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## **Response to AEMC Draft Rule Change Proposals Electricity Transmission Revenue Requirements**

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# Executive Summary

## CONCLUSIONS

1. The Energy Action Group (EAG) and Energy Users Association of Australia (EUAA) consider the AEMC's draft Rule change proposals, and the Rule Proposal Report that is intended to justify and explain the proposals, inadequate in many respects.
2. We are concerned that the AEMC has failed to clearly explain why the changes are necessary, how they will act to improve existing regulatory practice or impact on end-users or, most importantly, how the proposals will better facilitate achievement of the Single Market Objective (SMO).
3. In particular, we note that the AEMC has failed to provide any evidence to demonstrate that the proposals will improve regulatory outcomes for end users or explain how weighting of different aspects of the SMO have been determined or why there is an apparent key focus on providing 'investment certainty' for TNSPs – when investment in the shared network has been at historically high levels. Nor has the AEMC provided any argument that the proposals will facilitate more 'efficient' investment in inter-regional interconnection that is correctly identified by the MCE as a high priority.
4. We consider the absence of 'hard, factual' evidence that supports qualitative argument and theory to be a serious failing by the AEMC. This reduces the value and robustness of the proposals. It is our strong view that any Rule changes must be justified by clear evidence that change is necessary and that energy users will derive on-going and long-term benefits that are direct, transparent and deliverable. Rule changes must also clearly and transparently 'strengthen' efficiency incentives, not weaken them. Any Rule change must be consistent with the SMO and clearly demonstrated to be so by the AEMC. The AEMC has clearly failed to achieve these outcomes in the current proposals.
5. At best, the AEMC's proposals merely formalise existing practice by elevating aspects of the SRP to the Rules. However, the proposal to allow re-opening of a revenue determination if actual capital expenditure exceeds forecast levels, in an apparent attempt to create 'clear incentives for investment', will substantially weaken incentives for TNSPs to manage their affairs efficiently and clearly act against the interests of end users who will not have reciprocal rights to force reopening if actual expenditure is less than forecast.
6. The AEMC has provided no evidence or any compelling arguments to support this dilution of the 'efficiency incentive' that is – or should – be an essential element of the regulatory regime. Indeed, as we outline in this submission, there are reasons to believe that the minor changes to existing regulatory practice contained in the proposals will significantly weaken incentives for efficient investment by:
  - a. taking pressure off TNSPs to reasonably forecast business conditions and be held accountable for those forecasts; and

- b. 'lowering the hurdle' for TNSPs to demonstrate that their revenue proposals are based on 'efficient' costs by requiring only that forecast cost be 'reasonable' – with no primary objective of being efficient.
7. We have proposed a number of recommendations to address these serious deficiencies. These are generally consistent with recommendations made in our earlier response the AEMC's Issues Paper. We believe that adoption of these recommendations would better allow the AEMC to demonstrate that the changes to the Rules were consistent with achievement of the SMO.
8. We also note that consideration be given to improving the effectiveness of existing end user Advocacy funding arrangements to ensure end user interests can be effectively presented and represented in the shortened revenue review process. We recognise that this is not part of the Rule Proposals currently being considered, but it would better allow the proposals to be effective.

## RECOMMENDATIONS

### GENERAL ISSUES

9. Rule changes clearly and transparently 'strengthen' efficiency incentives, not weaken them.
10. Any Rule changes be justified by clear evidence that change is necessary and that energy users will derive on-going and long-term benefits (consistent with the SMO which the AEMC is required to satisfy) that are direct, transparent and deliverable.
11. The AEMC clearly articulate the arguments that supports its proposed move to obvious and heavy weighting on providing 'certainty' to transmission owners, particularly when there is no evidence the current arrangements and practices have adversely affected investment levels and when there are other aspects of the SMO that appear to have been ignored or assign much lesser weightings.

### DEFINITION OF PRESCRIBED SERVICES

12. The AEMC exercise some care to ensure that the definition of Prescribed Transmission Services considers the monopoly role of TNSPs. A narrow definition may allow TNSPs to exploit market power because of a lack of competition or contestability.

### POST-TAX REVENUE MODEL

### REGULATORY ALIGNMENT

13. The AEMC should amend its proposals to introduce the forms of incentive for efficient expenditure that have been implemented in the distribution sectors. In particular, 'efficiency incentives' – and corresponding potential to transfer efficiency benefits to end users – would be enhanced by making TNSPs (and the AER) accountable for:
  - a. linking forecast costs to actual costs;

- b. meeting their commitments within ‘efficient’ forecast expenditure limits; and
  - c. meeting specific service standards that deliver benefits to end users.
14. If the AEMC declines to improve the Rule change proposals, we believe that it is essential to make it clear that the ‘low-powered’ capital expenditure incentives proposals are to be confined to regulation of electricity transmission. To avoid doubt, the AEMC should expressly exclude similar proposals being extended to either gas transmission, or gas and electricity distribution.
15. In addition, we believe it is essential that the proposed Rule change relating to ‘in-period’ re-opening, if retained, be amended to make it reciprocal by requiring the AER to undertake an ‘in-period’ review when requested by end-users in circumstances where a TNSP significantly under-spends its allowed capital expenditure forecast within a regulatory period. This would, of course, also require prompt, transparent and accurate public reporting of TNSP financial performance – and precise comparison between actual and forecast expenditure, which would in turn require significant improvement to the performance reporting regime established by the ACCC.

#### LOCK-IN OF RAB

16. Our acceptance of the ‘lock-in’ of RAB values is conditional on retaining powers for the AER to undertake a prudence and efficiency review in circumstances where this appears warranted. As a minimum, such circumstances would be where there is concern that a TNSP has made a poor investment decision, or where execution of the investment was poorly managed. In these cases, the AER should be obliged to exclude roll-in of any inefficient or imprudent investment cost.

#### REGULATORY INTRUSION & ‘REASONABLE ESTIMATE’ TEST

17. The proposed Rule change should reflect the existing focus on efficient investment given efficient operating and maintenance practices or be more effectively aligned with existing (and equivalent) provisions of the Gas Code with an overarching requirement that revenue allowances are determined and reviewed based on the efficient cost (or anticipated efficient cost) of providing the Prescribed Services.
18. As a minimum, the proposed Rule change should clearly define ‘reasonableness criteria’ (v) and (vi) as having higher weighting than others; and require that demand forecasts (in (vii)) be compatible with efficient expenditure forecasts. This would go some way towards ensuring the AER would be able to withstand legal challenge that the AER’s interpretation of ‘reasonable’ did not breach the ‘Wednesbury principle.’

#### REGULATORY PERIOD AND WACC

19. The AEMC should not proceed with a ‘lock-in’ of WACC parameter values within the Rules but rather ensure that the review periods of all TNSPs are fully aligned into a single review process. This could be achieved by the AEMC exercising its Rule-making powers and mandating that the alignment be achieved at a particular date; or require the AER to achieve alignment of TNSP reviews by extending

existing regulatory periods until they all align. This would better facilitate achievement of the SMO and be more likely to achieve ‘best practice regulation’. It would also achieve a 5 yearly review of WACC without having to specify this in the Rules.

20. Consideration should also be given to achieving alignment between the timing of gas transmission and electricity transmission reviews as has been implemented in the UK. This would go some way towards addressing the conflicts between incentives/signals in the gas and electricity sectors at a time when there are steps being taken to align regulation of electricity and gas and as there is certain to be greater involvement of gas-fired generation in the electricity sector.

#### INFORMATION DISCLOSURE

21. As a minimum, the proposed Rule changes should be amended to require:
  - a. the AER to develop, in consultation with TNSPs and end users, effective and enforceable guidelines and procedures that define, and precisely and clearly specify, the information that must be provided to the AER;
  - b. these requirements and the timing of information to be provided be rigorously and consistently enforced;
  - c. reliable and verifiable information to be disclosed about the actual costs incurred in providing services, including for un-regulated activities, and the levels of service performance.
22. As a minimum, the AER should be given the same powers to obtain and enforce information provision by the TNSP as other Australian regulators, such as the Australian Securities and Investment Commission (ASIC), ACCC and the Australian Taxation Office (ATO).
23. Further, the Rules should limit discretion in allocation of costs and interpretation of performance information as tightly as possible. This would appear to be the only way of minimising the exercise of ‘strategic behaviour’, obfuscation and/or confusion over information disclosure.

#### INCENTIVE MECHANISMS

24. The AEMC should introduce similar incentives for efficient expenditure to those used in the distribution sectors. This would require TNSPs (and the AER) to:
  - a. link forecasts to prudent/efficient actual expenditure and any material changes in obligations, service standards or user requirements based on costs that are demonstrated to be efficient;
  - b. ‘live with’ the forecast expenditure amounts for the full regulatory period, which allows the TNSPs to ‘capture’ efficiency benefits during the regulatory period; and

- c. transfer assessed efficiency benefits to end users (either directly or through a sensible efficiency carry-over mechanism) at the end of each regulatory period.
- 25. As the AEMC noted in its Issues Paper, the incentive mechanism developed for NGC in the UK has been effective in substantially reducing system costs. We believe that an incentive mechanism with potential for similar benefits should be introduced in Australia as this would better facilitate achievement of the SMO.
- 26. However, if the AEMC persists with proposals in the Rule change package, better definition is required of a 'performance incentive' regime that attempts to align TNSPs' interests with the electricity market. A limit of +/-1% of total TNSP revenue is extremely modest compared to the impacts that TNSPs can have on the market.

#### ASSET STRANDING AND NEGOTIATION

- 27. We object strongly to any proposals that would provide regulated networks with 'protection' from 'stranding' (i.e. poor investment decisions) and effectively pass these costs on to end users. This approach is not consistent with the SMO; nor is it consistent with the policy objective of having the regulatory regime mimic the outcomes of a competitive market. Protection from asset stranding is not possible in competitive markets where shareholders must bear the risks of poor decisions and suffer the consequences (not their customers). It would be a major step forward if the AEMC were to recognise this and ensure that the Rule changes reflected it.
- 28. We acknowledge that the AEMC's proposals in respect of asset stranding are more-or-less consistent with arrangements currently in place. However, they provide only weak incentives for TNSPs to negotiate so as to avoid by-pass by transmission users. If retained, the proposals should be extended to provide clear incentives for TNSPs to address and accommodate the potential risk of asset stranding created by changes in consumer preferences. This can only be addressed by creating clear incentives for TNSPs to better understand the potential impacts of emerging technologies (and end user response to these technologies) and allow for this in their forecasts (and pricing policies).

# 1. Introduction

This submission contains a response from the Energy Action Group (EAG) and Energy Users Association of Australia (EUAA) to a number of issues raised by the Australian Energy Market Commission (AEMC) in its Rule Proposal Report that relates to electricity transmission revenue determination. In particular, the submission responds to issues presented by the AEMC at the Public Hearing held in Melbourne on 8 March 2006 which we presume to be the issues seen as most important by the AEMC.

The response compliments an earlier submission on matters arising from the AEMC's Issues Paper. That earlier submission represented a concerted attempt by end-users to make a constructive contribution to the important matters under debate. The submission provided a critique of the broad ranging proposals covered by the Issues Paper. Most importantly, the earlier submission attempted to 'add value' to the AEMC's Issues Paper by referring to quantified examples from existing regulatory practices in Australia as evidence to support our proposals and recommendations. It was a concern to us, as representatives of end users, that this was missing in the AEMC's own work on this important review.

We are deeply disappointed that the AEMC failed to effectively acknowledge this contribution either directly<sup>1</sup> or by using the information we provided on behalf of end users to enhance the quality of its own Rule change proposals. The AEMC could have made such improvements by demonstrating, through quantified and specific examples:

- why the proposed Rule changes were necessary;
- how they will act to improve existing regulatory practice or impact on end-users; and
- how the Rule changes would facilitate achievement of the Single Market Objective (SMO) specified in section 7 of the National Electricity Law (NEL).

Instead, the AEMC has continued to present general qualitative arguments supported by reference to academic theory on regulatory economics. We consider the absence of 'hard, factual' evidence that supports qualitative argument and theory to be a serious failing by the AEMC that reduces the value and robustness of the proposals.

It has not been demonstrated that these proposals – and the justification for them that has been presented by the AEMC – are either in the best interests of users or consistent with the SMO. The proposals contain no evidence to demonstrate that achievement of the SMO will be better facilitated than with the current arrangements that we have previously argued need fundamental overhaul. Indeed, as we outline in this submission, there are reasons to believe that the changes to existing regulatory practice contained in the proposals will significantly weaken incentives for efficient investment by:

- taking pressure off TNSPs to reasonably forecast business conditions and be held accountable for those forecasts by allowing a TNSP to request re-opening of a revenue determination if actual costs exceed the forecasts; and

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<sup>1</sup> Our submission in response to the Issues Paper dealt with a broad range of Issues identified in the Issues Paper. Only three of our responses are referred to at all in the Rule Proposal Report and none appear to have been seriously considered by the AEMC. The responses referred to are (1) implementation of a more robust and auditable information disclosure regime (on p. 39); (2) a vague reference to the 'reasonable range approach' (p. 45); and (3) and even vaguer reference to weakening of incentives through re-opening of a revenue determination (p. 76).



- ‘lowering the hurdle’ for TNSPs to demonstrate that their revenue proposals are based on ‘efficient’ costs by requiring only that forecast cost be ‘reasonable’ – with no primary objective of being efficient.

We believe that this review by the AEMC (and the others it is conducting) is an important milestone in the process that commenced with the package of energy reforms agreed to by COAG in the early 1990s. A main driver that stimulated initiation of the reforms was the imperative to increase the competitiveness of the Australian economy that was being increasingly exposed to international market forces. As part of related but broader economic reforms, protective industry tariffs were reduced or eliminated exposing Australian manufacturing and commercial businesses to more competition from imports (and the need to gain and maintain access to competitive inputs including energy). Hence, the equally broad range of energy market (and later other utility) reforms aimed to improve export competitiveness by reducing input prices in the energy sector to economically sustainable and efficient levels. The latest round of changes in energy market reform, which include formation of the AEMC and allocation to it of the important role of Rule change and market development, was deemed necessary by the MCE to better facilitate the goals set for energy market reform. In particular, further reforms in the electricity transmission sector were explicitly identified as being of high priority by the MCE. In our strong view, therefore, the AEMC has a responsibility to facilitate this further reform, including through this review.

While far from perfect, outcomes from the reforms so far suggest they have delivered some benefits to end users. Australia’s historically favourable energy prices – which reflect the natural advantages arising from energy abundance and (relatively) close proximity of primary energy sources to major load centres – has been generally maintained and even improved to some extent. Electricity prices to large industrial and commercial end users have stabilised or, in some cases, fallen and there has been downstream investment in energy intensive businesses (although it is not clear how much of this can be attributed directly to energy market reforms when the downstream investment is largely due to a booming productive economy and strong demand for minerals and minerals processing).<sup>2</sup>

The Rules covering energy networks, and the implementation of the Rules at a national and jurisdictional level, have also delivered a number of positive outcomes. Reliability has improved in some jurisdictions (notably Victoria) and has generally not deteriorated in others. Capital and labour productivity – and the profitability – of regulated energy network entities have improved markedly, especially where assets have been privatised. Investment in regulated energy infrastructure is at unprecedented levels even for publicly-owned TNSPs whose forecasting performance has not been as robust as their private sector counterparts.

The AEMC should note that we are not arguing that the current arrangements are adequate. We totally agree with the MCE, for example, that changes are required to better facilitate investment in inter-regional transmission capacity; and we strongly agree that incentives for TNSPs’ performance must be aligned with outcomes in the energy and Ancillary Services markets. We recognise that these are not matters that can be improved only through changes to the revenue determination process. However, we believe it is appropriate for the AEMC to consider how it can facilitate such outcomes as part of this Rule change process.

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<sup>2</sup> There is no direct evidence that suggests strong demand for minerals from China and India is directly related to the successes in energy market reform achieved to date. However, it is possible that ‘freeing up’ previously moribund capacity in State-owned instrumentalities has assisted in facilitating downstream investment that is necessary for that demand to be met.

The sustained increase in profitability by private sector TNSPs (above the ‘efficient’ costs allowed by regulators) provides direct incentives for further efficient investment (and it is be encouraged). This outcome should also provide:

- opportunities for the AER to pass efficiency benefits to end users; and
- ‘competition by comparison’ incentives for publicly-owned TNSPs to do a much better job of serving end users.

Accordingly, it is not at all clear why the AEMC has focussed on providing ‘greater certainty’ for further investment or limiting the scope for changes to Rules governing transmission revenue to essentially elevating parts of current practice to the Rules. The focus might more logically be to help ‘transform’ public sector TSNP managers to behave like their private sector counterparts, strengthen incentives for efficient investment and operations and ensure that future (and past) efficiency benefits are passed to end users.

Both CoAG and the MCE have accepted arguments that we, and many other stakeholders, have put that substantially more effort was required to reinvigorate the reforms and carry them through so that the Australian economy is better placed to compete in an increasingly challenging international environment.

It is our strong view that the AEMC’s Rule change proposals miss an important opportunity to move forward the gradual attempts by the ACCC and jurisdictional regulators (particularly those in Victoria, South Australia and Western Australia) to improve incentives for continuing efficiency gains in the regulated energy sectors. The AEMC’s proposals appear likely to both stifle efficiency incentives for TNSPs and inhibit transfer of the benefits of efficiency gains to end users. If the proposed Rule changes are formalised, the AEMC will put at risk some of the gains that have been made so far and establish an unacceptable precedent for the future national regulation of the gas and electricity distribution sectors.

**Unfortunately for end users and directly contrary to the SMO, the AEMC’s Rule change proposals will clearly and substantially shift the balance of the transmission regulatory regime in favour of TNSPs in a manner that will act against the long term interests of end users.**

This outcome will occur without adding significantly to the already substantial levels of investment in regulated energy assets. The proposals substantially reduce incentives for TNSPs to pursue economic efficiency and move transmission regulation much closer to US-style ‘cost-of-service’ regulation where utilities have no direct incentive to improve efficiency. This is almost certain to reduce ongoing efficiency gains in the electricity transmission sector. If these proposals are implemented and provide a precedent for changes to regulation of the distribution sectors it will have the same effect there. In that sense, the transmission element could be the proverbial ‘tip of the iceberg’ that sinks the reforms achieved to date.

If the AEMC also allows the TNSPs’ proposals to add a ‘contingency investment’ allowance to the proposed ‘re-opening’ provisions already proposed, the regulatory regime would be likely to produce outcomes that are even less beneficial to end users than ‘cost-of-service’ regimes in the US. TNSPs would no longer face any effective incentives to pursue economically efficient outcomes and end users would have no realistic mechanism to access

the benefits of efficiency gains that private sector TNSPs have demonstrated are so obviously possible in electricity transmission.

It is our strong view that any Rule changes must be justified by clear evidence that change is necessary and that energy users will derive on-going and long-term benefits that are direct, transparent and deliverable. Any Rule changes must clearly and transparently ‘strengthen’ efficiency incentives, not weaken them. And any Rule change must be consistent with the SMO and clearly demonstrated to be so by the AEMC. The AEMC has clearly failed to achieve these outcomes in the current proposals.

The AEMC says that the Rule Change Proposal continues economic regulation (including a revenue cap approach)<sup>3</sup> for Prescribed Transmission Services substantially based on the current approach to transmission regulation set out in the Statement of Regulatory Principles (SRP).<sup>4</sup> The Rule Proposal elevates key components of the SRP into the Rules. Where the SRP does not provide a complete framework for regulation, the AEMC states it has attempted to provide greater clarity in the Rules or further guidance to the AER where regulatory discretion is appropriate. The AEMC also says that the proposed Rule changes promote greater clarity, certainty and transparency of regulatory processes and decision-making.

We agree that these later objectives are highly desirable goals. However merely formalising existing practice and introducing what appear to be minor changes in an attempt to placate supply-side lobbyists’ unsubstantiated concerns about ‘certainty’ in the investment climate is hardly ‘best practice’ regulation<sup>5</sup> – which is what the AEMC should be seeking to enshrine in the Rules.

The NERA and Gilbert & Tobin (NERA *et al*) report to the MCE identified five broad criteria as characterising ‘best practice regulation’. These were:

- (a) transparency and predictability;
- (b) adaptable to change through transparent and equitable process;
- (c) minimising compliance costs;
- (d) separation between rule making and rule enforcement; and
- (e) accountability to all parties.

It is our view that this is the minimum set of criteria that should be applied, but we note that apart from criteria (c) there is very little focus on the outcomes from regulation. We believe that, in the context of the AEMC’s current reviews and the TNSP revenue Rule Proposal, a further criterion for ‘best practice regulation’ should be that it facilitates achievement of the outcome-focussed SMO.

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<sup>3</sup> We note that the AEMC’s Issues Paper canvassed a range of possible regulatory approaches. However, there is no discussion in the report that explains why the alternative approaches were rejected. Presenting options that turned out to be ‘straw men’ that were ignored by the AEMC simply wasted the limited resources available to end users.

<sup>4</sup> We recognise that the Proposal also provides incentives for the negotiated or competitive supply of services or, for pursuing non-network solutions where feasible. Emphasis on this aspect of regulation is welcome, although as we note later in this submission relatively few end-users are affected by this aspect of regulation and it constitutes a small proportion of total TNSP revenue.

<sup>5</sup> p. 11, *Public Consultation on a National Framework for Energy Distribution and Retail Regulation*, The NERA et al and Gilbert & Tobin, May 2005

As noted in later sections of this submission, it appears that the AEMC has focused its attention on NERA *et al*'s criteria (a) on the basis that this will assist in facilitating investment certainty, but has paid too little attention to other criteria. It is far from clear that the Rules Proposal addresses other criteria equally well, if at all. For example:

- Elevating many of the aspects of current regulatory practice into the Rules has the effect of formalising the 'legal status' of that practice, which is arguably transparent. But the fact that the Rules have the effect of law greatly increases the difficulties that end-users might face if they were aggrieved with the Rule change process or its outcome and sought to challenge the outcome – as this would require a costly challenge through the Courts. A better outcome may be derived by allowing the maximum amount of discretion to remain with the AER and define objectives in the Rules for guiding that discretion.
- The AEMC may seek to make the Rule change process adaptable through a transparent and equitable process. But end users will always be disadvantaged by resource constraints. Again, it would appear to be desirable to enshrine in the Rules an obligation for the AER to ensure that end users not merely get an opportunity, but 'get a fair hearing' in all regulatory processes.
- The AEMC has clearly failed to address NERA *et al*'s criteria (c). As we noted in our earlier submission (and repeat later in this submission), the AEMC should take this opportunity to align all TNPS regulatory reviews into one single process. This would very substantially reduce the cost of regulation (for end users, the AER and TNSPs in our view) and would be far more likely to result in outcomes that more effectively facilitated achievement of the SMO by providing coherent and common incentives that applied in identical timeframes for all TNSPs. This would encourage the TNSPs to operate as though they were in fact parts of a single, crucial national infrastructure.
- By transferring much of the SRP, and other aspects of current regulatory practice, to the Rules – and limiting the AER's discretion in respect of aspects such as treatment of 'contingency investments' and re-opening, the AEMC is doing more than 'rule making and enforcement'. The AEMC is also taking on some of a role of active regulation and limiting discretion that might assist the AER develop the regulatory regime that more effectively facilitates achievement of the SMO.
- It is not at all clear that the Rules Proposal achieves NERA *et al*'s criteria (e), which implies transparent processes in which all parties have the opportunity to be heard, together with a clear and effective dispute process. In particular, difficulties will remain for end-users wishing to participate in the regulatory processes. The fixed time frame proposed for conduct (by the AER) of transmission revenue reviews, which allows for up to three opportunities for input from end-users within a four month period,<sup>6</sup> will place great strains on end-users to meet such a tight timetable. This process appears to provide numerous opportunities but not much meaningful input from end-users. The regulated businesses will have the resources to handle this with ease. This part of the proposal illustrates that the AEMC wants to show it provides for multiple input at the same time as it meets the MCE objective of 'streamlining regulation' (which could be a completely wrong objective anyway since it focuses entirely on inputs not outcomes). It also demonstrates that the AEMC is being naive about end user input and the constraints

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<sup>6</sup> Written submissions are permitted (1) on publication by the AER of a TNSP's Revenue Proposal three months into the review process; (2) on publication by the AER of an (optional) Issues Paper four months into the review process and (3) on publication by the AER of its Draft Decision six months into the review process.

that end users face in regulatory processes. Development of streamlined procedures that effectively exclude the key stakeholder group from meaningful participation is hardly ‘best practice’ regulation or even ‘due process’.

## 2. Achievement of the single market objective

As noted in section 1 above, it is our strong view that the AEMC has failed to demonstrate in any substantive way that the Rule Proposal will better facilitate achievement of the SMO than current regulatory practice.

The minimum content requirements for a Rule change proposal, as set out in Clause 8 of the National Electricity Law (NEL) Regulations, include:

- a statement of the issues in the Rules that is addressed by the Rule proposal;
- an explanation of how the draft Rule addresses the issues;
- a description and draft of the draft Rule; and
- an explanation as to how the proponent (which is the AEMC in this case) considers the draft Rule is likely to contribute to the SMO.

The AEMC's Rule Proposal Report purports to meet these requirements but it is not transparently clear how the AEMC intended to demonstrate that the proposed Rule changes contribute to achievement of the SMO. The AEMC needs to transparently and clearly set out its reasons and confirm the above requirements such that it has satisfied key stakeholders. At this point in time, end users are not satisfied that this has been done.

The SMO is specified in Section 7 of the NEL as:

*The national electricity market objective is to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.*<sup>7</sup>

Section 88 of the NEL also sets out a Rule making test that must be applied by the AEMC in making the assessment of a proposed Rule, which states:

- (1) The AEMC may only make a Rule if it is satisfied that the Rule will or is likely to contribute to the achievement of the national electricity market objective.*
- (2) For the purposes of subsection (1), the AEMC may give such weight to any aspect of the national electricity market objective as it considers appropriate in all the circumstances, having regard to any relevant MCE statement of policy principles.*<sup>8</sup>

The NEL therefore obliges the AEMC to satisfy the SMO, in its capacity as proponent, in developing this Rule Proposal.

The NEL also permits discretion for the AEMC to give weight to different aspects of the SMO. The AEMC's report says the AEMC *has focused on why it considers that the draft Rule is likely to contribute to the NEM objective, and this Rule Proposal Report addresses*

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<sup>7</sup> p21, AEMC Rule Proposal Report, February 2006

<sup>8</sup> *Ibid.*

*this in relation to specific issues and for the Proposal as a whole.*<sup>9</sup> The AEMC's Rule Proposal report is deficient in that it does not explain how weighting was applied to any of the aspects of the SMO. Nor does the report refer to any MCE statement of policy principles to justify the focus that has been taken. As we note throughout this submission, it is our considered view that this is a major, and critical, failure of the proposal that must be remedied by the AEMC.

Despite the deficiencies indicated above, and the fact that the AEMC does not clearly explain how the Rule Proposals will facilitate achievement of the SMO, it appears clear that a primary focus of the AEMC's report is to implement Rule changes that promote 'certainty',<sup>10</sup> as a means of facilitating adequate investment in reliable transmission capacity. An argument in support of this focus appears to be that this is consistent with *a number of related Rule change proposals submitted ... by the Ministerial Council on Energy (MCE) ... directed at facilitating timely and efficient transmission investments that are sufficient to meet future demand growth and reliability requirements.*<sup>11</sup> But these proposals by the MCE cannot be interpreted to carry the weight of an 'MCE statement of policy principle'. The MCE has said that the transmission sector is in need of further reform – and that there is a need for additional 'efficient' investment that removes regional energy price differentials. But we are not aware that the MCE has said investment certainty should have higher weighting than any other aspect of the SMO in the transmission sector. The MCE has not issued any 'statement of policy principle' to this effect and has not said that investment certainty is a key issue that needs to be addressed by Rule changes.

The AEMC report does not provide a clear explanation of any link between improving 'investment and regulatory certainty' and achievement of the long term interests of consumers. The report does, however, claim a link between the 'interest of consumers' and:

- *a 'goal of designing a regulatory regime that will facilitate efficient investment in and operation of transmission services, thereby promoting competition and efficiency in the electricity wholesale and retail markets';*<sup>12</sup>
- *increasing the clarity, certainty and transparency of the regulatory framework, so as to provide a more certain regulatory environment in which investors can make efficient investment decisions which deliver market outcomes;*<sup>13</sup>
- *ensuring an appropriate level of investment;*<sup>14</sup> and
- *a particular need to provide incentives to TNSPs to facilitate operations that are in line with the wholesale market.*<sup>15</sup>

The AEMC also acknowledges that *respondents recognised the need for balance between keeping prices and services at efficient levels (for the benefit of participants in upstream and*

<sup>9</sup> *Ibid.*

<sup>10</sup> The terms 'certain, certainty and uncertainty' are used in reference to the climate for investment and regulatory processes affecting TNSP revenue determination. The AEMC report contains no reference at all to impact on end-user investment.

<sup>11</sup> p. 6, AEMC Rule Proposal Report, February 2006.

<sup>12</sup> p. 7, *Op Cit.*

<sup>13</sup> p. 26, *Op Cit.*

<sup>14</sup> p. 63, *Op Cit.*

<sup>15</sup> p. 81, *Op Cit.*



*downstream markets and final consumers) while meeting the investment and commercial requirements for the efficient operation of the network businesses.*<sup>16</sup>

These are all general ‘motherhood/apple pie’ principles with which we agree entirely. But we note that the AEMC provides no explanation or evidence to connect the proposed Rule changes to improvements in these areas as far as end users area concerned. In particular, we note that the AEMC makes no explicit comment about the upstream or downstream impacts of its proposals.

Overall, the AEMC Rule Proposal report appears to be based on a mix of hope and unsubstantiated belief that the proposals overall will benefit electricity users. For example, the AEMC says it *considers that the Rule Proposal offers a balanced package that should facilitate more efficient network investment and operation thereby promoting competition and efficiency in the electricity wholesale and retail markets. It believes that the resulting efficiencies will provide long-term benefits for energy using industries and households in terms of more efficient prices and reliable services.*<sup>17</sup>

As we noted in our previous submissions to this review, the views expressed by the AEMC have been devoid of any quantified assessment of previous regulatory practices (or outcomes) – despite the fact that electricity transmission has been subject to ‘independent’ economic regulation for at least 10 years. A key criticism of the current proposal is that the AEMC has provided no evidence that revenue determination Rules hinder investment. We accept that expenditure over the last regulatory period has been higher than forecast in NSW and QLD, which (presumably) is not considered to be acceptable by the relevant State Treasuries. But relaxing the ‘efficiency incentive’ in an attempt to improve ‘investment certainty’ just to mollify State Treasuries is not going to assist in improving the forecasting capabilities of Transgrid and Powerlink, which is clearly the major problem that needed to be addressed.<sup>18</sup>

In our view these are major deficiencies in the AEMC’s process that undermine the credibility of the proposed Rule changes. We believe it is imperative that the AEMC explicitly consider the impacts on end-users as part of any Rule change process. Wherever possible, this should include consideration of quantified impacts, both positive and negative, so as to increase the likelihood that any Rule change has a capability of delivering material benefits to energy users. Where quantification is not possible, the AEMC should provide clear and justifiable reasons for its decisions and provide a transparent explanation of how the Rule change proposals explicitly facilitate achievement of the SMO.

It is our view that it is absolutely essential that the AEMC clearly articulate the arguments that support such obvious and heavy weighting on providing ‘certainty’ to transmission owners, particularly when there is no evidence the current arrangements and practices have adversely affected investment levels.

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<sup>16</sup> p. 26, *Op Cit.*

<sup>17</sup> p. 9, *Op Cit.*

<sup>18</sup> Indeed, Transgrid demonstrated in its last revenue review by the ACCC that it had ‘learned its lessons well’ and as a result increased forecast expenditure substantially for the current regulatory period. We fully anticipate Powerlink doing likewise for its forthcoming review.



### 3. Scope of regulation

The AEMC's Rule Proposal report says that (the AEMC believes) greater clarity is needed in the definition of transmission services that are subject to economic regulation. The AEMC also believes that the lack of clarity in delineating types of transmission services has resulted in an over-inclusion of services into the revenue cap, which it says is undesirable. If the categories of services subject to a revenue cap are too broad, the cost of regulation is greater than optimal and market outcomes will be distorted by crowding out the opportunities for competitive supply of services and commercial negotiations between TNSPs and transmission users. However, we also note that there may also be an opposite effect if the delineation of regulated services is too narrow and TNSPs can exploit market power because of a lack of competition or contestability.

The current form of Chapter 6 of the NER also focuses on allocating costs on the basis of the assets of TNSPs rather than transmission services. The AEMC has sought to develop a Rule Proposal which applies economic regulation to transmission services rather than transmission assets.

The AEMC has adopted the following classifications of transmission services:<sup>19</sup>

- Prescribed Transmission Services - use of system services supplied by the shared transmission network which meet (but do not exceed) the network performance requirements specified under any legislation of a participating jurisdiction (including instruments made or issued under such legislation eg., regulations, codes, licences) and the network performance requirements set out in Schedule 5.1 of the NER (prescribed transmission services do not include negotiated transmission services or market network services); and
- Negotiated Transmission Services - connection services (entry, exit and TNSP to TNSP connection services); use of system services supplied by the shared transmission network which exceed the network performance requirements specified under any legislation of a participating jurisdiction (including instruments made or issued under such legislation eg., regulations, codes, licences) or which are above or below the network performance requirements set out in Schedule 5.1 of the NER; and use of system services in respect of agreed transmission network augmentations or extensions for loads, generators and MNSPs (negotiated transmission services do not include market network services).

Maximising opportunities for accessing services through competitive processes is welcome, but could be improved by also allowing transmission users to negotiate lower prices based on reduced standards of service.

The current arrangements have worked extremely well for at least a few end users,<sup>20</sup> and should be extended wherever possible. However, we note that relatively few end-users are

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<sup>19</sup> We accept that services that fall outside the definitions of Prescribed and Negotiated Transmission Services, such as consultancy services, will not be subject to any form of regulation under Chapter 6 of the NER. However, it is of concern that the AEMC's classifications say nothing about services that are true monopoly. This should be a fundamental element of the definition for Prescribed Services.

<sup>20</sup> Two specific examples are the supply arrangements for Air Liquide and Perseverance Mining in Victoria, where these end users have been able to negotiate direct connection to transmission assets at reduced cost and significantly enhanced service quality compared to previous distribution connected arrangements.

affected by this aspect of regulation and these services constitute a small proportion of total TNSP revenue.

We also noted in our earlier submissions that the AEMC should consider the ‘practicality’ of establishing a competitive environment for provision of services. Little benefit will accrue to end-users if they do not have sufficient economic power to negotiate effectively in a ‘competitive market’.

The EAG and EUAA support this aspect of the AEMC’s proposals – including the establishment of a Working Group that will examine and provide advice on issues relating to the categorisation of transmission services. The EUAA and some of its members are working with the AEMC on this matter, although it is noted that requiring outcomes from the Working Group to be completed prior to the Commission's Draft Determination of the Rule Proposal (in April 2006) is extremely challenging.

We also note that the AEMC expects that over time, as a consequence of this Rule Proposal, more assets will be outside the regulatory asset base (RAB) than is currently the case and that, in these circumstances, the question of cost allocation (allocation of asset costs between Prescribed Transmission and Negotiated Transmission Services) will become a significant regulatory issue. We agree wholeheartedly that cost allocation must be subject to regulatory oversight by the AER to avoid the risk that TNSPs 'double dip' by recovering costs through both the Prescribed Transmission Services' revenue and negotiated charges, or engage in cross subsidisation of services. We also support the requirement that future assets only be rolled into the RAB when the costs of those assets are appropriately allocated to Prescribed Transmission Services in accordance with AER cost allocation principles. But we also note that this will require the AER to consider – in development of its financial reporting and cost allocation Guidelines:

1. adequate powers to ensure TNSPs provide the information needed for effective regulation;
2. how the changes in Service definition will be reflected in a change in the asset base; and
3. how past investments in assets that change category will be treated.

## 4. Regulated Revenue for Prescribed Transmission Services

The AEMC proposes that the Rules contain a complete methodology for making a revenue cap determination for Prescribed Transmission Services, with the methodology set out in the Rule Proposal based on the SRP. This includes codification of a ‘Propose-respond’ process, specification of a fixed timetable for regulatory decision-making and provision of guidance to be applied by the AER when exercising discretion, including relevant consultation procedures.

In this respect, the AEMC says that it believes this approach will improve the predictability and transparency, and over time, consistency, of revenue cap determinations; and claims the Draft Rule proposal would result in greater alignment in the regulation of infrastructure access between the electricity and gas markets.

### 4.1. Regulatory Alignment

We accept that the basis of these particular aspects of the Rule changes closely reflect current practice. We also accept that it is desirable to align regulatory arrangements between gas and electricity transmission – and, as far as practicable, between distribution and transmission.

However, we note that substantial differences will remain unless the AEMC introduces fundamental changes in the regulation of electricity transmission services. In our previous submission made in response to the AEMC’s Issues Paper we argued that some of the attributes adopted for regulation of electricity distribution should be ‘translated’ to the regulation of electricity transmission. In particular, ‘efficiency incentives’ – and corresponding potential to transfer efficiency benefits to end users – would be enhanced by making TNSPs (and the AER) accountable for:

- linking forecast costs to actual costs;
- meeting their commitments within ‘efficient’ forecast expenditure limits; and
- meeting specific service standards that deliver benefits to end users.

These arguments were made partly in response to the broad range of options canvassed in the AEMC’s Issues Paper, some of which are not referred to at all in the Rule Proposal report. The arguments were also presented partly because it appears to us that both the Victorian Essential Services Commission and IPART had attempted to establish a regulatory regime for electricity and gas distribution that seeks to provide clear incentives for efficient service delivery and ensure the benefits from this are transferred to consumers.<sup>21</sup>

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<sup>21</sup> However, we note neither the ESC nor IPART has been entirely successful in ensuring ‘efficiency’ benefits were transferred to consumers. Failure of the information disclosure regime inhibited the ESC’s analysis of actual efficient costs incurred by United Energy and forecast expenditure for the third electricity distribution regulatory period were much higher than actual expenditure trends of the previous decade. And IPART actually approved slightly higher expenditure than requested by NSW distributors, which were well above (the higher than forecast) actual expenditure trends of the previous two regulatory periods.

The AEMC's proposals show little evidence of attempting to 'translate' these features to regulation of electricity transmission. For example, the AEMC's proposals allow re-opening of a revenue determination where actual expenditure exceeds forecasts. This approach has been explicitly rejected for gas distribution in Victoria and for electricity distribution in NSW.

In addition, we also note that there are major differences in pricing that need to be addressed. In electricity transmission, 100% of the cost of shared electricity transmission services are imposed on end-users, which allows existing large, remote coal-fired generators (and, potentially, future gas-fired generators) to avoid both electricity and gas shared transmission charges. In distribution, use of system charges are imposed on both consumptive users and embedded generators, but with complex pricing rules (for 'shallow connection' and 'avoided' transmission costs) that attempt to 'compensate' for the distorted pricing arrangements in electricity transmission. These differences have the effect of distorting investment decisions that impact adversely on distributed generators and enhance the monopoly power of electricity network owners.

We still believe it would be appropriate, and produce better regulatory outcomes, for the above matters to be resolved and for similar 'incentive and pricing arrangements' to be implemented in both electricity distribution and transmission. However, the AEMC's proposals have the effect of formalising many of the regulatory arrangements implemented in the National Electricity Code and reinforced by the ACCC. As indicated above, these arrangements differ significantly, and in crucial aspects, to arrangements implemented for regulation of distribution services. This circumstance has never been adequately explained by the ACCC in any of its previous Determinations – nor is it explained by AEMC in the Rule Proposal report.

The only apparent explanation for these discrepancies in regulatory approach appears in the MCE Expert Panel report on Energy Access Pricing.<sup>22</sup> That report notes that there are significant differences in the capital expenditure profiles between electricity distribution and electricity transmission. The principal difference being that capital expenditure in distribution is made up of (relatively) large numbers of (relatively) small individual investments spread across the whole network (or, at least, those parts of the network that are subject to 'above-average' demand growth or 'above-average' age); whereas capital expenditure in electricity transmission is made up of (relatively) few (relatively) large individual investments whose timing may not be able to be forecast accurately within a single regulatory period. The MCE's Expert Panel describes this circumstance in the following terms:

*For the class of facilities that are regulated, there are a number of further differences between electricity and gas, transmission and distribution that have important implications for the design of access regulation. All of the sectors are highly capital intensive, so that matters related to the recovery of capital costs (and related issues, like the cost of capital and regulatory value of the assets) are likely to dominate access pricing reviews. However, the variability of annual capital expenditure differs across the sectors – with transmission investments typically coming in infrequent but large 'lumps', whereas the rate of investment in distribution networks tends to be more constant over time,*

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<sup>22</sup> Expert Panel on Energy Access Pricing – Draft Report to the Ministerial Council on Energy, March 2006.

*reflecting factors such as economic growth and the growth of the housing stock. The ‘lumpy’ nature of investment in electricity transmission makes it difficult to provide strong financial incentives for the regulated entity to minimise cost given that such incentives may impose large risk if the timing of the ‘lumps’ differs to the forecast, and also provides a constraint to using a form of regulation that assumes a regulated entity’s revenue and expenditure is in a ‘steady state’ (i.e. the TFP approach).<sup>23</sup>*

The AEMC should note that we do not accept the argument made by the MCE Expert Panel. As experience has shown, electricity DNSPs in NSW and Queensland also got their expenditure (and demand/consumption) forecasts wrong in their previous regulatory periods. This required them to make very substantial above-forecast investments to maintain service delivery. On the other hand, the TNSPs in Victoria and SA have managed to achieve actual expenditure below forecast levels. We believe this demonstrates that all network utilities have the capacity to respond to the same forms of ‘efficiency incentive’. What they do need to achieve this is to develop adequate and robust forecasting skills – and better understand consumer needs and drivers of consumer choice. We do not accept that ‘pandering’ to supply side lobbying or making ‘concessions’ that reduce the impact of efficiency incentives for TNSPs will deliver good regulation.

However, it would appear the MCE Expert Panel’s view has some currency. The AEMC appears to have assumed (as did the drafters of the initial National Electricity Code) that this difference in expenditure profiles ‘justifies’ a different regulatory treatment between electricity transmission and electricity distribution. For example:

- the AEMC’s proposals allow for ‘ex-post’ or ‘in-period’ adjustments to capital expenditure where a *TNSP can apply for a reopening of a revenue cap where it needs to undertake capital investment to meet its regulatory obligations, and where such expenditure cannot be accommodated within the expenditure forecast.*<sup>24</sup>
- By (extreme) contrast, jurisdictional regulators in Victoria, NSW and Queensland have explicitly declined to undertake ‘in-period’ reviews (or adjustments) of capital expenditure notwithstanding substantial and sustained pressure from adversely affected DNSPs and substantial amounts of ‘above-forecast’ capital expenditure.<sup>25</sup>

We have seen no evidence that directly supports this different treatment. It may be that uncertainty in large, ‘lumpy’ investment creates a financial risk for individual TNSPs. But even if this is the case, it is – most likely – caused by the jurisdictional structure of electricity transmission not by any fundamental difference in circumstance that justifies different regulatory treatment. Aggregating all electricity transmission assets into a single ‘National

<sup>23</sup> p. 13, MCE Expert Panel report, March 2006.

<sup>24</sup> p. 86. The AEMC argues that this is different to the ‘capex contingency’ allowance permitted by the ACCC in its most recent Determinations, which we accept. But the difference is a matter of degree compared to the fundamental differences that exist currently between regulation of distribution and transmission.

<sup>25</sup> Two specific examples are the over-expenditure of \$35 million by TXU’s gas distribution arm in Victoria during the first regulatory period (from 1998 through 2002) and very substantial above forecast expenditure of around \$1 billion by NSW electricity distributors during the period 1999-2004. In the first case, the (then) Office of the Regulator-General formally rejected TXU’s prolonged plea to ‘re-open’ its revenue allowance. In the second, IPART rejected requests for major adjustments to the ‘hybrid revenue cap’ – although it did permit EnergyAustralia to raise prices by about 3% in 2003-04 above the pre-determined prevailing revenue cap. In both cases, the regulators allowed ‘roll-in’ to the RAB of actual, above forecast, capital expenditure at the end of the regulatory period – and there was no evidence that this treatment acted as a ‘disincentive’ for investment.

Electricity Grid Company’, as initially intended by CoAG, may well have ‘eliminated this regulatory problem by creating an entity with sufficient ‘capital inertia’ to reduce the relative ‘size of the capital lumps’. In that case, the management of this capital risk could be ‘safely’ left with the single national TNSP and the same regulatory arrangements could be implemented in electricity transmission and distribution.

We see no reason for the AEMC to institutionalise an inefficiency that is capable of being rectified by other (policy or capital market) means. It would be far better for the AEMC to emphasise that responsibility for managing any risks that ‘balkanisation’ of key national infrastructure creates rests with the asset owners and managers. A key focus of regulation should be to create incentives for TNSP managers to understand and respond to the legitimate needs of end users – by improving their forecasts of demand, consumption and costs. The main reason why investment ‘lumpiness’ causes problems for TNSPs is that their forecasting is not adequate or their forecasting is made more difficult by the ‘balkanisation’. But neither case justifies transferring increased costs to end users. ‘Softening’ regulatory incentives so that higher costs are likely to be passed onto end users will do nothing to address the inherent problems created by the ‘balkanisation’ of electricity transmission assets. Nor is it consistent with facilitating achievement of the SMO.

If the AEMC declines to improve the Rule change proposals, we believe that it will be essential to make it clear that the ‘low-powered’ capital expenditure incentives included in the Rule change proposals are to be confined to regulation of electricity transmission. To avoid doubt, the AEMC should expressly exclude similar proposals being extended to gas transmission or gas and electricity distribution. This will reduce any opportunistic move by other regulated entities to argue for ‘me too’ treatment when the time comes for the AEMC to review the Rules relating to regulation of distribution (including other parts of Chapter 6) and gas regulation.

In addition, we believe it will be essential that the proposed Rule change be amended to make it reciprocal by requiring the AER to undertake an ‘in-period’ review when requested by end-users in circumstances where a TNSP significantly under-spends its allowed capital expenditure forecast within a regulatory period. This would, of course, also require prompt, transparent and accurate public reporting of TNSP financial performance – and precise comparison between actual and forecast expenditure, which would in turn require significant improvement to the performance reporting regime established by the ACCC. The AEMC should consider making this need clear in the Rules.

In conclusion, we believe the current proposals are unacceptably one-sided. They allow a TNSP to initiate an in-period review where expenditure exceeds the forecast. This bias clearly produces an imbalance between the interests of end-users and TNSPs that is not supported by reference to the SMO.

## **4.2. Post-Tax Revenue Model**

The AEMC’s Rule Proposal provides for the revenue cap to be derived from a post-tax revenue model, based on a building block approach, with the Draft Rule including the following key elements:

- The calculation of the RAB on a ‘locked-in’ value of the assets.



- The locked-in value of the RAB will be adjusted for each year of the regulatory period by the AER approved forecast capital expenditure.
- The RAB will be adjusted using depreciation profiles proposed by the TNSP.
- The methodology for calculating the cost of capital (based on CAPM), and a number of the parameters, will be included in the Rules. The CAPM parameters are based on those in the SRP. The parameters will be subject to review by the AER every five years.
- Operating expenditure will be based on efficient forecasts on a firm-specific basis. An efficiency benefit scheme will apply.

The post-tax revenue model is to be based on the principles in the Rules and subject to consultation. This model is to be used by the AER in making revenue cap determinations.

We note that the AEMC also canvassed forms of regulation other than ‘revenue caps’ in its Issues Paper, but these are totally ignored – without any explanation of why this is so - in the Rule Proposal report. Rather than repeat comments made in our submission to the Issues Paper, which we commend to the AEMC we have constrained comments in this submission to matters dealt with in the AEMC Rule Proposal.

#### **4.2.1. Lock-In of RAB**

We have always been and remain opposed to the ‘lock-in’ of regulatory asset values, based on values previously determined by jurisdictions and the ACCC, plus ‘roll-in’ of prudent and efficient actual capital expenditure. This is an unfortunately and costly (to end users) consequence of regulatory precedent in Australia. We have great difficulty seeing how the AEMC can justify this given that it is required to satisfy the SMO.

If the AEMC persists with this approach it should be made conditional on the AER retaining powers, and flexibility, to undertake a prudency and efficiency review in circumstances where this appears warranted. As a minimum, such circumstances would be where there is concern that a TNSP has made a poor investment decision, or where execution of the investment was poorly managed. In these cases, the AER should be obliged to exclude roll-in of any inefficient or imprudent investment cost. The Rules should not allow poor management to be protected, or require end users to bear costs associated with poor management by a TNSP. Again, we fail to see how the AEMC could support this and still satisfy the SMO.

#### **4.2.2. Regulatory Intrusion & ‘Reasonable Estimate’ Test**

The AEMC believes that, all other things being equal, it would be better to have a less intrusive regulatory approach rather than a more intrusive regulatory approach to determining the forecast capital and operating expenditure. The AEMC’s view is that while there is an incentive for TNSPs to seek to maximise their revenues through the regulatory process (which is a polite way of saying that TNSPs exercise ‘strategic behaviour’ or ‘game the regulatory process’), there is also a risk of under-investment and insufficient operating expenditure if the determination by the Regulator is later found to be too low.<sup>26</sup>

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<sup>26</sup> We note in passing that there is also an opposite risk, namely, that setting the expenditures too high will result in inefficiency and monopoly profits by the TNSP. A consequence of this will be a loss of competitiveness of

The AEMC says it has sought to balance these risks by providing that the AER must accept a TNSP's forecast expenditure if it is satisfied that the amount is a 'reasonable estimate' of the business' requirements having regard to a number of criteria including efficient costs, benchmark information and the regulatory obligations borne by the TNSP. The mechanism proposed to address this is to formalise a 'propose-respond' process with the TNSPs taking the initiative of defining their revenue requirements as a first step in the review process.

We accept that formalising the 'propose-respond' process is little different to the process previously adopted/accepted by the ACCC – apart from also formalising a definition of the information to be included in a TNSP's proposal. Indeed, something like a 'propose-respond' model is inevitable given the information asymmetry that favours TNSPs. However, as the AEMC alludes, the 'propose-respond' approach quite clearly allows considerable scope for, and possibly encourages, 'exercise of strategic behaviour' by TNSPs in developing their forecasts and revenue proposals. There is no precedent of which we are aware – in any regulated industry – where a regulated entity has knowingly and intentionally forecast lower than (reasonably) expected expenditure.<sup>27</sup> Indeed, there have been cases where regulators have substantially reduced proposed expenditure levels and on some occasions this has even been accepted without challenge by the regulated entity.<sup>28</sup>

In this respect, we have serious reservations about the robustness of an assumption that *a more intrusive regulatory approach* would create a risk of under-investment. There is no evidence, of which we are aware, from any jurisdiction or any regulated utility sector in Australia to support this assumption. Neither has this ever been the case in the more than 20 regulatory reviews with which we have been involved.

On the contrary, there is evidence that all regulated utilities recognise the benefits to be derived from exercise of strategic behaviour; and regulated utility investment is at historically high levels – despite protestations from regulated utilities that regulation is too 'heavy-handed' and 'interventionist'. Despite these criticisms by regulated utilities, the level of 'under-spend' against forecasts approved by regulators has been generally consistent for privately-owned utilities and is certain to increase for those government-owned utilities that have learnt the 'hard lessons' of preparing poor forecasts in their first regulatory periods.

It is our view that restricting the AER to assessing the 'reasonableness' of forecasts without placing 'prudence' and 'efficiency' as a clear and high priority in the 'reasonableness criteria' specified in Rules 6.2.6(b)(3) and 6.2.7(b)(2) (summarised in Chart 1 below) could create perverse incentives that encourage even greater 'strategic behaviour' by TNSPs. Implementing an 'accept if reasonable' requirement is also likely to weaken the effectiveness of the AER's review of expenditure proposals. In order to defend against an appeal that a TNSP's proposal was 'unreasonable', the AER may have to demonstrate that a TNSP had not given adequate weight to a relevant factor of great importance, or had given excessive weight to a factor of no great importance such that 'the proposal was so unreasonable that no

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major Australian industries which will be reduce incentives for downstream investment. It is unfortunate that Australian regulators have often talked about this but never acted upon it. We hope that the AEMC appreciates its importance and does act upon it.

<sup>27</sup> We are aware, however, of several cases where regulated entities forecasts have been wrong. This is certainly the case in the NSW and Queensland electricity distribution and transmission sectors in the previous regulatory periods. However, this outcome appears to have been the result of inadequate forecasting skill, or inadequate understanding of end users' motivation/requirements, which should not be protected by any regulator.

<sup>28</sup> A relevant example is QCA's decision on port costs.



reasonable person could have come to it' (i.e. the so-called 'Wednesbury principle').<sup>29</sup> This could mean that the AER may not be able to withstand legal challenge to rejection of a forecast expenditure estimate (for example) based on a 'reasonable', but conservative set of engineering assumptions derived from 'reasonable' technical assessment using a 'reasonable' framework but had a very low probability of occurrence – even if this resulted in an estimate of cost that was very clearly excessive compared to similar activities for which (lower) actual costs were known.

**CHART 1 : AEMC PROPOSED 'REASONABLE ESTIMATE CRITERIA'**

(i) information in <i>Revenue Proposal</i> ;
(ii) need to comply with all applicable <i>regulatory obligations</i> ;
(iii) submissions received in the course of consultation;
(iv) analysis undertaken/ <i>published</i> as part of <i>AER</i> decision process;
(v) the actual and expected TNSP expenditure during any preceding <i>regulatory control periods</i> ;
(vi) efficient TNSP benchmark expenditure over the <i>regulatory control period</i> ;
(vii) demand forecasts on which the forecast expenditure is based;
(viii) the relative prices of operating and capital inputs;
(ix) efficient substitution possibilities between operating and capital expenditure;
(x) whether the forecast total labour costs are consistent with the incentives provided by the <i>service target performance incentive scheme</i> ;

In particular we note that the AEMC's 'reasonable estimate' proposal is a significant and important departure from the current requirements in the Rules that require the AER to assess whether proposals meet the criterion of *efficient investment given efficient operating and maintenance practices*.<sup>30</sup> The proposal also represents a substantial departure from requirements specified in the Gas Code, for which the *overarching requirement is that when*

<sup>29</sup> The 'Wednesbury principle' refers to the error of law that the decision was unreasonable in the sense laid down in *Associated Picture Houses, Ltd v Wednesbury Corporation [1948] 1 KB 223*. That ground applied where a decision maker had not given adequate weight to a relevant factor of great importance, or had given excessive weight to a relevant factor of no great importance. The basis for such a conclusion is that the decision was 'manifestly unreasonable' in the sense explained in the Wednesbury case, namely that 'the decision was so unreasonable that no reasonable person could have come to it'. (See *Minister for Aboriginal Affairs v Peko-Wallsend Ltd (1986) 162 CLR 24 at 41*).

<sup>30</sup> See: Rule 6.2.2(b)(2) and 6.2.3(d)(4).

*Reference Tariffs are determined and reviewed, they should be based on the efficient cost (or anticipated efficient cost) of providing the Reference Services.*<sup>31</sup>

We point out that the emphasis on efficient costs is consistent with the original intent of energy reforms, whereby regulation was meant to ‘mimic’ the outcomes achieved in a competitive market and that this was closely aligned with the policy objective of ensuring that energy infrastructure was provided on a competitive basis. It seems to us that a change to an essentially legal term such as “reasonable” without maintaining the primary emphasis on ‘efficiency’ greatly risks skewing outcomes back towards the interests of regulated businesses, allowing them to become less efficient and more profitable at the expense of end users. This would reverse the (desirable) policy objectives of energy reform and would be contrary to CoAG’s energy reform principles, to the MCE’s objectives and would not satisfy the SMO.

The proposed Rule change should clearly define ‘reasonableness criteria’ (v) and (vi) as having higher weighting than others; and require that demand forecasts (in (vii)) be compatible with efficient expenditure forecasts. This would assist the AER withstand legal challenge that the AER’s interpretation of ‘reasonable’ did not breach the ‘Wednesbury principle.’

However this would be very much a second best outcome and we strongly recommend that the proposed Rule change be amended to reflect the existing focus on efficient investment given efficient operating and maintenance practices or be more effectively aligned with existing (and equivalent) provisions of the Gas Code with an overarching requirement that revenue allowances are determined and reviewed based on the efficient cost (or anticipated efficient cost) of providing the Prescribed Services.

#### 4.2.3. Regulatory Period and WACC

The AEMC has retained the current requirement<sup>32</sup> that the regulatory period must not be less than five years for each individual TNSP but can be longer. The AEMC has also proposed that WACC parameter values, currently specified in the SRP, be ‘elevated’ to the Rules and fixed for a period of five years (to 1 July 2011),<sup>33</sup> subject to review at that time and every subsequent five years by the AER – and subject to an estimate of a risk free rate to be applied to individual TNSPs at each determination as required.

This is one aspect of the proposed Rule change that we completely disagree with. We believe this would work substantially against the long term interests of consumers of electricity, i.e. contravene the SMO. There are two principal reasons for this.

The first is that, as the AEMC notes, *the rate of return has been subject to considerable debate in recent years*,<sup>34</sup> and the reasons for this debate are that:

<sup>31</sup> p. 47, Clause 8, Reference Tariff Principles, General Principles, *National Third Party Access Code for Natural Gas Pipeline Systems*, November 1997 (as Amended). Clause 8.2(e) also requires that *any forecasts required in setting the Reference Tariff represent best estimates arrived at on a reasonable basis*; but that requirement must be consistent with the ‘overarching requirement’ specified above.

<sup>32</sup> The minimum regulatory period is currently specified in Rule 6.2.4(b) as *a period of not less than 5 years*.

<sup>33</sup> Proposed Rule 6.2.4(e).

<sup>34</sup> p. 63

- market evidence – limited though it is – suggests that Australian regulators have been excessively ‘cautious’ in estimating values for both the Market risk Premium (MRP) and Equity Beta;
- Australian regulators continue to rely primarily on retrospective analysis of historic statistical market data to estimate the MRP and Equity Beta values even though the relevant parameters seek to forecast a value for WACC;
- UK regulators place greater weight on forecasts and opinions provided by respected financial market observers; and
- every regulatory decision in Australia since 2000 has highlighted views from respected financial market observers that future expectations are likely to be lower than past experience (on which the regulators base their estimates for MRP and Beta).

This means that end users are paying more than they should be in network charges.

The second reason is that there is some evidence that the continuing debate on the above issues is leading to progressive, if small, improvements in the explanation by regulators of their WACC decisions. Virtually all regulators now present information sourced from financial market observers in their decisions which highlight the differences between the ‘cautious/conservative’ decisions of regulators and the more ‘realistic’ views of financial market observers. We believe that continuation of this debate in a transparent manner is important and could eventually produce outcomes that are consistent with the long-term interests of end users.

Basically, we do not accept that Australian regulators have any clear justification for continually taking a ‘cautious/conservative’ position on WACC parameter values. We are not aware of any evidence that suggests a reluctance to invest in regulated utilities (in Australia or in similar ‘incentive’ regulatory regimes in the UK). Indeed, investment in energy infrastructure in Australia is running at historically high levels. We also reiterate the observation made in many of our previous submissions to regulatory determinations that UK experience has shown conclusively that the primary focus of regulators should be the future expectations of reasonable financial markets/investors, not the expectations of current utility owners. “Locking in’ WACC parameter values through the Rules when there are obvious differences between financial market views and regulatory determinations risks overcompensating TNSP owners particularly where a ‘5 yearly WACC value’ was used in conjunction with staggered TNSP reviews that would allow the ‘effective life’ of the WACC value to extend up to 10 years.

A further issue that was raised in our earlier submissions, but is passed over without comment in the AEMC’s report, is that it would be more rational to align the reviews of all TNSPs into a single regulatory review process rather than adopt a ‘5 yearly WACC value’ and leave the staggered, sequential TNSP reviews’. Indeed, as we argued in our earlier submission, it is both reasonable and would be cost-effective to align all TNSP regulatory periods. We note that this would have the effect of delivering 5 yearly WACC values without having to ‘elevate’ this aspect of the SRP to the Rules.

The existing Rules allow alignment of TNSP review periods to be achieved by the same mechanism as proposed by the AEMC (i.e. a regulatory period of at least 5 years). The AEMC could exercise its Rule-making powers and mandate that the alignment be achieved at a particular date; or require the AER to achieve alignment of TNSP reviews by extending

existing regulatory periods until they all align. This would better facilitate achievement of the SMO and be more likely to achieve ‘best practice regulation’.<sup>35</sup>

The benefits of aligning regulatory reviews are transparent and obvious:

- regulatory costs, and effort, would be reduced substantially;
- better coordination of transmission service standards and performance would be achieved with all TNSPs being subject to the same service/performance standards regime in the same time frame;
- improved benchmarking across all TNSPs;
- more effective integration of a single ‘whole-of-NEM’ transmission system would be achieved; and
- end-users would be more likely to effectively resource participation in a single coordinated review.

Accordingly, we once again recommend that the AEMC amend the proposed Rule change to require the earliest possible alignment of TNSP regulatory reviews. Consideration should also be given to achieving alignment between the timing of gas transmission and electricity transmission reviews as has been implemented in the UK. This would go some way towards addressing the conflicts between incentives/signals in the gas and electricity sectors at a time when there is certain to be greater involvement of gas-fired generation in the electricity sector.

#### **4.2.4. Contingent Capital**

We note that the AEMC has not adopted the AER's 'contingent project' regime for capital expenditure, because it did not adequately address the potential need for necessary major capital projects that may have either have been unforeseen or, planned, but the timing was uncertain. Rather, the Rule Proposal provides that the revenue cap may be reopened in specified circumstances where a TNSP needs to undertake significant capital expenditure which was not provided at the commencement of the regulatory period. This is said to increase flexibility for infrastructure responses to market needs.

As we have noted above, we believe this to be a substantial step away from creating effective incentives for efficient investment that is unnecessary and very likely to produce outcomes that are detrimental to facilitating achievement of the long-term interests of energy users.

#### **4.2.5. Information Disclosure**

In addition to its existing guidelines on ring-fencing and annual certified accounts, the AEMC’s proposed Rule changes require the AER to consult, prepare and publish guidelines

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<sup>35</sup> The NERA/Gilbert & Tobin report to the MCE identified five criteria as characterising ‘best practice’ regulation. These are (a) transparency and predictability (which in turn facilitates investment certainty); (b) adaptable to change through transparent and equitable process; (c) minimising compliance costs; (d) separation between rule making and rule enforcement; and (e) accountability to all parties (implies transparent processes in which all parties have the opportunity to be heard, together with a clear and effective dispute process).

Aligning TNSP reviews would substantially reduce ‘compliance costs’ and lead to more rational and coordinated outcomes.

on information requirements for the transmission determination process, the public release of information, cost allocation methods, and the post-tax revenue model. Guidelines may be amended in accordance with the new consultation procedures which are set out in the AEMC's proposed Rule changes.

These proposals are unsatisfactory and will do little if anything to promote the SMO.

As we noted in our earlier submission, the current information disclosure and reporting arrangements implemented by the ACCC are totally inadequate. No coordinated public domain records exist for performance of any TNSP prior to 2001. Several TNSPs have (effectively) treated the current reporting obligations as optional – by declining to provide information to the ACCC. Each TNSP is free to choose the format (and parameter) used for reporting even the simplest measures (such as energy throughput). And, finally, the TNSPs retain the option of claiming 'commercial confidentiality' as a basis for not reporting information – or restricting the power of the AER to publicly report information provided.

We believe that the AEMC's proposals will do nothing to address these pre-existing deficiencies.

As a minimum, the proposed Rule changes should be amended to require:

- the AER to develop, in consultation with TNSPs and end users, effective and enforceable guidelines and procedures that define, and precisely and clearly specify, the information that must be provided to the AER;
- these requirements and the timing of information provision be rigorously and consistently enforced (with penalties and sanctions for non-compliance);
- reliable and verifiable information about the actual costs incurred in providing services, including for un-regulated activities, and the levels of service performance.

We further consider that, at a minimum, the AER should be given the same powers to obtain and enforce information provision by the TNSP as other Australian regulators, such as the Australian Securities and Investment Commission (ASIC), ACCC and the Australian Taxation Office (ATO).

Further, the Rules should limit discretion in allocation of costs and interpretation of performance information as tightly as possible. This would appear to be the only way of minimising the exercise of 'strategic behaviour', obfuscation and/or confusion over information disclosure.

#### **4.2.6. Incentive mechanisms**

There are essentially four incentive mechanisms in the AEMC's Rule change proposals. These include mechanisms that the AEMC says will encourage efficiency in capital, operating expenditure, improved reliability and availability of transmission services, and to provide incentives for better management of potential commercial stranding risk.

The AEMC also says it has continued the SRP's low powered incentive regime for capital expenditure. The actual capital expenditure of the TNSP will be rolled into the RAB at the commencement of the next regulatory period, subject to the AER's discretion to conduct efficiency and prudence reviews, in accordance with clear criteria set out in the Draft Rule.

The TNSP will retain the benefit (or bear the cost) in relation to the return on capital allowed for in the revenue cap determination for any under-(over-) spend compared with forecast. In contrast to the SRP, depreciation will not form part of this incentive regime.

The details of the incentive regime for operating expenditure are to be developed by the AER but must provide a continuous incentive (equal in each year) to reduce operating expenditure below forecast levels. The principles for this incentive regime set out in the Draft Rule are said to be consistent with the incentive mechanism set out in the SRP.

As we have discussed in earlier sections of this submission, we do not support continuation of a 'low power' incentive for capital expenditure that allows TNSPs access to re-opening if actual costs exceed forecasts. Nor do we support the current approach adopted by the AER that allows 'contingent capital' amounts. We see no justification for this regulatory treatment that is fundamentally different to that used in the energy distribution sectors. Both approaches reduce pressure on TNSPs to adequately understand the needs of energy users and pursue efficient expenditure.

As an alternative, we have recommended that the AEMC introduce similar incentives for efficient expenditure to those used in the distribution sector. This would require TNSPs (and the AER) to:

- link forecasts to prudent/efficient actual expenditure and any material changes in obligations, service standards or user requirements based on costs that are demonstrated to be efficient;
- 'live with' the forecast expenditure amounts for the full regulatory period, which allows the TNSPs to 'capture' efficiency benefits during the regulatory period; and
- transfer assessed efficiency benefits to end users (either directly or through a sensible efficiency carry-over mechanism) at the end of each regulatory period.

The incentive mechanisms for performance standards proposed by the AEMC are intended to provide incentives for TNSPs to provide greater reliability of the system at times when the system is most valued and in relation to those elements that are most important to determining wholesale spot prices. The AEMC believes requiring the AER to develop such an incentive mechanism will be an important evolution in the NEM. This development is consistent with the objective of the Review in aligning the operation of the transmission grid with the market incentives of the NEM.

The AEMC proposes that the reward/penalty adjustments in the incentive mechanisms for performance standards should be capped at no more than +/-1% of the revenue cap.

We strongly support any attempt to better align incentives for TNSPs and outcomes from the energy market. However, the primary mechanism to achieve this should be through clear specification of obligations that require TNSPs to perform the service they are paid (by end users) to provide.

The AEMC's proposals are a 'second best' alternative to clear specifications of service obligations. The proposals also set very modest goals and create modest financial incentives given the dynamic nature of energy market impacts that TNSPs can effect. For example, 1% of Transgrid's annual revenue cap is around \$5 million. In October 2001, Transgrid took out two lines in northern NSW for planned maintenance over several days. During this period a Queensland generator had a forced outage which caused high demand for Frequency Control



Ancillary Services (FCAS) that cost some \$25 million for the week. There have been five occasions since this event where weekly FCAS costs have exceeded \$5 million, not all of which could have been ameliorated by TNSPs. There are an even greater number of events that occur in the energy market that could be influenced by TNSPs' response.

An incentive mechanism that 'encouraged' a TNSP to keep its lines in service during high demand would, most likely, have avoided the high FCAS costs incurred in October 2001. But that mechanism will need to cope with dynamic load conditions and must recognise the potential for a TNSP's response to the incentive mechanism to impact total energy supply costs by substantially more than 1% of the total aggregate TNSP revenue.<sup>36</sup>

As the AEMC noted in its Issues Paper (and then dismissed), the incentive mechanism developed for NGC in the UK has been effective in substantially reducing system costs. We believe that an incentive mechanism with potential for similar benefits should be introduced in Australia as this would better facilitate achievement of the SMO.

#### **4.2.7. Asset Stranding and Negotiation**

In line with the AEMC's stated goal of developing greater scope for commercial negotiation between TNSPs and transmission users, the proposed Rule changes establish a limited regime for managing the risks of potential commercial stranding. This is said (by the AEMC) to be a departure from the SRP.

The AEMC says it wishes to adopt a regime for the economic regulation of transmission services which provides TNSPs with an incentive to negotiate with large end-users (whose future decisions may pose a commercial stranding risk in relation to dedicated assets) for an appropriate allocation of risk between them, and which provides an effective incentive for TNSPs to negotiate a prudent discount with users, when it is efficient to do so.

The Rule Proposal provides that the AER will have the power to remove assets from the RAB, which are the subject of commercial stranding, but only where the TNSP has not taken steps to either:

- enter into contractual arrangements with the user to manage stranding risk (for assets where construction is committed to after 16 February 2006); or
- to offer a prudent discount to such users in appropriate circumstances.

The ability of the AER to remove assets from the RAB is limited to assets that the AER determines are no longer contributing to the provision of Prescribed Transmission Services and where the current value of those assets exceeds a certain threshold. The AEMC is proposing a threshold of \$20m (in 2006 dollars).

We note that this proposal has some similarities with arrangements implemented for electricity and gas distribution in some jurisdictions – particularly Victoria, where virtual 'cast iron' guarantees have been given to distributors (and water utilities) to offset asset

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<sup>36</sup> In the example quoted here Transgrid responded directly to the incentive it faced to keep Opex costs as low as practicable (by paying the maintenance contractor to undertake work when the contractor's costs were lowest). Constructing an incentive mechanism that 'cut out' when a TSNP's costs reached 1% of total revenue could produce results that are not intended by the AEMC.

stranding risk of what are deemed to be initially ‘prudent’<sup>37</sup> investments. Similar arrangements have also (effectively) been implemented in other jurisdictions, although they are not as clearly articulated by the relevant regulators.

In essence, the Victorian ESC (or ORG initially) has stated explicitly that utilities may recover the value of any stranded assets created by an initially ‘prudent’ investment through accelerated depreciation. Stranding may be created through ‘bypass’ (which can be avoided by negotiating a lower access price with the bypasser) or by change in user consumption/demand patterns. End users (still connected to the system) effectively pay for the stranded asset through incrementally higher access and usage charges.

These arrangements provide ‘investment certainly’ but only neutral incentives for effective negotiation. No matter what the outcome of the negotiation, the utility has access to a mechanism to recover the full value of the initial investment. Applying conditions before the AER can remove assets from the RAB provides some further incentive for TNSPs to negotiate but would still result in ‘stranded asset’ risk being transferred to end users through higher transmission prices.

We object strongly to any proposals that would provide regulated networks with ‘protection’ from ‘stranding’ (i.e. poor investment decisions) and effectively pass these costs on to end users. This approach, which has become an unfortunate part of the so-called incentive regulation regime in Australia, is not consistent with the SMO nor is it consistent with the policy objective for energy network regulation of having the regulatory regime mimic the outcomes of a competitive market. Protection from asset stranding is not possible in competitive markets where shareholders must bear the risks of poor decisions and suffer the consequences (not their customers). It would be a major step forward if the AEMC were to recognise this and ensure that the Rule changes reflected it.

The proposals also do nothing to address the potential for asset stranding that may occur if there is future development – and wide-scale proliferation – of low-cost, small-scale distributed generation technologies. This can only be addressed by creating clear incentives for TNSPs (and possibly more particularly DBs) to better understand the potential impacts of emerging technologies (and end user behaviour to these technologies) and allow for this in their forecasts (and pricing policies).

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<sup>37</sup> The initial investment is presumed to be ‘prudent’ if the decision to invest was based on ‘reasonable information’ available at the time and taken in accordance with Good Industry Practice. Once accepted for ‘roll-in’ to the regulatory asset base, the investment is deemed to have been ‘prudent’; and that decision is not subject to further review.



## 5. Conclusions

The AEMC's draft Rule change proposals, and the Rule Proposal Report that is intended to justify and explain the proposals are inadequate in many respects, some of which are identified in this submission.

We are concerned that the AEMC has failed to clearly explain why the changes are necessary, how they will act to improve existing regulatory practice or impact on end-users or, most importantly, how the proposals will better facilitate achievement of the SMO. In particular, we note that the AEMC has failed to provide any evidence to demonstrate that the proposals will improve regulatory outcomes for end users or explain how weighting of different aspects of the SMO have been determined or why there is an apparent key focus on providing 'investment certainty' for TNSPs – when investment in the shared network has been at historically high levels. Nor has the AEMC provided any argument that the proposals will facilitate more 'efficient' investment in inter-regional interconnection that is correctly identified by the MCE as a high priority.<sup>38</sup>

We consider the absence of 'hard, factual' evidence that supports qualitative argument and theory to be a serious failing by the AEMC. This reduces the value and robustness of the proposals. It is our strong view that any Rule changes must be justified by clear evidence that change is necessary and that energy users will derive on-going and long-term benefits that are direct, transparent and deliverable. Rule changes must also clearly and transparently 'strengthen' efficiency incentives, not weaken them. Any Rule change must be consistent with the SMO and clearly demonstrated to be so by the AEMC. The AEMC has clearly failed to achieve these outcomes in the current proposals.

At best, the AEMC's proposals merely formalise existing practice by elevating aspects of the SRP to the Rules. However, the proposal to allow re-opening of a revenue determination if actual capital expenditure exceeds forecast levels, in an apparent attempt to create 'clear incentives for investment', will substantially weaken incentives for TNSPs to manage their affairs efficiently and clearly act against the interests of end users who will not have reciprocal rights to force reopening if actual expenditure is less than forecast.

The AEMC has provided no evidence or any compelling arguments to support this dilution of the 'efficiency incentive' that is – or should – be an essential element of the regulatory regime. Indeed, as we outline in this submission, there are reasons to believe that the minor changes to existing regulatory practice contained in the proposals will significantly weaken incentives for efficient investment by:

- taking pressure off TNSPs to reasonably forecast business conditions and be held accountable for those forecasts; and
- 'lowering the hurdle' for TNSPs to demonstrate that their revenue proposals are based on 'efficient' costs by requiring only that forecast cost be 'reasonable' – with no primary objective of being efficient.

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<sup>38</sup> We recognise that this aspect is intended to be addressed in the AEMC's review of the MCE's Regulatory Test rule Change proposal. But we believe it is valid to highlight that this is the only area where there is consensus that increased investment is required – and that the AEMC's Rule Proposals will do nothing to facilitate this outcome.

We have proposed a number of recommendations to address these serious deficiencies that are consistent with recommendations made in our earlier response the AEMC's Issues Paper (most of which appears to have been totally ignored by the AEMC). We believe that adoption of these recommendations would better allow the AEMC to demonstrate that the changes to the Rules were consistent with achievement of the SMO.

Key recommendations for improving the proposals are, in summary:

### **General Issues**

- Rule changes must clearly and transparently 'strengthen' efficiency incentives, not weaken them.
- Any Rule changes must be justified by clear evidence that change is necessary and that energy users will derive on-going and long-term benefits (consistent with the SMO which the AEMC is required to satisfy) that are direct, transparent and deliverable.
- Consideration be given to improving the effectiveness of arrangements to ensure end user interests can be effectively presented and represented in the shortened revenue review process.
- The AEMC should clearly articulate the arguments that supports its proposed move to obvious and heavy weighting on providing 'certainty' to transmission owners, particularly when there is no evidence the current arrangements and practices have adversely affected investment levels and when there are other aspects of the SMO that appear to have been ignored or assign much lesser weightings.

### **Definition of Prescribed Services**

- The AEMC should exercise some care to ensure that the definition of Prescribed Transmission Services considers the monopoly role of TNSPs. A narrow definition may allow TNSPs to exploit market power because of a lack of competition or contestability.

### **Post-Tax Revenue Model**

- We note that the AEMC also canvassed forms of regulation other than 'revenue caps' in its Issues Paper, but these are totally ignored – without any explanation of why this is so - in the Rule Proposal report. Rather than repeat comments made in our submission to the Issues Paper, which we commend to the AEMC and request that they read, we have constrained comments in this submission to matters dealt with in the AEMC Rule Proposal.

### **Regulatory Alignment**

- The AEMC should amend its proposals to introduce the forms of incentive for efficient expenditure that have been implemented in the distribution sectors. In particular, 'efficiency incentives' – and corresponding potential to transfer efficiency benefits to end users – would be enhanced by making TNSPs (and the AER) accountable for:
  - linking forecast costs to actual costs;
  - meeting their commitments within 'efficient' forecast expenditure limits; and
  - meeting specific service standards that deliver benefits to end users.

- If the AEMC declines to improve the Rule change proposals, we believe that it is essential to make it clear that the ‘low-powered’ capital expenditure incentives included in the Rule change proposals are to be confined to regulation of electricity transmission. To avoid doubt, the AEMC should expressly exclude similar proposals being extended to either gas transmission, or gas and electricity distribution.
- In addition, we believe it would be essential that the proposed Rule change relating to ‘in-period’ re-opening be amended to make it reciprocal by requiring the AER to undertake an ‘in-period’ review when requested by end-users in circumstances where a TNSP significantly under-spends its allowed capital expenditure forecast within a regulatory period. This would, of course, also require prompt, transparent and accurate public reporting of TNSP financial performance – and precise comparison between actual and forecast expenditure, which would in turn require significant improvement to the performance reporting regime established by the ACCC.

### **Lock-In of RAB**

- Our acceptance of the ‘lock-in’ of RAB values is conditional on retaining powers (as proposed) for the AER to undertake a prudence and efficiency review in circumstances where this appears warranted. As a minimum, such circumstances would be where there is concern that a TNSP has made a poor investment decision, or where execution of the investment was poorly managed. In these cases, the AER should be obliged to exclude roll-in of any inefficient or imprudent investment cost.

### **Regulatory Intrusion & ‘Reasonable Estimate’ Test**

- The proposed Rule change should be amended to reflect the existing focus on efficient investment given efficient operating and maintenance practices or be more effectively aligned with existing (and equivalent) provisions of the Gas Code with an overarching requirement that revenue allowances are determined and reviewed based on the efficient cost (or anticipated efficient cost) of providing the Prescribed Services.
- As a minimum, the proposed Rule change should clearly define ‘reasonableness criteria’ (v) and (vi) as having higher weighting than others; and require that demand forecasts (in (vii)) be compatible with efficient expenditure forecasts. This would go some way towards ensuring the AER would be able to withstand legal challenge (on appeal from a disgruntled TNSP) that the AER’s interpretation of ‘reasonable’ did not breach the ‘Wednesbury principle.’

### **Regulatory Period and WACC**

- The AEMC should not proceed with a ‘lock-in’ of WACC parameter values within the Rules but rather ensure that the review periods of all TNSPs are fully aligned into a single review process. This could be achieved by the AEMC exercising its Rule-making powers and mandating that the alignment be achieved at a particular date; or require the AER to achieve alignment of TNSP reviews by extending existing regulatory periods until they all align. This would better facilitate achievement of the SMO and be more likely to achieve ‘best practice regulation’. It would also achieve a 5 yearly review of WACC without having to specify this in the Rules.
- Consideration should also be given to also achieving alignment between the timing of gas transmission and electricity transmission reviews as has been implemented in the

UK. This would go some way towards addressing the conflicts between incentives/signals in the gas and electricity sectors at a time when there are steps being taken to align regulation of electricity and gas and as there is certain to be greater involvement of gas-fired generation in the electricity sector.

### **Information Disclosure**

- As a minimum, the proposed Rule changes should be amended to require:
  - the AER to develop, in consultation with TNSPs and end users, effective and enforceable guidelines and procedures that define, and precisely and clearly specify, the information that must be provided to the AER;
  - these requirements and the timing of information provided be rigorously and consistently enforced;
  - reliable and verifiable information about the actual costs incurred in providing services, including for un-regulated activities, and the levels of service performance.
- At a minimum, the AER should be given the same powers to obtain and enforce information provision by the TNSP as other Australian regulators, such as the Australian Securities and Investment Commission (ASIC), ACCC and the Australian Taxation Office (ATO).
- Further, the Rules should limit discretion in allocation of costs and interpretation of performance information as tightly as possible. This would appear to be the only way of minimising the exercise of ‘strategic behaviour’, obfuscation and/or confusion over information disclosure.

### **Incentive mechanisms**

- The AEMC should introduce similar incentives for efficient expenditure to those used in the distribution sector. This would require TNSPs (and the AER) to:
  - link forecasts to prudent/efficient actual expenditure and any material changes in obligations, service standards or user requirements based on costs that are demonstrated to be efficient;
  - ‘live with’ the forecast expenditure amounts for the full regulatory period, which allows the TNSPs to ‘capture’ efficiency benefits during the regulatory period; and
  - transfer assessed efficiency benefits to end users (either directly or through a sensible efficiency carry-over mechanism) at the end of each regulatory period.
- As the AEMC noted in its Issues Paper, the incentive mechanism developed for NGC in the UK has been effective in substantially reducing system costs. We believe that an incentive mechanism with potential for similar benefits should be introduced in Australia as this would better facilitate achievement of the SMO.
- However, if the AEMC persists with proposals in the Rule change package, better definition is required of an ‘performance incentive’ regime that attempts to align TNSPs interests with the electricity market. A limit of +/-1% of total TNSP revenue is extremely modest compared to the impacts that TNSPs can have on the market.

### **Asset Stranding and Negotiation**

- We object strongly to any proposals that would provide regulated networks with ‘protection’ from ‘stranding’ (i.e. poor investment decisions) and effectively pass these costs on to end users. This approach, which has become an unfortunate part of the so-called incentive regulation regime in Australia, is not consistent with the SMO and nor is it consistent with the policy objective for energy network regulation of having the regulatory regime mimic the outcomes of a competitive market. Protection from asset stranding is not possible in competitive markets where shareholders must bear the risks of poor decisions and suffer the consequences (not their customers). It would be a major step forward if the AEMC were to recognise this and ensure that the Rule changes reflected it.
- We acknowledge that the AEMC’s proposals in respect of asset stranding are more-or-less consistent with arrangements currently in place. However, they provide only weak incentives for TNSPs to negotiate so as to avoid by-pass by transmission users. If retained, the proposals should be extended to provide clear incentives for TNSPs (and more generally DNSPs) to address and accommodate the potential risk of asset stranding created by (currently unforecast) changes in consumer preferences. This can only be addressed by creating clear incentives for TNSPs (and possibly more particularly DBs) to better understand the potential impacts of emerging technologies (and end user behaviour to these technologies) and allow for this in their forecasts (and pricing policies).