pipeline Limited (APA)
- Public Interest Advocacy Centre (PIAC)
- Australian Pipelines & Gas Association (APGA)
- South Australian Council of Social Services (SACOSS)
- Energy Networks Australia (ENA)
- IFM Investors, Spark Infrastructure, AustalianSuper, AMP Capital, Hastings Funds Management, Macquarie Infrastructure and Real Assets, ATCO (joint submission) (IFM)
- Infrastructure Partnerships Australia (IPA)
- Power and Water (PW)
- SA Power Networks, Citipower, Powercor, Australian Gas Infrastructure Group and United Energy (joint submission) (SAPN)
- TransGrid
- Grattan Institute
- Energy Consumers Australia