

Australian Energy Market Commission

Rule Determination

National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No.18

16 November 2006

Signed:

A handwritten signature in black ink, which appears to read 'John Tamblyn', is written over a horizontal dotted line.

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About the AEMC

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (AEMC) in July 2005 to be the Rule maker for national energy market. The AEMC is currently responsible for Rules and policy advice covering the National Electricity Market. It is a statutory authority. Our key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council as requested, or on AEMC initiative.

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Preface

The National Electricity Law (NEL) requires the Australian Energy Market Commission (AEMC¹) to review the National Electricity Rules (NER) governing the regulation of electricity transmission revenue and pricing before January 2007 (the Review).

Publication of the Transmission Revenue Rule (the Revenue Rule²) and this Rule Determination represents the final step in the Commission's Rule change process in relation to the revenue regulation aspects of the Review.

In conducting this Review of the Rules for the economic regulation of electricity transmission revenue and pricing, the Commission has placed particular emphasis on the crucial role the transmission network plays in facilitating competition and efficient resource use in Australia's wholesale and retail electricity markets.

The significance of the interactions of the transmission network with the competitive sectors of the electricity system, together with the substantial potential for the exercise of market power that can be associated with the supply of core transmission services are widely recognised by market participants and energy consumers. As a consequence, submissions from market participants have been concerned with ensuring that the regulatory arrangements for transmission are effective in promoting efficient behaviour and outcomes across the market.

This Review is part of a broader program of reform of the arrangements governing investment in, and operation of, the national electricity transmission grid and its contribution to the efficient performance of the National Electricity Market (NEM) as a whole.

The Commission is currently processing a number of related Rule change proposals submitted to it by the Ministerial Council on Energy (MCE) that are directed at facilitating timely and efficient transmission investments that are sufficient to meet future demand growth and reliability requirements.³ The MCE has also directed the Commission to review and recommend options for improved management of congestion in the transmission network. Under the auspices of the Commission, the Reliability Panel is also conducting a review of the Reliability Standard and related

¹ The AEMC is referred to as 'the Commission' through out this report. The exception is those instances where the national rule making framework and policy and regulatory institutions are being discussed in which circumstances it is referred to as 'the AEMC' for clarity.

² National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, referred to throughout this Determination as 'the Revenue Rule'

³ Regulatory Test Principles Rule change proposal, 12 October 2005 for which, a Draft Rule and Determination were released on 21 September 2006, and Last Resort Planning Power Rule change proposal, 12 October 2005, with a Draft Rule and Determination scheduled for release on 23 November 2006.

arrangements which influence investment to underwrite the reliability and performance of the national electricity system.

The Commission's Review has been guided by the NEM objective of promoting an efficient, reliable and safe electricity system. Its goal has been to design 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 and the long-term interests of consumers of electricity. It has also sought to improve the environment for investment by increasing regulatory clarity and certainty through the Rules.

The Revenue Rule provides a balanced regulatory framework with appropriate incentives for efficient network investment and operation. The framework is designed to manage the potential for the exercise of market power by network operators while maintaining effective regulation with an appropriate requirement for clarity, transparency and accountability on the part of the regulator.

The Revenue Rule continues direct price and revenue regulation of Transmission Network Service Providers (TNSPs) and the shared network services in recognition of the need to manage the associated market power. However, it also establishes incentives for the competitive or negotiated supply of network services and for pursuing economic non-network solutions where feasible.

The issues identified in stakeholder submissions throughout the various consultation phases of the Review process have had a direct bearing on the development of the Revenue Rule. A key theme identified in stakeholder submissions on the Scoping Paper⁴ and the Issues Paper⁵ was the need for a better alignment between transmission investment and operation decisions and the requirements of network users and electricity customers. A second key theme was the desire for greater clarity, certainty and consistency in the specification and implementation of the regulatory framework by the regulator.

Consequently, these themes were prominent in the Rule Proposal and Draft Rule Determination published by the Commission in February 2006 and July 2006 respectively. The Rule development associated with these themes has received support from stakeholders in the submissions.

In line with the views expressed in many submissions, the Revenue Rule draws heavily on existing practice and experience. The principal components of the Statement of Regulatory Principles (SRP), developed by the Australian Competition and Consumer Commission (ACCC) and adopted by the Australian Energy Regulator (AER), have been reflected in the Revenue Rule, including:

⁴ Australian Energy Market Commission, Review of Transmission Economic Regulation: Revenue Scoping Paper, July 2005

⁵ Australian Energy Market Commission, Review of Transmission Economic Regulation: Revenue Issues Paper, 19 October 2005

- the adoption of a revenue cap approach;
- a post-tax revenue model using the building blocks methodology; and
- an incentive regime to promote and balance expenditure efficiency and service reliability.

In view of the interconnected, any-to-any features of shared transmission network services and the lumpiness of the associated capital requirements, the Commission has decided against providing for the use of alternative revenue cap methodologies based on productivity indices or benchmarks. However, the Revenue Rule guides the AER to take into account benchmarks in assessing a TNSP's capital expenditure and operating expenditure forecasts under the building blocks approach.

The Commission has also sought to improve the clarity, certainty and transparency of the regulatory process in framing the Revenue Rule through targeted measures including:

- codifying a procedural requirement for TNSPs to submit a Revenue Proposal to the regulator for consideration and determination and specifying fixed timetables for regulatory decision-making;
- providing clear guidance to be applied by the AER when exercising appropriate discretions; and
- specifying matters on which the AER must consult and areas in which its current guidelines are to be augmented.

An important feature in delivering these outcomes has been a further detailed examination of the specific word drafting of the Rule itself. As a result, the Commission has adopted wording to improve clarity and understanding of the underlying policy intentions.

Copies of this Rule Determination Report and the Rule can be obtained electronically from the Commission's website www.aemc.gov.au or in hard copy from its offices located at:

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Abbreviations

ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ACG	Allen Consulting Group
ACT	Australian Competition Tribunal
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
AGL	Australian Gas Light Company
AGS	Australian Government Solicitor
APIA	Australian Pipeline Industry Association Ltd
CALC	Consumer Action Law Centre
CAPM	Capital Asset Pricing Model
COAG	The Council of Australian Governments
Code	National Electricity Code
Commission	See AEMC
CPI	Consumer Price Index
CUAC	Consumer Utilities Advocacy Centre
DJV	Directlink Joint Venture
DNSP	Distribution Network Service Provider
Draft SRP	Draft Statement of Principles for the Regulation of Electricity Transmission Revenues (August 2004)
EAG	Energy Action Group
ERA	Western Australian Economic Regulation Authority
ESC	Essential Services Commission (Victoria)
ESCOSA	Essential Services Commission of South Australia
ESIPC	Electricity Supply Industry Planning Council
ETNOF	Electricity Transmission Network Owners' Forum
ETSA	ETSA Utilities
EUAA	Energy Users' Association of Australia
Gas Code	National Third Party Access Code for Natural Gas Pipelines
Gas Access Regime	National Gas Access Regime
IPART	Independent Pricing and Regulatory Tribunal (NSW)
ICRC	Independent Competition and Regulatory Commission (ACT)
MAR	Maximum Allowed Revenue
MCE	Ministerial Council on Energy
MEU	Major Energy Users Inc
MNSP	Market Network Service Provider
MTC	Murraylink Transmission Company
NEL	National Electricity Law
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company

NER	National Electricity Rules
NGF	National Generators Forum
NPV	Net Present Value
OEPC	Tasmanian Office of Energy Planning and Conservation
OTTER	Office of the Tasmanian Energy Regulator
PC	Productivity Commission
PIAC	Public Interest Advocacy Centre
PTRM	Post Tax Revenue Model
QCA	Queensland Competition Authority
RAB	Regulatory Asset Base
Rules	National Electricity Rules
SRP	Statement of Principles for the Regulation of Electricity Transmission Revenues (December 2004). The SRP comprises a background paper and a consolidated version of the principles.
TFP	Total Factor Productivity
TNO	Transmission Network Owner
TNSP	Transmission Network Service Provider
URF	Utility Regulators' Forum
WACC	Weighted Average Cost of Capital

Overview

Contribution to the National Electricity Market Objective

In conducting this Review of the economic regulation of transmission services, the Commission has been guided by the NEM objective, which is:

‘...to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to the price, quality, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.’⁶

In that respect, the goal has been to design 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 and the long term interests of consumers of electricity.

The development of the Revenue Rule was guided by the key themes that have emerged during the consultation process for the Review. These key themes relate to:

- aligning the incentives for transmission network service providers (TNSPs) in relation to investment in and operation of transmission networks with those of network users in order to deliver efficient outcomes; and
- increasing the clarity, certainty and transparency of economic regulation so as to provide a more certain regulatory environment for efficient long term investment by both TNSPs and transmission users.

The Commission has sought to address these themes in the context of seeking to balance the objectives and tensions that are associated with economic regulation of natural monopoly services.

Services supplied by the shared transmission network are generally supplied under natural monopoly conditions. Due to the large capital investment costs, low incremental operating costs and network externalities that are involved, transmission services can be supplied more efficiently by a single service provider rather than two or more. However, the resulting absence of competitive pressure from rivals introduces the potential for market failure due to the capacity of TNSPs to exercise their market power.

In these circumstances, economic regulation can be an appropriate policy response as a means of providing network operators with incentives for efficient investment in and operation of their infrastructure while containing the costs and inefficiencies that can arise from the potential exercise of market power. Economic regulation seeks to ensure the secure and reliable supply of services at efficient prices that do not distort downstream or potentially upstream economic activity.

⁶ Section 7, National Electricity Law (NEL)

However, economic regulation is an imperfect substitute for effective competition as the means of promoting efficient investment and resource use. The potential for failures in the regulatory process can impose costs and inefficiencies; including the direct costs incurred by regulated businesses and the regulator and the costs to society as a whole through the potential for regulatory error and induced inefficiencies.

In developing the Revenue Rule, the Commission has been conscious of the potential for both market failure and regulatory failure and has sought to design a balanced regulatory framework such that the inefficiencies from either are minimised. However, consistent with the NEM objective, economic regulation conducted within an effective regulatory framework can be expected to achieve a better balance between price and service outcomes for consumers over time than would occur if monopoly TNSPs were not regulated.

The CPI-X revenue cap form of regulation is the principal means of providing incentives for efficient network investment and operation, while minimising the scope to exercise market power. It does this by remunerating network operators on the basis of periodic forecasts of the efficient costs of service provision, such that they retain a proportion of unanticipated cost reductions and absorb unanticipated cost increases.

It is recognised, however, that the task of determining a revenue requirement based on forecasts is a difficult one that involves substantial information asymmetry between well informed service providers and the less informed regulator. In order to reduce this information asymmetry and encourage the TNSPs to reveal their efficient costs, the revenue cap regulatory model incorporates a suite of incentive mechanisms. For example, the Rule seeks to ensure that a TNSP has the incentive to provide a well developed and thorough revenue proposal to the regulator. It also seeks to provide a balanced approach between providing incentives to achieve cost efficiencies with appropriate incentives to maintain service quality and reliability. Similarly, incentives to achieve cost efficiencies should be designed to encourage efficient choices between capital and operating expenditure and between short term and long term investments. It is essential that this balance in the incentives regime is maintained in order to avoid unintended inefficiencies.

A further important consideration in balancing the tensions involved in economic regulation is the degree to which the framework provides clear obligations for the TNSP and the regulator in rules regarding both the methodology of, and process for, regulatory decisions while also providing for flexibility and discretion where it may be needed. Designing rules that give clear and transparent instructions provide market participants with increased certainty about how long term assets will be treated at each revenue reset. This certainty and transparency also enables the regulator to obtain appropriate information on an *ex ante* basis because the TNSP is fully aware of its obligations.

Some matters in regulatory determinations, however, involve a degree of uncertainty such that it is necessary for the rules under which decisions are made to allow for the exercise of discretion and judgment by the regulator. The Commission's approach has been to consider the costs and benefits of providing certainty or flexibility in the context of the different elements of the regulatory framework specified in the

Revenue Rule. Where there is clearly increased benefit from providing certainty and transparency there is merit in codifying methodologies and processes in rules. However, where there is uncertainty, such as in the case of expenditure forecasts and the calibration of the operational features of incentive mechanisms, there are benefits in ensuring that the Rules provide the regulator with sufficient flexibility to exercise judgment in making informed decisions.

Based on these considerations the Commission has sought to strike a balance between codification of the regulatory approach and provision of guided discretion to the AER in implementing the regulatory framework. The Commission considers that the Revenue Rule will improve the economic efficiency of investment in, and use of, transmission services, including in relation to reliability and security and will therefore contribute to the long term interests of electricity consumers. It is satisfied therefore that the Revenue Rule meets the requirements of the NEM objective. The following Box 1.1 provides a summary of the elements of the Revenue Rule.

Box 1.1: Key Elements of the Revenue Rule

Scope and Form of Regulation

Prescribed Transmission Services

CPI-X revenue cap approach using the building block methodology.

Negotiated Transmission Services

Commercial negotiation with arbitration of disputes.

Building Block Revenue Requirement

PTRM

AER to develop a Post Tax Revenue Model (PTRM) which forms the basis for the calculation of the Maximum Allowed Revenue (MAR). The regulatory control period for which the PTRM applies is a minimum of five years.

X-factor

Nominated by the TNSP and accepted if the AER determines that the TNSP's proposal conforms with the requirements in the Rules.

Regulated Asset Base (RAB)

The initial RAB values are specified in the Rules and a roll-forward approach model to be developed by the AER to ensure that the RAB values are 'locked in'. Capital expenditure will not be subject to an *ex post* review before it is rolled into the RAB. The PTRM is to allow for the indexation of the RAB.

WACC

WACC methodology and parameters will be specified in the Rules and review on 1 July 2009. The AER is required to review the parameters and methodology each five years to allow for change to the methodology and parameters over time.

Tax

Tax should be estimated based on parameters for a benchmark business and not a TNSP's actual financial and tax arrangements. The value of imputation credits has been deemed to be 0.5.

Depreciation

Depreciation schedules are to be nominated by the TNSP and are to be accepted by the AER if they conform with principles set out in the Rules.

Forecast Expenditure

The AER is to approve forecast capital and operating expenditure if the AER is satisfied that they reasonably reflect efficient and prudent costs based on realistic estimates of forecast demand and cost inputs.

Incentives Package

Efficiency Benefit Sharing Scheme

The AER to develop an efficiency benefits sharing scheme providing for a revenue increment or decrement for each regulatory year where outturn costs are greater or less than forecast costs. The AER must approve the TNSP's proposed parameter values if it is satisfied they comply with the requirements of the scheme.

Performance Standard Incentives

Service incentive scheme to be designed by the AER with a restriction on the reward or penalty to be between +/- one to five per cent of regulated revenue.

Capital Expenditure Incentives

Higher powered incentives are provided for capital expenditure with a separate contingent projects regime for capital expenditure required for specific large projects.

Regulatory Procedures

A 13 month regulatory determination period commencing from the submission of the Revenue Proposal to be specified in the Rules. Time requirements specified for major milestones such as the Draft and Final Determinations and any resubmitted Revenue Proposal.

Information Requirements

AER required to develop information and submission guidelines. The Rules provide a clarification of the circumstances in which the AER can gather information. The

Rules also provide for the manner in which the AER can consider information from a third party that is not deemed to be at arms length.

Guidelines

The AER is required to develop the following guidelines, models or schemes:

- Information Guidelines;
- Cost Allocation Guidelines;
- Service Performance Target Incentive Scheme;
- Efficiency Benefit Sharing Scheme;
- Post Tax Revenue Model; and
- Roll-Forward of the Regulatory Asset Base Model.

The remainder of this chapter will discuss the key elements of the Commission's approach and provide the details of how the Commission has sought to achieve the appropriate balance in the Rules for the regulation of transmission revenues.

Service definition and the scope and form of regulation

As part of this review the Commission has identified the need to provide greater clarity regarding the types of transmission services that should be subject to a revenue cap determination and those that can be subject to a less intrusive form of regulation. The lack of clarity on this matter in the current Rules has lead to an over-inclusion of services in the revenue cap. As a result, the transmission use of system charge paid by consumers is likely to have included the cost of services that do not contribute to the services provided by the shared network. In addition, an over-inclusion of services under the revenue cap can distort market outcomes by crowding out the opportunities for the competitive supply of services and commercial negotiations between TNSPs and users.

The service definitions included in the Revenue Rule classify different services according to the degree of market power involved in their supply. The Revenue Rule distinguishes between two classifications of services:

- Prescribed Transmission Services; and
- Negotiated Transmission Services.

The Revenue Rule defines Prescribed Transmission Services as those services provided by shared network infrastructure, where there are strong economies of scale and network externality benefits, such that competition for these services is not economically feasible. Prescribed Transmission Services are also limited to services

that have relatively uniform performance characteristics across the network. Negotiated Transmission Services are defined in the Revenue Rule as services dedicated to or requested by specific parties which are characterised by either a lack of homogeneity, limited market power, or material countervailing buyer power.

Having classified services in this way, the Revenue Rule assigns appropriate forms of regulation to each that are commensurate with the market power characteristics of the services. For Prescribed Transmission Services, the Rule requires the regulator to use a CPI-X revenue cap form of price control and the associated revenue allowance using the building block methodology. This is considered by the Commission to be the most appropriate form of regulation for Prescribed Transmission Services at this stage of the development of the NEM. The Commission considers that a CPI-X revenue cap approach allows the regulator to apply appropriate constraints on the exercise of market power, the recovery of efficient costs while providing incentives for cost efficiency improvements in the future, consistent with the requirements of the NEL.⁷

For Negotiated Transmission Services, where there are fewer market failure concerns, the Revenue Rule specifies the less intrusive and less administratively costly commercial negotiation form of regulation. The end-users for these services are likely to be larger and better resourced, providing a counterweight to the market power possessed by the TNSP and making commercial negotiation a feasible proposition. Moreover, requiring generators and large end-users to negotiate with TNSPs about the recovery of costs directly incurred by the TNSP as a consequence of their connection will ensure that the efficiency of those costs is subject to scrutiny by a well informed and commercially interested counter-party.

Any services that fall outside of the definitions of Prescribed and Negotiated Transmission Services, for example, consultancy services, will not be subject to any form of regulation under the Rule.

The Rules strengthen the alignment of incentives between the TNSP and network users by ensuring that users only pay for those services that provide them with a benefit. Requiring above or below standard services to be dealt with through a negotiating regime encourages TNSPs to provide services at the standard desired by the relevant market participants. This approach is intended to deliver prices that are related to service outcomes and usage, and to facilitate competitive provision where this is feasible.

Incentive arrangements

A key role of economic regulation is to support measures to contain the exercise of market power with targeted incentives for efficient investment and operation of transmission services. Providing incentives to regulated businesses is intended to reproduce, to the extent possible, the behaviors and outcomes that would occur in a

⁷ Section 35(3)(a)&(b), NEL

effectively competitive market. Such incentives are an important means of addressing the information asymmetry problem and of aligning the performance of TNSPs with the interests of network users.

The Commission's approach to the provision of incentive arrangements for Prescribed Transmission Services has sought to reflect and balance the need for economic regulation to provide:

- an appropriate degree of certainty about the regulatory framework and investment environment in order to encourage timely and efficient development of network capacity;
- effective incentives to encourage TNSPs to build and operate their systems efficiently;
- incentives for TNSPs to effectively manage the risks that are reasonably within their control; and
- incentives for TNSPs to improve service quality where this is sufficiently valued (collectively) by customers and disincentives for TNSPs to increase profitability by inefficiently reducing service quality, particularly at times where it is most valued by the market.

The Revenue Rule codifies a suite of arrangements which provide these incentives. Efficient investment and operational incentives within the building blocks regime are provided through the following measures:

- TNSPs will be subject to a CPI-X revenue cap which rewards outperformance and penalises under performance relative to the capped revenue forecast;
- capital expenditure that has been incorporated into the TNSP's regulatory asset base (RAB) will not be removed from the RAB (i.e., 'optimised') except in specific situations where the TNSP has failed to reasonably manage the risks of commercial stranding;
- the efficiency incentive for capital expenditure will include both depreciation and the cost of capital in the calculation of the associated rewards and penalties;
- the allowed rate of return on assets will be based on benchmark assumptions, which will encourage TNSPs to pursue strategies to lower their cost of capital relative to the regulatory WACC as they will be entitled to retain the difference within the regulatory period; and
- the operating expenditure efficiency incentive scheme provides for symmetrical rewards and penalties which can be carried over to the next period to provide even incentives in each year of the regulatory control period.

Incentives for efficient investment in, and operation of, the transmission system in circumstances of cost or timing uncertainties and/or major unforeseen conditions and events are provided through the following measures:

- a separate contingent projects regime will apply for capital expenditure required for specific large projects triggered by particular events, with an associated incentive mechanism similar to that applicable to other capital expenditure;
- scope will remain for reopening revenue cap determinations in genuine *force majeure*- situations; and
- there will be allowance for appropriate pass-through of costs to avoid exposing TNSPs to risks that are beyond their reasonable control.

The Revenue Rule also requires the AER to implement a service and reliability incentives regime (and to develop guidelines regarding its operation) with the objective of encouraging TNSPs to maintain and enhance reliability at times when it is most valued by the market. Rewards and penalties from the service incentive arrangements are capped in the Revenue Rule at between one and five per cent of regulated revenue as determined by the AER for each TNSP.

The Commission considers that, together, these mechanisms provide a balanced package of incentives for TNSPs to operate their networks efficiently while maintaining the quality and reliability of transmission services. This approach recognises that while each element of an incentives regime is important, it is the interaction between incentive mechanisms that is essential to delivering efficient outcomes that meet the NEM objective.

Framework for regulatory decision making

The economic regulation of infrastructure industries involves both the substantive rules (methodologies and decision making criteria), which govern the application of regulation to individual cases, and the procedural rules, which govern the process by which decisions are made. In reviewing the regulatory framework to clarify the regulatory decision making process, the Commission has separately considered the appropriate balance between codification of the framework in the Rules and the conferral of discretions on the AER in the context of:

- process and procedural matters;
- the level of specification of methodologies; and
- the extent to which the Rules provide decision making criteria in areas in which the AER has discretion.

The Commission believes that there is no general principle that can be applied to determine the appropriate extent of codification of rules in all circumstances for all types of energy infrastructure. The Commission's general approach has been to improve the transparency and predictability of regulatory outcomes by codifying those elements of regulatory methodology and process which are comparatively uncontroversial, unlikely to need to vary in application across different TNSP's in different circumstances or which are necessary to be determined on an *ex ante* basis for the efficient administration of the regulatory process.

The Commission also understands that there are significant areas of regulatory decision making that should involve the exercise of judgment and discretion by the regulator. This is because good economic regulation should be sufficiently flexible to adapt to the individual circumstances of regulated businesses across different periods of time. Areas of flexibility and discretion also allow the regulatory process to evolve with experience, learning and innovation. Importantly, however, where legal rules confer discretions on regulators the rules should also specify criteria for exercising those discretions.

The Rules have continued to build on previous regulatory practice by providing for:

- a decision rule regulatory framework that varies the extent of codification and discretion assigned to different elements of the building block model;
- clear guidance on the processes and procedures to be adopted by the regulator; and
- the development of guidelines by the regulator regarding the exercise of discretion in specified areas.

These elements are outlined further below.

Decision rule framework

In order to improve the predictability, transparency, and over time, consistency, of the regulatory regime the Commission has specified in the Rules a full methodology for making revenue cap determinations. The methodology that has been included in the Rules is based on the AER's Statement of Regulatory Principles.

The Revenue Rule requires that the revenue cap for a TNSP be derived using a post-tax revenue model that is based on the building blocks approach. This methodology, to apply to a regulatory period of no less than five years, contains a codified approach to treatment of the regulatory asset base (RAB) and to the cost of capital financing.

The Commission believes that the mechanics of the building block approach are well understood having been adopted by economic regulators in Australia and overseas for over 10 years. Therefore, there are few, if any, risks to good regulatory outcomes from codifying the components of the building blocks methodology in the Rules.

In order to encourage efficient investment the Revenue Rule provides for the initial value of the RAB to be 'locked-in' and rolled forward on a specified basis with no provision for ex-post revenue and optimization of the RAB (except in limited circumstances). Clarity about the valuation of the RAB over time provides a stronger incentive for long term capital investment. The Rules also require the AER to develop the PTRM and roll-forward model based on guidance in the Rules. This approach seeks to provide an appropriate balance between guidance in the Rules and flexibility for the regulator.

The return on, and depreciation of, capital invested in the network by the regulated TNSP contributes a substantial component of its allowable revenue. The Commission has specified in the Rules the methodology to be applied and the value

of certain parameters to be adopted by the TNSP and the AER in estimating the weighted average cost of capital (WACC) with a requirement for their periodic review ever five years. This approach has been adopted to increase certainty and reduce administrative costs in the short run while providing medium term flexibility for changes to both methodology and parameters in line with financial market circumstances and practice.

The Rules provide TNSPs with the discretion to propose depreciation schedules which reflect principles specified in the Rules, including being reflective of the economic lives of the relevant assets and applying a generally accepted methodology in determining the depreciation profile. Where the AER is not satisfied that these principles have been applied it may reject the depreciation schedules. This approach provides sufficient flexibility for TNSPs to propose depreciation methodologies that reflect different asset and market circumstances but with scope for review and replacement by the AER where it is not satisfied that the principles have been applied.

The expenditure forecast component of the building blocks regime is an area where clarity and transparency are of particular importance. The Commission has sought to make improvements in this area by giving clear guidance to the regulator and the TNSP on the process and criteria for making decisions. Having considered the various legal opinions, the view expressed in submissions and conducted its own analysis, the Commission has concluded that further clarification of its policy intention in relation to the framework for the determination of expenditure forecasts in Rules is required.

While the Commission has maintained the objective and intention of achieving an appropriate balance between the interests of network operators and users, it has decided to revise the structure and wording of the decision criteria to be applied in determining expenditure forecasts to better reflect the policy balance that is sought. The Commission has elected to adopt a decision rule which requires the AER to accept the TNSP's proposal if it is satisfied that the amount "reasonably reflects" efficient and prudent costs based on realistic estimates of forecast demand and cost inputs. The Commission is satisfied that the Revenue Rule achieves an appropriate balance between the interests of TNSPs and network users and between the risks and costs of market and regulatory failure.

Decision making process and procedural requirements

The Commission considers that transparent and timely processes for regulatory determinations are necessary to ensure that the rights and obligations on all parties are clear at the outset of making a determination. This is a key requirement for effective regulation and should promote more efficient network investment, operation and service provision in the long term interests of consumers.

Ensuring clarity around a number of procedural issues such as timeframes, information provision and the circumstances when a revenue cap can be revoked provides greater certainty to market participants and energy consumers and reduces delays in regulatory decision making. The Revenue Rule codifies requirements for these elements of the regulatory framework to provide better balance, certainty and transparency compared with previous practice. The Commission's view is that

providing greater clarity and certainty on the timeframes and the information required for the AER to make determinations will create an incentive for TNSPs to submit their best proposal at the outset of the process knowing there is little scope for delay.

The Rules specify key process and procedural requirements that apply to both the TNSPs and the AER in the conduct of regulatory decision making processes. These include:

- procedural requirement for TNSPs to submit a Revenue Proposal to the regulator for consideration and determination;
- specified timeframes for Revenue Proposal submission, draft and final determinations from the AER, and submission specific Revenue Proposal revisions following an initial compliance assessment or draft determination from the AER;
- codification of information gathering and disclosure powers;
- provision for guided discretion through use of decision making criteria;
- requirement for the AER to develop submission and information guidelines; and
- requirement for the AER to prepare guidelines on other key areas of the regulatory framework, including incentive mechanisms, cost allocation principles, RAB roll forward and the PTRM.

Savings and transitional measures

The Commission understands that savings and transitional rules are necessary for a number of issues. Therefore, the Revenue Rule includes provisions⁸ which manage the transition from the existing Rules to the new regime.

⁸ Revenue Rule, Schedule 5.

1. Introduction to the Rule Determination

The following chapter describes the context in which the Commission has conducted this Review and completed the Rule change process for the Revenue Rule. This Rule Determination provides the Commission's reasons for its decisions; the Revenue Rule is attached. This chapter also sets out the structure of this Rule Determination.

1.1 Review Context

In the context of the current reforms to the regulation of the national energy market, the Australian Energy Market Commission (the Commission) has been required to conduct a review of the revenue and pricing Rules (the Review) to apply to the regulation of electricity transmission network services.⁹ The matters required to be reviewed are specified in items 15 to 24 of Schedule 1 of the National Electricity Law (see Appendix A) and include, amongst other matters:

- the regulation of transmission revenues (item 15); and
- the regulation of transmission prices (item 16).

Due to the complex nature of the review task, the Commission decided to undertake the Review in two stages:

First, the Commission has reviewed the existing Rules applicable to the regulation of transmission revenues earned by TNSPs, which has culminated in the publication of this Rule Determination which presents the Commission's rationale for the associated Revenue Rule; and

Second, the Commission has reviewed the existing Rules to apply to the pricing of Prescribed Transmission Services by TNSPs. The associated Rule Determination and Pricing Rules are expected to be published in December 2006.

There are important and strong linkages between the rules relating to the regulation of transmission revenues and pricing. In the absence of direct competitive pressures on TNSPs, revenue rules seek to provide:

- incentives for the efficient investment in, and provision of, transmission services; and
- constraints on the aggregate revenues TNSPs can earn from their customers through the provision of Prescribed Transmission Services.

In the absence of competitive pressures on TNSPs, pricing rules seek to also ensure prices provide incentives for the efficient use of the various transmission services. They do this by providing signals for efficient electricity consumption and production decisions, as well as efficient investment decisions by actual and potential network users.

⁹ The requirement is specified in Section 35(1) of the National Electricity Law (NEL)

In considering its Revenue Rule, the Commission has been mindful of the interactions between the revenue and pricing rules, and has endeavoured to design an overall effective regulatory framework for electricity transmission regulation.

1.2 Commission's Review Process

The publication of the Revenue Rule is accompanied by this Rule Determination which provides the Commission's reasons for its decisions. The publication of these two documents follows the extensive consultation and review process outlined below and represents the conclusion of the formal Rule change process for the electricity transmission revenue component of the Review.

The Commission has undertaken an extensive investigation and public consultation process. This involved release of the following consultation documents:

- the Initial Scoping Paper in July 2005, identifying various issues that the Commission believed to be important to these reviews, and inviting submissions from stakeholders;
- the Revenue Issues Paper in October 2005, presenting the Commission's further analysis of revenue issues identified in the Commission's Scoping Paper and raised in stakeholder submissions to the Scoping Paper, and inviting further submissions;
- the Rule Proposal Report and accompanying Draft Rule in February 2006, providing proposed rules and the Commission's rationale for those proposed rules, and inviting further submissions;
- the Draft Rule Determination accompanying the Draft Rule in July 2006, providing revised rules and the Commission's rationale for those rules, and inviting further submissions; and
- the Australian Government Solicitor's advice obtained by the Commonwealth Department of Industry, Tourism and Resources on the assessment of expenditure forecasts and subsequent Commission request in October 2006 for further submissions on this topic.

The Commission has carefully considered stakeholder submissions made in response to each of these papers in developing the Revenue Rule (see listing in Appendix B). The Commission has also taken into consideration the views and discussion raised during the development of the pricing Rule Proposal Report, released on 24 August 2006, as well as views expressed by the Working Group on Service Definitions.

In particular, a key area of consideration during this Review has been the approach to assessing expenditure forecasts. The Commission conducted a final supplementary round of consultation specifically on this issue in October 2006. The Commission received 17 submissions in this round of consultation (see Appendix B for a list of respondents). These were carefully considered and informed the approach adopted by the Commission.

The Commission is also aware that each of the States and Territories of the participating NEM jurisdictions have agreed¹⁰ to jointly and separately make an application under the *Trade Practices Act 1974* to the National Competition Council for certification of the national electricity access regime (as contained in the National Electricity Law and Rules) as an effective access regime. The rules relating to revenue and pricing of transmission services that are the subject of the Commission's current review affect core components of the national access regime for electricity network services – what services are subject to an obligation to supply and how the prices for those services are calculated. The Commission is mindful of the requirements for an effective access regime to satisfy principles set out in the Competition Principles Agreement (CPA). In order to facilitate the access related assessment of the new revenue and pricing rules in a holistic way, the Commission will consider any outstanding access related issues for both the revenue and pricing rules, as part of the assessment for the final Rule determination for the transmission pricing rules.

Another relevant consideration for the Review has been the wider debate on regulation in the energy market as reflected in recent reports by the Productivity Commission,¹¹ the Prime Minister's Taskforce on Exports and Infrastructure¹² and the Ministerial Council on Energy's Expert Panel.¹³

In forming its decision on the Revenue Rule, the Commission was required to satisfy a number of legislative requirements including:

- meeting minimum content requirements for a Rule Proposal;¹⁴
- ensuring the Rule Proposal satisfies the NEM Objective¹⁵ and Rule-making test;¹⁶ and
- ensuring the Proposed Rule is within the AEMC's Rule making powers.

The Commission is satisfied that it has met these requirements and additional details on how these requirements have been met are provided below.

¹⁰ Australian Energy Market Agreement (As Amended on 2 June 2006), clause 13.

¹¹ Productivity Commission, Review of the National Access Regime, Report no. 17, 2001, AusInfo, Canberra

¹² Exports and Infrastructure Taskforce 2005, 'Australia's Export Infrastructure', Report to the Prime Minister, Canberra, May 2005

¹³ Expert Panel on Energy Access Pricing, Report to the Ministerial Council on Energy, 2006

¹⁴ Clause 8, National Electricity Regulation

¹⁵ Section 7, NEL

¹⁶ Section 88, NEL

1.3 NEM Objective and Rule Making Test

The NEL sets out the overall objective for the National Electricity Market (the NEM objective):

“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.”¹⁷

The NEL also sets out the Rule making test that must be applied by the Commission in making its 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.¹⁸*

The NEL therefore, obliges the Commission to have regard to the NEM objective in developing the Revenue Rule. The Commission has focused on why it considers that the Revenue Rule is likely to contribute to the NEM objective, and this Rule Determination addresses this in relation to specific issues and for the Revenue Rule as a whole.

For the reasons set out in this Rule Determination, the Commission considers that the Revenue Rule is likely to satisfy the NEM objective and thus, the Rule making test.

1.4 Power to Make the Revenue Rule Under the NEL

The Rule determined by the Commission must fall within the Commission’s rule making power. The subject matters for the transmission revenue and pricing rules are listed in items 15 to 24 of Schedule 1 to the NEL, these are set out in Appendix A. These subject matters, along with section 34 of the NEL (the general head of power for rule making), form the specific heads of power under which this Revenue Rule has been made.

The Commission is satisfied that the *National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006* is for, or with respect to, a matter that the Commission may make a Rule under the NEL.

1.5 Structure of the Report

The regulatory decisions to be made by the AER under the Revenue Rule will involve consideration of many complex and often interrelated regulatory issues. Broadly speaking, these can be categorised as relating to the following topics:

¹⁷ Section 7, NEL

¹⁸ Section 88, NEL

- the building blocks approach to calculation of the maximum allowable revenue;
- the incentive mechanisms for investment in, and provision of, efficient and reliable transmission services; and
- the pass throughs of uncertain and unforeseen events with regard to timing or costs.

This Rule Determination sets out the Commission's rationale for the codification of the approach to making regulatory decisions on these topics. In addition, this Rule Determination outlines:

- the context within which the Commission's Review has taken place;
- the framework and approach for rule making;
- the key components of the Revenue Rule; and
- specific savings and transitional issues associated with the implementation of the Revenue Rule.

The remainder of this report is therefore structured as follows:

- Chapter 3 outlines the Commission's framework and approach in developing the Revenue Rule, providing an overview of the Commission's rationale for the level of procedural, decision making and decision criteria codification adopted in the Revenue Rule;
- Chapter 4 examines the Commission's assessment of the appropriate scope and form of regulation for electricity transmission services;
- Chapter 5 discusses the Commission's views on a number of key specific issues relating to the Revenue Rule, and provides a detailed rationale for the treatment of service definitions, expenditure forecasts, the WACC, contingent projects and determination re-openers in the Revenue Rule;
- Chapter 6 provides the Commission's assessment of the economic regulation of transmission revenues under the building block approach;
- Chapter 7 details the Commission's specification of the approach to incentive regulation;
- Chapter 8 presents the Commission's rationale for the information and guideline provisions contained in the Revenue Rule; and
- Chapter 9 considers specific savings and transitional issues associated with the implementation of the amended Revenue Rule.
- In addition:
- Appendix A reproduces Schedule 1, items 15 to 24, of the NEL; and

- Appendix B provides a list of stakeholders who made submissions to the various consultation documents released during the transmission revenue component to the Review.

2. Framework for developing the Revenue Rule

The Commission's general approach to the balance between Rule-based guidance and regulatory discretion is addressed in this chapter, together with its approach to the specification in Rules of the regulatory decision criteria to be applied by the Australian Energy Regulator (AER) in relation to certain elements of the building blocks revenue cap model.

In seeking to strike a balance between the level of codification of the decision making framework and exercise of guided regulatory discretion, the Commission has sought to promote the NEM objective (see section 1.3). In this regard, the Commission has consistently acted to enhance the certainty, transparency and predictability of the regulatory framework in order to better facilitate the continued development and operation of an efficient, reliable and safe electricity system.

This chapter presents the general principles and considerations that have guided the Commission's approach to the codification of regulatory process, methodology and decision making criteria. The more detailed aspects of the regulatory framework specified in the Revenue Rule are described in subsequent chapters.

2.1 Energy Market Governance and the Role of the Rules

A primary consideration for the development of Rules in this Review has been the introduction of the new institutional and governance arrangements for the implementation of energy policy and regulation in the context of the National Energy Market (NEM). More generally, the Council of Australian Governments (COAG) *Intergovernmental Agreement on an Australian Energy Market*¹⁹ endorsed new energy market governance arrangements recommended by the Ministerial Council on Energy (MCE) in its report to COAG of 11 December 2003. Those governance arrangements have now been fully implemented and comprise the institutional arrangements set out in Table 2.1.

Table 2.1 NEM Institutional Arrangements

Institution	Role within the NEM
MCE	The national policy and governance body for the Australian energy market including for electricity and gas, with a power to direct the AEMC with respect to Rule making and market development
AEMC	Responsible for Rule-making and market development functions in respect of electricity and natural gas transmission and distribution networks and retail markets (other than retail pricing)

¹⁹ COAG, 'Intergovernmental Agreement on an Australian Energy Market', 30 June 2004

AER	Responsible for enforcement of the Rules for the NEM and economic regulation of electricity transmission and distribution networks and retail markets.
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The MCE's report to COAG and the subsequent legislation establishing the AEMC and the AER and specifying their respective powers and functions make it clear that the AEMC has no direct regulatory enforcement or decision making functions and may not initiate Rule changes itself (other than in respect of the electricity transmission regulation Rules, in accordance with section 35 of the NEL and Schedule 1). In relation to the regulatory and enforcement role of the AER, section 16 of the NEL provides that those functions be performed in a manner likely to contribute to the promotion of the NEM objective and in accordance with the requirements of the Rules.

This governance structure provides relevant guidance regarding the role of the AEMC in making Rules and the role of the Rules in providing a framework for the performance of the AER's regulatory function. The central premise of these governance arrangements is the clear separation of the Rule making and Rule administration functions between the AEMC and the AER respectively.

A further feature of the NEM governance and institutional arrangements is that the Rules are subordinate legal instruments that have the force of law. A general principle of law making and good regulatory practice is that parties who are required to comply with the law are entitled to clearly know in advance what is expected of them²⁰. Thus, the Rules can be defined as legal commands that specify in advance applicable compliance requirements.

The role of the Rules is to provide regulators and market participants clear advance guidance about the content of the regulatory framework and how the regulatory functions should be carried out. As a result, key considerations of this review concern:

- the extent to which the Rules should specify in advance (codify) the criteria, methodologies and process to be applied by the AER; and
- the extent to which the AER should have discretion over those matters in performing its regulatory functions.

A further related matter for the Review is the nature and extent of guidance provided in the Rules in relation to the criteria to be applied by the AER in exercising discretions conferred on it by the Rules.

For the purposes of this Review, the Commission is required by section 35 of the NEL to make Rules for the regulation of electricity transmission revenues and prices, having regard

²⁰ Kaplow, L., "General Characteristics of Rules", in Boudewijn Bouckaert and Gerritt De Geest (eds.), *Encyclopaedia of Law and Economics*, University of Ghent, p.502

to the more detailed guidance provided by items 15 to 24 of Schedule 1 of the NEL. The matters referred to in Schedule 1 include:

- principles to be applied and procedures to be followed by the AER (items 17 and 24);
- the economic framework and methodologies to be applied by the AER for the derivation of maximum revenues and prices (items 19, and 20);
- determination by the AER of: asset values; depreciation allowances; rates of return on assets; and operating costs (items 21 and 22); and
- incentives to make efficient investment and operating decisions (item 23).

The Commission has interpreted this statutory guidance as requiring the development of Rules that establish clear processes for conducting regulatory reviews, a full methodology for making revenue cap determinations using a building blocks approach and appropriate criteria to inform the decision making framework of the AER.

In making Rules for this purpose, the Commission's objective has been to establish a framework for regulatory processes and decision making that provides appropriate certainty and predictability for transmission investors and users, while providing the AER with sufficient regulatory discretion and flexibility to perform its role effectively. In seeking to strike this balance the Commission has been cognisant of the view expressed in stakeholder submissions that greater clarity, transparency and predictability in the regulatory framework would improve investment confidence for TNSPs, network users and energy consumers.

The Commission has also had regard to several recent reviews and reports addressing the issues of regulatory guidance, discretion and decision making criteria in economic regulation. These include the reports by the Productivity Commission on the National Access Regime²¹ and the Gas Access Code²², the report of the Export Infrastructure Taskforce²³ and the April 2006 report to the MCE by the Expert Panel on Energy Access Pricing²⁴.

2.2 Rules for the Regulation of Transmission Revenues

The economic regulation of transmission revenues, and of network industries more generally, involves both the:

²¹ Productivity Commission 2001, 'Review of the National Access Regime', Report no. 17, AusInfo, Canberra.

²² Productivity Commission 2004, 'Review of the Gas Access Regime', Report no. 31, Ausinfo, Canberra.

²³ Exports and Infrastructure Taskforce 2005, 'Australia's Export Infrastructure', Report to the Prime Minister, Canberra, May 2005.

²⁴ Expert Panel on Energy Access Pricing 2006, 'Report to the Ministerial Council on Energy', April 2006.

- the procedural rules that govern the process by which regulatory decisions are made; and
- substantive rules (methodologies and decision making criteria) that govern the application of regulation to individual cases;

In assessing these components of the regulatory framework for regulated transmission revenues, the Commission has considered the balance between codification in the Rules and the conferral of discretions on the AER in their treatment.

In the context of the process, methodology and decision criteria for revenue determinations, the relevant consideration for the Commission is whether the balance between increased guidance or increased discretion encompassed in the Rules will provide superior outcomes with reference to good regulatory design and practice principles.

As an overarching principle, the Commission considers that the extent to which the Rules codify matters of process, methodology and decision making criteria should be determined through a Rule making process applied on a 'fit for purpose' basis. This is consistent with the findings of the MCE's Expert Panel which stated:

"In the Panel's view the preferred approach is to recognise the desirability of the AMEC being permitted to develop its Rules on a 'fit for purpose' basis, but to do so within a legislative framework which provides clear principles..."²⁵

In this light, the Expert Panel categorised the fit-for-purpose framework as one that gives recognition to the fact due to the range of dimensions involved in a price and service offering that the regulator should be able to apply different decision criteria to different elements of the proposal.²⁶

The Expert Panel also made the following observations regarding prescription that should be included in the Rules.

"In terms of the level of discretion given to the regulator through the Rules, this raises a number of conflicting objectives, particularly from the viewpoint of regulated entities. Prescription in the Rules promotes certainty and stability of regulatory outcomes. It also assists in promoting a transparent commercial and policy assessment of the regulatory approach, given the nature of the Rule making process that now applies under the NEL and that is to be included in the NGL. Conversely, a high level of prescription reduces the regulator's ability to accommodate the particular circumstances of individual market participants in regulatory decisions."²⁷

The extent of codification or discretion will be dependent upon the nature and circumstances existing for each particular component of the regulatory regime. Consider as an example, where an element of the regulatory framework applicable to a given industry has received

²⁵ Expert Panel on Energy Access Pricing 2006, 'Report to the Ministerial Council on Energy', April 2006, p.84

²⁶ Ibid, p.60.

²⁷ Ibid, p.26

consistent regulatory treatment in successive regulatory decisions and is unlikely to change frequently over time. In such circumstances, it will be more appropriate to codify the decision framework regarding that issue. While this was the intent of the ACCC's Statement of Regulatory Principles (SRP),²⁸ the SRP was not a binding framework. Thus, the Commission's approach of codifying many key aspects of the SRP through the Revenue Rule, represents a step in the evolution of 'fit for purpose' rule making.

The Commission's approach to the codification of processes and methodologies and decision criteria are discussed in the following sections.

2.2.1 Codification of processes

The Commission considers that well designed procedural requirements assist in ensuring that the regulator administers the regulatory regime in an appropriate manner. This includes providing opportunities for regulated businesses and interested stakeholders to make submissions to the regulator and the opportunity for full and thorough analysis of the submissions and the regulator's decisions (including draft decisions). Transparent decision making in this way is conducive to reducing regulatory risk, and the probability of error and decreasing the administrative costs of regulation. Appropriate time constraints within this process also assist in ensuring that regulatory decision-making is timely and efficient.

The Commission's Revenue Rule formalises the procedural requirements for making regulatory determinations by codifying a process that requires regulated businesses to submit a Revenue Proposal at the commencement of the regulatory period, specifies how the regulator is to respond to the Proposal in making its decision and sets out the key elements of the regulatory process. These rules give the AER and regulated businesses some flexibility to vary the regulatory procedures timetable to suit the circumstances of individual cases within the overall requirement of a fixed timeframe within which a final determination must be made (13 months).

The imposition of a fixed 13 month timeframe reflects the Commission's recognition of concerns expressed in various reviews of economic regulation, including those by the Productivity Commission and Export Taskforce, that considerable delays in decision making about the economic regulation of significant infrastructure not only adversely affects the regulated business but also the economy as a whole.

2.2.2 Codification of Methodology and decision making criteria

The Commission notes that there is very little guidance or restriction on the decision making discretion of the AER in the current National Electricity Rules. The regulator is essentially free to decide what it considers to be the best revenue requirement with regard to the very high level principles set out in the Rules.

While the majority of submissions to this Review process supported a continuation of the general approach to revenue cap regulation embodied in the SRP (with variations on matters

²⁸ ACCC 2004, 'Statement of principles for the regulation of electricity transmission revenues', 8 December 2004

of detail) there was widespread support amongst market participants for elevating to the Rules the key elements of the SRP in order to increase the transparency, clarity and predictability of the regulatory decision making.²⁹

The Commission has concluded that there is significant benefit in specifying in the Rules the methodology for the determination of revenue caps. Through this Review the Commission has therefore codified the continuation of the general building blocks approach to revenue cap regulation embodied in the ACCC's SRP.³⁰ By elevating to the Rules the key elements of the SRP, the transparency, clarity and predictability of regulatory decision making is increased thereby supporting the promotion of the NEM objective. As a result, the Revenue Rule provides a greater degree of direction and guidance about the regulatory principles and procedures for making revenue determinations from that contained in Part B of Chapter 6 of the current Rules.

However, the Commission also recognises that having specified a methodology in Rules there are consequences from conferring on regulators either insufficient or excessive discretion in applying the methodology. Insufficient specification in Rules can lead to uncertainty and inconsistency which can impact adversely on long term investment, while insufficient discretion can limit the ability of the regulator to respond flexibly to the different market and commercial circumstances of individual regulated businesses.

Good regulatory design dictates that, irrespective of the extent to which the Rules for economic regulation may codify the methodologies to be adopted by regulated businesses and regulators, the Rules should confer on the regulator areas of discretion. This is because good economic regulation cannot be reduced to an entirely mechanical exercise. Each exercise of regulation involves applying rules and principles to the particular circumstances of individual businesses operating in potentially different environments. Good economic regulation incorporates options and flexibility so that outcomes can be tailored to the individual case.

The Revenue Rule provides the AER with discretion to exercise judgement in relation to the following elements of the building blocks revenue determination methodology:

- asset values are rolled forward using a model to be determined by the AER after the initial values are specified in the Rules;³¹
- initial WACC methodology and parameters to be specified in the Rules (based on the current requirements of the SRP) and are required to be reviewed and determined by the AER every five years (see section 5.5);³²

²⁹ EnergyAustralia, 20 March 2006, pp.5-6 and Electricity Transmission Network Owners' Forum, March 2006, p.21

³⁰ ACCC 2004, 'Statement of principles for the regulation of electricity transmission revenues', 8 December 2004.

³¹ Draft Rule, clauses 6A.6.1 and S6A.2.1

³² Clause 6A.6.2

- depreciation schedules to be nominated by the TNSP, accepted by the AER if they conform with Rules requirements or otherwise as determined by the AER;³³
- forecast capital and operating expenditure to be approved by the AER if it is satisfied that the TNSP's estimate reasonably reflects efficient costs, costs incurred by a prudent TNSP in the position of the TNSP and realistic forecasts of demand and cost inputs, having been assessed against a list of factors specified in the Rules;³⁴ and
- cost efficiency and service performance incentive schemes to be developed by the AER and the AER to approve parameter values proposed by the TNSP if they comply with the requirements of the scheme.³⁵

In relation to these areas of regulatory discretion, the Revenue Rule also provides guidance on how the discretions are to be exercised. For instance, the approach to assessing proposed forecast operating and capital expenditure in the Revenue Rule is an example of the Rules providing appropriate decision making discretion to the regulator (given the inherent uncertainty of such forecasts) with specific guidance on how that discretion is to be exercised. In other areas where the AER is provided discretion in the exercise of its regulatory function, the Commission has sought to provide additional certainty via requirements for the regulator to consult and develop guidelines.

The Commission considers that the Revenue Rule strikes an appropriate balance between codification of methodology and decision making criteria and the exercise of guided regulatory discretion. These features of good regulatory design will, over time, increase the predictability and consistency of regulatory decision making and facilitate the promotion of the NEM objective.

³³ Clause 6A.6.3

³⁴ Clauses 6A.6.6 and 6A.6.7

³⁵ Clauses 6A.6.5 and 6A.7.4

3. Scope of Regulation

This chapter addresses the extent to which transmission services should be subject to economic regulation, and where they are regulated, the forms of regulation that should be applied.

Consistent with generally accepted policy and regulatory thinking,³⁶ the Commission concluded early in the Review process that more intrusive forms of economic regulation (such as revenue or price cap regulation) should be confined to those services that are supplied under monopoly (or near monopoly) conditions, with less intrusive forms of regulation, or no regulation, being applied to services supplied under conditions where there is limited market power or the potential for competitive supply.

The approach to addressing the scope and form of regulation reflects the need to ensure that the benefits of regulation (e.g., more efficient resource use) are greater than its direct and indirect costs (including the potential for regulatory error and induced inefficiencies). It also reflects the view that there has been an over-inclusion under the revenue cap form of regulation of services where there is countervailing buyer power or the potential for contestable supply conditions. In these circumstances it would be more appropriate for services to be subject to either less intrusive forms of regulation or no regulation at all.

Therefore, a tiered approach has been adopted for the regulation of transmission services that seeks to ensure that the form of regulation applied to different classes of service is commensurate with the degree of market power involved in their supply.

The Commission has concluded that the existing definitions of what services are regulated in the Rules are unclear, circular and require amending. It has also concluded that the scope and form of regulation is more appropriately determined on the basis of the functional and economic characteristics of services provided by the TNSPs, rather than on the basis of the assets involved in the delivery of services.

On this basis the Commission identified two categories of transmission service:

- Prescribed Transmission Services – defined as 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 and in Schedule 5.1 and 5.1(a) of the Rules; and
- Negotiated Transmission Services – defined as connection services (exit, entry and TNSP-to-TNSP connection services); use of system services supplied by a shared transmission network which exceed the network performance requirements specified under any legislation in a participating jurisdiction or under Schedule 5.1 and 5.1(a) of the Rules; and use of system services in respect of agreed transmission augmentations or extensions for loads, generators and Market Network Service Providers (MNSPs).

³⁶ Expert Panel on Energy Access Pricing, 'Report to the Ministerial Council on Energy', April 2006 Chapter 4, Productivity Commission 'Review of the Gas Access Regime', [date] chapters 7 – 8

The Commission has decided that different forms of regulation should apply to each of these types of transmission services, reflecting its assessment of differences in the degree of market power applying to each.

This chapter describes the general approach developed in the Draft Rule and refined in the Revenue Rule, focusing particularly on the areas where the approach has been changed during the Review process. Those areas are:

- the delineation of prescribed and negotiated transmission services;
- cost allocation between prescribed and negotiated transmission services;
- clarification that contestable services are outside of the scope of regulation;
- the form of regulation to be applied to different services; and
- the scope of the proposed dispute resolution scheme for negotiated transmission services.

3.1 Delineation of services

A fundamental element of the Rules for determining the scope and form of regulation relates to the delineation of services. This involves the specification of service definitions that enable industry participants to readily identify those electricity transmission services that are subject to various forms of price, revenue or service regulation under the NEL.

There is a strong case for defining as clearly as possible the prescribed transmission services that are to be subject to direct revenue or price regulation and for distinguishing them from services that are amenable to less intrusive forms of regulation (namely commercial negotiation) or no regulation at all.

Such an approach reduces the overall burden of regulation. It also prevents the crowding out of potential efficiency benefits that would otherwise arise from increasing the opportunities for commercial negotiation of the prices and conditions of supply, for contestable third party provision of services and for the adoption of non-network solutions where feasible.

This Review has sought to overcome the evident circularity and ambiguity of the current definitions of prescribed services, excluded services and negotiable and contestable services which has arisen from the current multi-layered approach to the regulation of transmission services (e.g., by excluding certain negotiable services from the revenue cap and providing for lighter-handed regulation of contestable services).

As a result of the ambiguity of these definitions in the Rules, the Commission understands that the current practices of different TNSPs in allocating assets (and therefore costs) to prescribed services differs markedly such that charges for essentially the same connection service may vary widely across the NEM, with no underlying rationale. In addition, such ambiguity potentially creates an environment in which TNSPs could engage in double dipping by recovering certain costs in both prescribed and connection service charges or an over-inclusion of assets into the RAB.

The Commission believes that improvements in cost and performance efficiency can be obtained by requiring TNSPs to negotiate prices, terms and conditions for dedicated service and non-standard use of system services directly with generators and large users. Such bilateral negotiations outside the revenue cap would subject the costs incurred by the TNSPs to commercial testing by informed and self-interested users who, with the support of a right to independent dispute arbitration, would be in a position to apply considerable countervailing negotiation power.

The definitions specified in the Revenue Rule therefore reflect the Commission's view that it is important for the Rules to establish clearer definitions and classifications of different services according to the degree of market power involved in their supply and to clearly specify the form of economic regulation to be applied to each class of service. This approach is consistent with the findings of the Expert Panel.³⁷

On this basis the Commission has set the classification of shared network use of system services with regard to specified performance standards as prescribed transmission services reflects their natural monopoly characteristics, the absence countervailing buyer power and the large associated externalities. Negotiated transmission services have been maintained as a separate service classification and are limited to those service characterised by limited market power, or countervailing market power.

3.1.1 Commission's analysis and reasoning

In responding to the approach proposed for the Rules, most submissions agreed that clearer definitions are required for the services that are to be subject to the main revenue cap form of regulation and of the services that are to be subject to different forms of regulation.³⁸

However, not all agreed that the definitions proposed in the Draft Revenue Rule provided sufficient delineation between prescribed and negotiated service and some considered there to be insufficient scope for allocation and recovery of certain shared transmission costs.³⁹ Specifically, the Electricity Transmission Network Owners Forum expressed concern that certain costs should not 'fall between the cracks' with regard to service definitions and their associated cost allocations. The ETNOF stated concern that the following items were not 'omitted' from the Draft Rule definition of prescribed transmission services:

- services resulting from an application of the market benefits limb of the regulatory test;
- services required by the Rules but not by NEMMCO (for example, the provision of information to the market, such as outage information and augmentation plans);

³⁷ Expert Panel on Energy Access Pricing, 'Report to the Ministerial Council on Energy', April 2006, pp.41-42, 56-57

³⁸ Ergon Energy, 20 March 2006 p.2, Hydro Tasmania 20 March 2006, p.3, Electricity Transmission Network Owners' Forum, 20 March 2006, pp.6,27, Australian Energy Regulator, 7 July 2006 p.49, Integral Energy, 28 March 2006, pp.1-2, Economic Regulation Authority, Western Australia, 20 March 2006, p.3, Energy Users' Association of Australia, 4 April 2006 p.ii

³⁹ The Group, September 2006; ETNOF, September 2006; and NEMCO, September 2006

- services required by NEMMCO to be provided under the Rules in addition to those necessary to ensure the integrity of the transmission network (for example, communications services to support market operations); and
- where, as a result of efficient pre-building of capacity, services may currently exceed the requirements of jurisdictional electricity legislation or exceed the requirements of schedule 5.1a or 5.1.⁴⁰

Throughout the Review the Commission has sought to define prescribed transmission services in a manner which encapsulates a reasonably objective description of the ‘quality’ attributes of the service, so there can be a clear delineation of shared transmission services which exceed or do not meet the network performance requirements.

The Revenue Rule relies, in part, upon Schedule 5.1 and 5.1a of the Rules to delineate between: shared network services that should remain part of prescribed transmission services; and shared network services provided to a requirement that exceeds those of a standard service that should be subject to commercial negotiation. However, efficient pre-building of capacity for the benefit of the shared network could result in the network exceeding the requirements of Schedule 5.1 and 5.1a. Under the Draft Revenue Rule a Prescribed Transmission Service cannot exceed the network performance requirements, in such a case it would be considered a Negotiated Transmission Service. The Commission accepts however, that efficient pre-building is a normal part of providing Prescribed Transmission Services. Therefore, it is important that the Rules clearly articulate that such pre-building should fall within the definition of Prescribed Transmission Services rather than Negotiated Transmission Services.

In the Revenue Rule the Commission has clarified the definition of Prescribed Transmission Service to allow for an occurrence where a shared transmission service may exceed the standard network performance requirements but still provides what should be a Prescribed Transmission Services. This has been achieved by including in the definition a service that is an “above-standard system shared transmission services”. An “above-standard system shared transmission service” is a service that exceeds the network performance requirements referred to in paragraph (a)1 or (2) of the definition of Negotiated Transmission Service principally as a consequence of investments that have system-wide benefits.

The Commission considers that the increased clarity provided in the Rules on the definition of services should ensure that services are allocated on an appropriate basis. The Rules are now drafted in such a manner to provide a clear delineation between services that are a normal part of the standard service and those that result from a request for service or the negotiation of a service different from the normal standard service. Due to this clear delineation, it has not been necessary to draft Rules that explicitly provide for every individual service that a TNSP may undertake.

The Commission also agrees that any costs associated with investments which have satisfied the Regulatory Test should not be allocated to negotiated services (unless a user has elected

⁴⁰ ETNOF, September 2006, p. 13

to make a funded augmentation for commercial reasons). Investments associated with an approved application under the Regulatory Test contribute to shared transmission services and therefore should be included in the RAB and revenue cap. However, this issue is best resolved through the Revenue Rule's cost allocation principles rather than through the definition of prescribed transmission services.

The Group was of the view that a definition of contestable services should be included in order to avoid disputes in the future. The Commission does not support this view. If a service is contestable it is provided by more than one provider in the participating jurisdiction. If there is no other provider in the jurisdiction that can provide the service it is clearly not a contestable service. This will be a question of fact which depends upon the individual circumstances. If there are disputes about whether a service is capable of competitive supply these disputes should be resolved, including through a dispute resolution procedure, on the facts of each case.

3.2 Form of regulation

The form of regulation has been specified by taking into account the level of market power of the service provider and any countervailing power associated with each of the defined services. The following section sets out the Commission's considerations and reasoning with regard to the appropriate form of regulation.

The Commission maintains the view that a revenue cap methodology using a building blocks approach is the appropriate form of regulation for prescribed transmission services at this stage of development of the NEM, given the extensive network externalities and potential market power associated with the shared transmission network. The specification of a revenue cap approach in the Revenue Rules provides consistency and certainty for TNSPs and their customers in the absence of a persuasive reason for making a change.

A CPI -X revenue cap approach allows for the recovery of efficient costs while providing incentives for future cost efficiency, consistent with the requirements of the NEL.⁴¹ Such incentives are not present under a cost of service regulatory approach. The Commission has also concluded that the building block approach remains preferable to alternative regulatory approaches which utilise industry-wide benchmarks (such as total factor productivity (TFP) based approaches) in view of the lumpiness and uniqueness of shared transmission network costs.^{42,43} The Commission considers that the revenue cap approach contained in the Revenue

⁴¹ Section 35(3)(a)&(b), NEL

⁴² Australian Energy Market Commission, 'Rule Proposal Report', February 2006, p.35. See also Expert Panel on Energy Access Pricing, 'Report to the Ministerial Council on Energy', April 2006 p.105; In proposing that the development of TFP-based approaches for energy access regulation would be worthwhile, the Panel observed that "...the case for TFP appears less compelling in electricity transmission, where significant lumpiness of future capital expenditure demands is an important part of the industry landscape."

⁴³ However, the Commission recognises that TFP indices may prove useful in the context of applying a building block approach. For example, in considering expenditure forecasts or as a means of benchmarking the derived X factors.

Rule is more appropriate for the regulation of prescribed transmission services than a tariff basket or price cap as the costs of shared network services are largely fixed and do not vary significantly with the quantity of service provided. A revenue cap, therefore, minimises the largely unmanageable volume risk for the TNSPs.

For negotiated transmission services, the Commission believes that there are fewer market failure concerns, therefore, a less intrusive (and therefore less costly) form of regulation has been applied in the Revenue Rule. In particular, the end-user for these services is likely to be larger and better resourced, acting as a counterweight to the market power possessed by the TNSP. Moreover, requiring generators and large end-users to negotiate with TNSPs about the recovery of costs directly incurred by the TNSP as a consequence of their connection will ensure that the efficiency of those costs is subject to increased scrutiny. The Revenue Rule therefore specifies a commercial negotiation regime for these services supported by an effective dispute resolution regime.

In this regard, the Commission has received a number of submissions which stated that the arbitration provisions should be specified to include non-price issues and that the Draft Rule limiting of arbitration to price based issues is unduly restricting. Moreover, this limitation may lead to service and reliability standards becoming the unfettered mechanism of adjustment to accommodate pricing outcomes achieved through arbitration.

The Commission agrees that it is not desirable to limit arbitration to pricing matters as this could limit the parties' ability to arbitrate innovative solutions to user needs including by varying the package of price, service and reliability offerings to meet customised needs. In addition the outcome of TNSPs using service and reliability levels as an adjustment mechanism to accommodate pricing outcomes achieved through arbitration is not consistent with the NEM objective.

The Commission believes it would be desirable to include within the Rules a comprehensive commercial arbitration framework for non-price outcomes with regard to both negotiated and prescribed transmission services. However, the Commission is reviewing the implementation of such a regime in the context of the Pricing Rules, and if feasible, would strongly support its inclusion in the Rules.

The MEU considered that the AER is best placed to provide the arbitrator role due to its economic and cost knowledge and already being a party to the industry. They proposed that the Rules nominate the AER as the relevant arbiter rather than third party commercial arbitrators.⁴⁴

The Revenue Rule provides for the AER to refer matters of dispute regarding the price of negotiated transmission services to an independent commercial arbitrator who is required by the Rules to make a decision within 30 days. The Commission maintains the view that it is important that the arbitrator be skilled in dispute resolution techniques and have regard to the negotiation framework/criteria set out by the AER in the relevant Revenue Determination. However, considering the commercial nature of these negotiations and with

⁴⁴ Major Energy Users, September 2006, pp.20-21

an interest in maintaining a timely arbitration process, the Commission has retained the use of commercial arbitrators given their skill in commercial dispute resolution and likely proficiency in resolving disputes within the required 30 day timeframe. In addition, it ensures that the costs of arbitration are remain with the negotiating parties.

4. Key Transmission Revenue Rule Issues

The elements of the Commission's Draft Rule for revenue regulation that have attracted particular comment are the treatment of expenditure forecasts, the contingent projects and revenue cap reopening regimes, and the requirement for AER-developed guidelines.

These components of the regulatory regime represent particular examples of the 'fit for purpose' approach the Commission has adopted in developing the Revenue Rule. For example, the decision criteria for expenditure forecasts provide specific guidance for both the regulated business and the regulator in relation to the development of reasonable expenditure forecasts. The contingent projects regime reflects the need to ensure there is appropriate flexibility for the treatment of uncertain projects in an *ex ante* regime. The requirement for guidelines gives effect to the Commission's approach of providing the AER with guided discretion in those areas that require a detailed knowledge of matters between the regulator and the regulated business.

This chapter describes the Commission's treatment of these components of the revenue cap determination model in the Revenue Rule and its responses to the submissions which commented on these issues during the Review.

First, the chapter considers the regime for the approval or determination of expenditure forecasts. Second, the approach adopted for the contingent projects regime is described including where changes have been made to this regime in response to submissions. The arrangements for reopening the revenue cap will also be discussed in this section. Third, the chapter discussed the approach of codifying the use of guidelines, and the associated requirements for the development and review of such guidelines, in those areas where the regulator has guided discretion in the exercise of its regulatory decision making powers.

4.1 Treatment of Expenditure Forecasts

4.1.1 Background

Under the current rules, the criteria for making regulatory decisions have not always been clear. How the regulator would assess submissions by the TNSPs and what sources of evidence it would use have not been expressly articulated in Rules. Therefore, in establishing a framework for the decision criteria relating to expenditure forecasts the Commission has sought to reduce the scope for uncertainty and risk in a number of areas. Through the consultation process of this Review, different stakeholder groups have emphasised that a high level of regulatory discretion and uncertainty in this area increases the risk and decreases the predictability of decisions. In addition, stakeholders consider that insufficient regulatory discretion can result in inefficient costs and prices through the increased scope for regulated businesses to benefit from their market power.

The Commission has sought to make improvements in this area by giving clear guidance to the regulator and the TNSP on the process and criteria for making decisions. In developing the decision criteria for expenditure forecasts the Commission sought to ensure that the assessment of forecasts encourages efficiency through least cost operations and timely and prudent investment in capital.

In the Draft Rule the Commission adopted a decision rule for capital and operating expenditure that sought to ensure the forecast was a reasonable estimate of the TNSP's

requirements with regard to a number of criteria. This decision rule was designed to recognise the inherent uncertainty of expenditure forecasting in the context of economic regulation. The approach expressly required the AER to make the determination regarding the reasonableness of the forecasts and gave guidance in the Rules regarding the criteria and evidentiary matters the AER must have regard to in making that determination.

4.1.2 Submissions and consultation

Since the commencement of the Commission's review process there has been a broad ranging debate around the appropriate test for the determination of expenditure forecasts. In addition to submissions to this review this issue has been the focus of a number of other reviews such as the Export and Infrastructure Taskforce and the Expert Panel on Access Pricing. Submissions discussing the expenditure forecast test contained in the Draft Rule tended to focus on the list of criteria that the regulator is to have regard to. A further discussion of these submissions and the Commission's response can be found in section 5.2 of this Rule Determination.

The decision criteria for expenditure forecasts has also been under consideration in the context of the development of rules for the regulation of electricity distribution networks. That process prompted the Department of Industry, Tourism and Resources (DITR) to seek legal advice from the Australian Government Solicitor (AGS) (the AGS advice⁴⁵) on a number of matters related to expenditure forecasts. DITR published this advice and made it available to the Commission with a view to informing the debate.

The Commission considered the AGS advice an aspect of the Review that required further comment and therefore sought comments from interested parties on some of the questions the advice raised. Among others, the AGS addressed the following questions:

- When given a total estimate of operating and capital expenditure with information that meets the submission guidelines, does the AER need to make a determination of whether that total is a reasonable estimate?
- What is the nature of the discretion of the AER to reject what it considers to be an unreasonable proposal?
- Would there be a range of totals that the AER must accept under the AEMC Rule?
- Would a formulation that required the AER to determine whether the total was the 'best estimate that is reasonably possible in the circumstances result in the greater discretion for the regulator to reject proposals that it considers to be inefficiently high?

In summary, while also expressing some views on the policy issues that are involved, the AGS opined that in the context of the Draft Rules:

⁴⁵ Legal Advice from the Australian Government Solicitor (10 October 2006) "Assessment of expenditure forecasts"

- the AER cannot substitute a new total unless it reaches a decision that the proposed total is not reasonable, requiring a decision that the proposed total is unreasonable before the AER can substitute an alternative total;
- given the inherent uncertainty of forecasting and factors which lead to divergent conclusions, a number of different totals may be seen as reasonable and any of which would necessarily have to be accepted by the AER under the Commission's Draft Rule (para.42 AGS advice); and
- an appropriately worded 'best estimate' test would make it clear that the AER should assess whether the proposal is the optimal total amount and give the AER discretion to substitute a better total when it is not satisfied with that proposed by a service provider.⁴⁶

In particular, in relation to the interpretation of what will be a reasonable estimate the AGS found:

*"The reasonable estimate decision framework based on the twelve factors does enable the AER to reject total forecasts which are not based upon reason, or exceed the limits prescribed by reason, after critically analysing all the evidence. However, the use of the 'reasonable estimate' test, uncertainty in forecasting, the existing case law in Gasnet and Telstra and the role of the pricing principles in resolving conflict, will result in the AER being required to accept a range of forecasts higher than those it would determine as the most appropriate or best estimate."*⁴⁷

Stakeholder views in response to the AGS advice and the further consultation sought by the Commission focused on three key areas:

- the potential for upward bias associated with a reasonable estimate test;
- uncertainty created by the terminology; and
- the ability to determinate a clear 'best' estimate.

These issues are addressed in turn below.

4.1.2.1 Potential for upwardly biased estimates

The AGS expressed the view that the reasonable estimate test would require the AER to accept forecasts within the set of reasonable estimates higher than the forecast it would determine as the most appropriate or best estimate. A number of submissions expressed concern should this be the outcome of the Rule.

⁴⁶ Legal Advice from the Australian Government Solicitor (10 October 2006) "Assessment of expenditure forecasts", p.3

⁴⁷ Legal Advice from the Australian Government Solicitor (10 October 2006) "Assessment of expenditure forecasts, paragraph.53

Submissions taking this view considered that the Rule developed by the Commission unduly constrained the regulator from making a determination that provided symmetry and protected the interests of consumers. These submissions believed that the regulatory regime should provide for balanced decision-making such that the views and interests of consumers can be adequately represented in the regime. For instance CUAC stated:

“CUAC agrees with the Commission that incentives for strategic behaviour by regulated entities are a reality in a regulatory process. But it must be remembered that the cost of that behaviour is ultimately borne by consumers, who have no ability to choose alternate suppliers and very limited capacity to question those costs. Consumers therefore rely heavily on the regulator to ensure that prices are fair. As such, CUAC strongly believes that regulators must have sufficient authority to identify and minimize gaming by regulated entities. We do not believe that the draft Rules convey that authority to the AER.”⁴⁸

PIAC supported this view stating that affording discretion to the regulator is an important element in achieving the balance required to service the long-term interests of consumers. In addition, PIAC stated that the potential for reviews of regulatory decisions should be regarded as a further step in achieving an appropriate balance between the interests of the supply businesses and end-users.⁴⁹

The EUAA was also concerned that the use of a term such as reasonable would lead to an upward bias in favour of the businesses. In particular, it believed that the use of a term such as reasonable without maintaining the primary emphasis on efficiency greatly risked skewing outcomes towards the interests of regulated businesses. This would allow them to become less efficient and more profitable at the expense of end-users.⁵⁰

An opinion obtained by the ETNOF from Stephen Gageler SC (Gageler Opinion) considered the potential for the reasonable estimate test to lead to an upward bias in outcomes and provided an alternative view on the matter. In particular the Gageler Opinion stated:

“We agree with the observation in paragraph [42] of the AGS advice that the likelihood is that “there will be a number of total forecasts that are “reasonably open” to a TNSP in the sense that each can be described as a “reasonable estimate”. If any of them is proffered by the TNSP, it would have to be accepted by the AER. That is the logical corollary of the fact that there can be no uniquely correct or preferable or appropriate forecast and of the fact that it is for the AER in the first instance not to determine a forecast for itself but to determine whether the forecast proffered by the TNSP is the product of sound judgement. We do not see it as an invitation to exploitation. A TNSP which sought deliberately to adopt a forecast at the upper end of what it considered the AER might be prepared to accept as a “reasonable estimate” would be in breach of its obligation under cl 6A.6.6(a) or cl 6A.6.7(a) to include in a Revenue Proposal a forecast of expenditure which the TNSP genuinely considers to be reasonably required. The TNSP would also run the

⁴⁸ Consumer Utilities Advocacy Centre, 20 October 2006, p.2.

⁴⁹ Public Interest Advocacy Centre, 19 October 2006, p.2.

⁵⁰ Energy Users Association of Australia, 20 October 2006, p.3.

significant risk of overreaching and of thereby allowing the AER to make and substitute its own estimate.”⁵¹

4.1.2.2 Certainty and predictability

Some submissions expressed the view that uncertainty has been created by the reasonable estimate terminology. The opposing legal views of the AGS and Gageler are indicative of the differing legal interpretations that can be placed on that terminology. A number of submissions therefore, called for increased clarity in the drafting of the Rules. The MEU, for instance, stated the following:

“Whether the AEMC is of the view that the Rules, as written, might not result in the outcome feared by consumers is not the issue. The Rules should make it abundantly clear that the AER is not bound as feared: there is no merit in leaving this issue to future doubt.”⁵²

CUAC considered that ‘reasonable estimate’ remained too broad to provide sufficient guidance and discretion to the regulator in making a price determination in accordance with the NEM objective.⁵³ The AER also was of the view that the clarity of the Rules would be improved if the reasonable estimate test was removed.⁵⁴

4.1.2.3 Determination of a ‘best’ estimate

A number of submissions expressed concern about the prospect raised in the AGS advice of a decision rule requiring the AER to determine the ‘best estimate that is reasonably possible in the circumstances’. Submissions that responded on this point were of the view that it is not possible for a regulator or the TNSP to determine a best or ‘optimum’ forecast. To illustrate this point the CitiPower and Powercor submission stated the following:

“The Australian Competition Tribunal decision in Application by Gasnet Australia (as quoted by the AGS advice page 9) however makes it clear that in analogous circumstances (setting a tariff under the Gas Code) there is no ‘single correct figure’ when forecasting such matters and that ‘different minds acting reasonably can be expected to make different choices within a range of possible choices’. In this circumstance it appears peculiar that the AGS advice then proposes that the AER will determine an ‘optimal amount’ or ‘best estimate’, which presupposes that a single ‘correct’ or best figure exists.”⁵⁵

Submissions opposed to the ‘best estimate’ test believed that it will increase the risk of regulatory error and provide disincentives for long-term investment in infrastructure assets. For instance, EnergyAustralia demonstrated the risks of regulatory error and the impact of

⁵¹ Legal Advice provided to ETNOF by Stephen Gageler SC, 25 October 2006, paragraph 16.

⁵² Major Energy Users, 16 October 2006, p.3.

⁵³ Customer Utilities Advocacy Centre, 20 October 2006, p.2.

⁵⁴ Australian Energy Regulator, p.3.

⁵⁵ Citipower & Powercor, 20 October 2006, para 13.

those risks on the safe and reliable operation of the transmission network with reference to a “disallowed” regime for replacing circuit breakers.⁵⁶

The Gageler Opinion also made reference to the use of a best estimate test, in particular it stated:

“The AER would no longer be asking whether the forecast proffered was the product of sound judgment but whether it was the product of a right judgment in the sense of it being a judgment that coincided precisely with its own.”

*In effect, the AER would be empowered to simply make its own estimate.*⁵⁷

Accepting the view that a ‘best estimate’ test would effectively allow the AER to making its own estimate, some submissions considered that this removed the incentives for the businesses to provide a robust and realistic proposal. For instance AGL stated in its submission that under a ‘best estimate’ test the service provider is more likely to build an ambit claim into its forecasts in the anticipation of a negotiation with the regulator.⁵⁸

4.1.3 Commission Analysis and Reasoning

Having considered the various legal opinions, the views expressed in submissions and conducted its own further analysis, the AEMC has concluded that further clarification of its policy intention in relation to the framework for the determination of the capital and operating expenditure forecasts in the Rules.

Before addressing that matter in detail, however, it is worth re-emphasising that the essence of the debate that has arisen on this issue is concerned with striking an appropriate balance between competing policy objectives and stakeholder interests that arise in the context of regulating natural monopoly infrastructure such as electricity transmission services.

On the one hand, economic regulation is adopted to address the costs and inefficiencies that can result from the capacity of TNSPs to exercise market power, while at the same time providing incentives for them to invest in and operate their networks efficiently. On the other hand, economic regulation is an imperfect substitute for effective competition and the potential for regulatory error can also impose costs and inefficiencies, including in relation to the incentive and financial capacity to undertake long-term investments in transmission infrastructure.

In the Draft Rule the Commission sought to address the inefficiencies that can arise from both market and regulatory failure, by developing a well specified, transparent and balanced regulatory framework which clarified the rights and obligations of both TNSPs and the AER in the regulatory decision-making process. This included requirements for full information

⁵⁶ EnergyAustralia, 19 October, pp.6-8.

⁵⁷ Legal Advice provided to ETNOF by Stephen Gageler SC, 25 October 2006, paragraphs 31 and 32

⁵⁸ AGL, 20 October 2006, p.2.

disclosure by TNSPs, identification of the areas of decision-making discretion to be exercised by the AER and guidance in the Rules regarding the exercise of this discretion by the AER.

For example the Draft Rule specified the following methodologies and procedures to be adopted by TNSPs and the AER during the regulatory decision-making process:

- the AER to determine, through development of submission guidelines, the form of the TNSP's proposal and the necessary supporting information;
- the AER to develop a PTRM model in accordance with specifications in the Rules to be applied to all businesses;
- specification on the determination of the opening RAB with AER guidelines on the manner in which it is to be rolled forward.
- the WACC methodology and parameters to be specified in the Rules with periodic review by the AER;
- the AER to determine, through development of models and guidelines, incentive mechanisms to be adopted by TNSP's in building their revenue cap proposal;
- specification of the application of contingent project, pass through and re-opening regimes; and
- the AER to develop cost allocation guidelines in accordance with principles in the Rules.

The decision-making framework to be applied by the AER to the TNSPs' proposals in relation to expenditure forecasts therefore needs to be considered and evaluated in the broader context of the regulatory framework as a whole and the balance it achieves between the competing policy objectives and interests that are involved.

The Draft Rules required the TNSPs to include in their Revenue Proposals forecasts of both capital and operating expenditure for the regulatory period that they consider to be required to satisfy expected demand, to comply with applicable regulatory obligations and to maintain the reliability and security of prescribed transmission services and the transmission system. The expenditure forecasts submitted by the TNSPs were also required to comply with submission guidelines and the cost allocation methodology published by the AER.

Having received a TNSP's Revenue Proposal incorporating expenditure forecasts which reflect the TNSP's assessment of its expenditure requirements for the specified purposes and supported against the decision criteria, the AER was required by the Draft Rules to accept the TNSP's forecasts if it determined that they were reasonable estimates of the expenditure requirements after taking into account the specified criteria. The criteria the AER was to consider in making its determination included:

- the information provided in the TNSP's Revenue Proposal;
- submissions received during consultation;
- analysis undertaken by the AER and published prior to or as part of the draft or final determinations;

- actual and expected operating and capital expenditure in preceding regulatory periods; and
- the reasonableness of the underlying demand forecasts and of benchmarks of operating and capital expenditure by an efficient TNSP.

If the AER determined that the forecasts were not reasonable estimates it was required to provide its reasons for that decision and to replace the TNSP's forecasts with those it considered to be reasonable estimates, providing its reasons in terms of the specified decision criteria.

The Commission considered that this approach achieved an appropriate balance between the risks of market failure and regulatory failure and between the interests of network service providers and users. It gave the TNSPs the opportunity to put forward a fully specified case in support of their expenditure forecasts while ensuring that the regulator's requirements in terms of information disclosure and cost allocation were satisfied. The approach also provided clear guidance to both TNSPs and the regulator regarding the purposes for which the expenditure is required and the criteria against which the forecasts and supporting materials were to be assessed by the AER.

The Draft Rules required the AER to exercise judgement in assessing the reasonableness of the forecasts in terms of the criteria and to reject the forecasts and replace them with its own if it found them to be not reasonable in terms of the assessment criteria. The Commission indicated in its Draft Rule Determination that it had adopted the "reasonable estimate" decision criterion in recognition of the reality that expenditure forecasting is necessarily conducted under conditions of uncertainty about future market demand and cost conditions and that no unique or correct forecast of future expenditure requirements can be made under those circumstances. The Commission took the view therefore that the AER should be required to assess the reasonableness of the forecasts and to only reject forecasts it considered to be not reasonable against the assessment criteria.

Since the publication of the Draft Rule Determination, and particularly since the publication by DITR of the legal opinion by the AGS, discussion on this issue has focussed on the interpretation of the "reasonable estimate" decision rule and its implications for the balance in regulatory decision-making between the interests of TNSPs and those of users of transmission services.

The views of stakeholders on this matter are divided as between representatives of network users and energy consumers and representatives of network service providers. User and consumers groups have expressed the general concern that the "reasonable estimate" decision-rule favours the interests of TNSPs by potentially biasing regulatory decisions towards the higher bound of estimates that are assessed by the AER as being reasonable and by limiting unduly the discretion of the AER to adopt expenditure forecasts which it considers would better satisfy the decision criteria in the Rules. However, representatives of network service providers have uniformly supported the approach adopted in the Draft Rule on the basis that it achieves an appropriate balance in requiring fully supported forecasts to be submitted by TNSPs and providing the AER with the discretion to reject and replace forecasts which it determines to be not reasonable in terms of the decision criteria.

Much of the debate about the "reasonable estimate" decision rule has focussed upon the question whether the rule strikes the appropriate balance between the interests of owners

and users in the context of level of costs and charges. The supplementary consultation process has allowed the Commission to reflect further on the various options for the decision rule for determining forecast expenditure and the need to balance the risks of a regime which may result in inefficient costs and charges being incurred and the risk of a regime which may result in errors in regulatory decision making such that appropriate expenditure is effectively disallowed with the risk of an adverse impact on reliability.

Having considered these stakeholder views and the various opinions on the legal interpretation of the wording of the Draft Rule and of possible alternative wording that could be adopted, the Commission has concluded that there is a need to further clarify its policy intention in relation to this matter and the wording used in the Rule to give effect to that intention.

The Commission has maintained the objective and intention of achieving an appropriate balance between the interests of network operators and users, consistent with the views of stakeholders on either side of the current debate. However it has also revised the structure and wording of the decision criteria to be applied in determining expenditure forecasts to better reflect the policy balance the Commission is seeking to achieve.

First, the Commission has better specified the objectives of the expenditure forecasts to be incorporated into the building block methodology. The Revenue Rule provides that a Revenue Proposal must include a total forecast operating/capital which the TNSP considers is required in order to meet the operating expenditure and capital expenditure “objectives”. The “objectives” are defined as: meeting expected demand; complying with applicable regulatory obligations; and maintaining quality, reliability and security of supply and of the system.

Second, the Commission has better specified the procedural requirements for expenditure forecast proposals. The Revenue Rule provides that the proposals must: comply with the requirements of the AER’s submission guidelines; be for expenditure properly allocated to prescribed transmission services in accordance with the Cost Allocation Methodology; and include both the total forecast expenditure and the forecast for each regulatory year.

Third the Commission has clarified the decision-making rule. The Revenue Rules provide that the AER must accept the TNSP’s forecast “if it is satisfied” that the forecast “reasonably reflects” efficient costs, the costs a prudent operator in the circumstances of the TNSP would require and a realistic expectation of demand and cost inputs. The Commission has also restructured the Rules to separately specify the evidentiary matters the AER should have regard to in undertaking its assessment including: the submissions made by the TNSP and interested parties; analysis presented by the TNSP in its proposal and by the AER itself (provided that it has been published); benchmark data; and the actual and expected expenditure of the TNSP during any preceding periods.

In formulating the Revenue Rule the Commission has been assisted by the advice of Mr Neil Williams SC and Dr Ruth Higgins in relation to the decision-making rule and criteria

adopted in the Draft Rule.⁵⁹ The Commission has not thought it appropriate for the Rules to impose a legal burden of proof in the manner that is commonly understood. The advice of Williams SC and Higgins makes it clear that no “burden of proof” arises. Of course the TNSP faces a practical hurdle that if it fails to provide sufficient information to enable the AER to be “satisfied” as to whether the proposal meets the decision rules its proposal will be rejected.

Further, the Commission did not think it appropriate to adopt a decision rule which required the AER to conclude that the TNSP’s proposal was “unreasonable” before it could reject it. Again the Commission has been assisted by the advice of Williams SC and Higgins which states that this is not the case. Rather the decision rule operates to require the AER to reject the TNSP’s proposal if it is not satisfied that it meets the criteria specified.

Finally, the Commission has elected to not use the language of “reasonable estimate” or “best estimate” in the decision rule. The Commission considers that the terms “reasonable estimate” and “best estimate” have accumulated considerable “baggage” in the course of the debate that has ensued from the publication of the AGS advice.

The Commission believes that the subject of the regulation – the forecast capital expenditure and operating expenditure for substantial, highly complex and technical infrastructure for a five-year period is not a matter that is amenable to the level of precision and confidence that would enable one to sensibly say there is one correct or “best” figure. It considers that Rules that could be interpreted in that way are likely to result in a heightened risk of regulatory error. Equally the Commission does not intend that the Rules contemplate such a range of permissible outcomes that there is a risk of inherent bias toward higher amounts.

Having regard to these considerations the Commission has elected to adopt a decision rule which requires the AER to accept the TNSP’s proposal if it is satisfied that the amount “reasonably reflects” efficient and prudent costs based on realistic estimates of forecast demand and cost inputs.

The Commission is satisfied that the Revenue Rule achieves an appropriate balance between the interests of TNSPs and network users and between the risks and costs of market and regulatory failure for the following reasons.

The Rule continues to provide the TNSPs with the opportunity of presenting a fully developed and supported Revenue Proposal to the AER, including in relation to the purposes for which the forecast expenditure is required and the assumptions and analysis on which the forecasts are based.

The requirement that TNSPs submit forecasts that comply with the AER’s submission guidelines and cost allocation methodology will ensure that they provide detailed submissions in support of their forecasts, reducing substantially the risks of regulatory error associated with the regulator’s information disadvantage and providing the basis for informed and meaningful participation in the decision-making process by other

⁵⁹ Legal Opinion to AEMC dated 24 October 2006.

stakeholders. The decision-making process set out in the Revenue Rule will also reduce the incentive for TNSPs to submit forecasts which represent ambit claims. Such exaggerated forecasts would be likely to fail to satisfy the decision criteria to be applied by the AER and therefore to run the risk of being rejected and replaced by the AER with a less favourable forecast.

The introduction of more objective, operationally focussed decision criteria for the AER's assessment of whether or not it is satisfied with the basis of the forecasts, removes to a considerable degree the subjectivity associated with criteria such as reasonable or best estimates of expenditure requirements.

While informed opinions may differ on what are efficient costs, costs of a prudent operator or realistic expectations of forecast demand and input costs in the circumstances facing the regulated entity, those matters can be tested readily by reference to objective evidence drawn from history, the performance and experience of comparable businesses and the assessments of electricity industry experts.

Under the Revenue Rule, the AER is required to exercise judgement in deciding whether it is satisfied that the forecasts reflect the specified criteria, having regard to the specified factors. However, the exercise of that judgement is constrained and guided by the need to be satisfied as to the efficiency and prudence of the forecast and that cost forecasts reflect realistic expectations. In exercising its judgement the AER must also have regard to the information provided in the TNSPs proposal and the other evidentiary considerations specified in the Rule. That is, the AER is not at large in being able to reject the TNSPs forecast and replace it with its own. It must also provide reasons in terms of the decision criteria and the factors for both a rejection of the forecasts and their replacement with forecasts that it considers do meet the requirements of the Rule.

The announced availability of limited merits review of AER decisions imposes a further discipline on the AER in its decision-making on the expenditure forecasts.

4.2 Contingent Projects

Contingent projects are identified capital projects that are sufficiently uncertain that they cannot be included in the maximum allowed revenue at a regulatory reset. The Draft Rule responded to concerns in submissions about the lack of a framework in the Proposed Rule for uncertain projects, by developing a mechanism for contingent projects in the Rule.

The Commission's framework modifies the methodology used by the ACCC, and outlined in the SRP, by requiring:

- the TNSP to identify projects with associated, objective trigger events at each regulatory reset;
- the AER to assess the proposed contingent projects against specified criteria;
- if and when the need for a contingent project is triggered, the TNSP to propose the forecast total expenditure; and
- the AER to accept the proposed expenditure if it determines that the expenditure estimate is reasonable, having assessed them against specified criteria.

The contingent projects rule complements and adds to the incentive arrangements TNSPs face when investing in capital. It seeks to provide an appropriate balance between providing incentives for investment and efficiency in the context of TNSP regulation.

4.2.1 Commission's Analysis and Reasoning

While there have been divergent views⁶⁰ as to the relative merits of a contingent projects regime, either in combination with, or in place of, provisions allowing for the reopening of the revenue cap in certain circumstances, the Commission has retained the contingent projects provisions in the Revenue Rule.

TNSPs, like most businesses, operate in an uncertain environment. Uncontrollable, external events as diverse as changes in economic growth, climate and regulatory obligations can alter the quantity and nature of the services required to be provided by TNSPs. In a normal competitive market, production and pricing behavior adjusts in response to these changes. In these markets, efficient producers are able to recover their costs and should generally earn at least a normal return on their investments. As highlighted above, the regulatory arrangements need to mimic the operation of a competitive market as closely as possible. That is, if TNSPs are required to respond to market demand by altering their production behavior and this requires unexpected investment in new network capacity, the arrangements need to provide for this.

Several regulatory mechanisms are available to manage the costs of meeting uncertain production/investment obligations. The Commission has adopted a modified version of the contingent projects mechanism as provided for by the ACCC in the SRP.

Under the SRP approach to contingent projects, the regulator sets a project-specific five year revenue cap in respect of each contingent project, commencing when the project is committed. After the end of the five year period, the actual depreciated expenditure is rolled into the RAB. This provides the TNSP with an incentive to minimise expenditure on the contingent project, even if the project is commissioned late in a regulatory control period.

The key reason for the Commission including a contingent project mechanism was concern that only having a revenue cap reopening provision created a hurdle that may be too high for TNSPs. As a result, this may cause the TNSPs to:

- argue for the inclusion of the costs of uncertain projects in the revenue cap, which may cause customers to pay for costs that are never incurred or for projects that are not efficient. Subsequently, this may result in more intrusive forms of regulation once the cost of this behavior becomes evident; and/or

⁶⁰ EnergyAustralia, 20 March 2006, p.22; Australian Energy Regulator, March 2006, p.40; Electricity Transmission Network Owners' Forum, March 2006, p.12; Energy Users Association of Australia, April 2006, p.27; Electricity Transmission Network Owners' Forum, September 2006, pp.8-11; Energy Users Association of Australia, April 2006, pp.27, 34; PIAC, September 2006, p.3

- avoid spending money on unexpected projects until the next regulatory period. In turn this may either deter or delay the projects that place additional unexpected demands on TNSP spending.

The contingent projects mechanism requires TNSPs to identify contingent projects (together with triggers) at each regulatory reset. If and when the need for a contingent project is triggered, the TNSP can propose the forecast total cost and timing of the project as well as a profile of expenditure for inclusion in the MAR during that regulatory period. The AER must accept the project cost, profile of expenditure and timing if it is satisfied that these proposed features reasonably reflect efficient and prudent costs based on realistic estimates of forecast demand and cost inputs with regard to a number of evidentiary factors.

The treatment of expenditure on the contingent project varies according to whether all the expenditure is expected to be incurred in the original (i.e., the first) regulatory period, or whether the expenditure is expected to spill over into the next (i.e., the second) regulatory period.

In the first case where the contingent project is expected to be completed within the first regulatory period, the TNSP would be allowed to recover a return on and of the forecast capital expenditure during that period. This means that if the TNSP under-spends on the project, it receives a reward equal to the return on and of the under-spend for the remainder of the first period. Conversely, if the TNSP overspends on the project, it faces a penalty equal to the return on and of the overspend for the remainder of the first period. In either case, the actual expenditure is rolled into the TNSP's RAB at the end of the first period. This means that the reward for under-spending or the penalty for overspending ceases at the end of the first regulatory period.

The alternative situation is where development of the contingent project is expected to commence in the first regulatory period but be completed in the second regulatory period. If the TNSP under-spends on the contingent project during the first regulatory period compared to the allowed expenditure profile for that period, the actual expenditure is rolled into the RAB at the end of the first period and the under-spent value is added to the forecast capital expenditure for that project for the second regulatory period. At the same time, the under-spend is not permitted to be taken into account in either:

- setting (i.e., reducing) the TNSP's forecast capital expenditure allowance for that contingent project in the second regulatory period; or
- setting (i.e., reducing) the TNSP's remaining (i.e., non-contingent) capital expenditure allowance for the second regulatory period.

Overall, this provides a strong incentive for TNSPs to operate efficiently and consistently seek to under-spend their contingent project allowances. Box 4.1 provides a worked example of the contingent projects regime.

Box. 4.1: Contingent project worked example

Assume that a contingent project is triggered in the fourth year of a regulatory period and that the total expected cost of the project is \$150 million. The project is expected to commence development in the fifth year of the first regulatory period and be completed

sometime in the second regulatory period. Further assume that the TNSP has proposed an expenditure profile of \$50 million for the fifth year of the first regulatory period, with the remaining \$100 million to be spent in the second regulatory period. If the TNSP actually spends only \$40 million in the final year of the first regulatory period, the \$40 million would be rolled into the RAB at the end of that first period and its capital expenditure allowance for that project in the second regulatory period would be the remaining \$100 million plus the \$10 million under spent amount (\$110 million in total). This allows the TNSP to earn a reward on that under spend (assuming it is permanent) until the end of the second regulatory period, at which time its actual expenditure would be rolled into its RAB and the reward would cease.

If, instead, the TNSP overspends on the contingent project during the first regulatory period, the actual expenditure would be rolled into the RAB at the end of the period and the overspent value is subtracted from the contingent project expenditure allowance for the second regulatory period. Further, the overspend is not permitted to be taken into account in setting the remaining (i.e., non-contingent) capital expenditure allowance for the second regulatory period. This provides a strong incentive for TNSPs not to overspend their contingent project allowances.

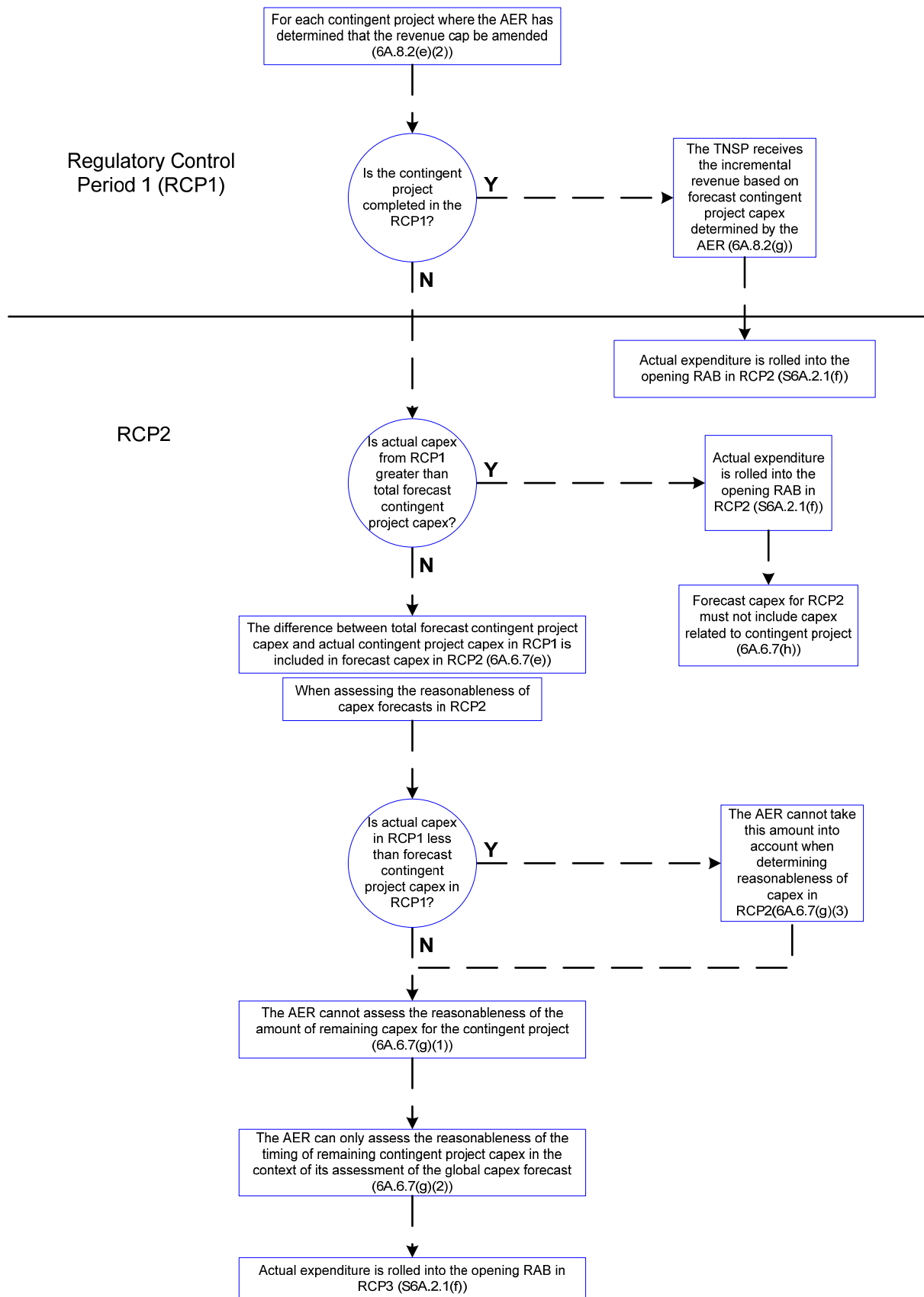
This can be illustrated by drawing on the above example. If the TNSP actually spent \$60 million in the final year of the first regulatory period (instead of the forecast \$50 million), \$60 million would be rolled into the RAB at the end of the first period. The capital expenditure allowance for that project for the second regulatory period would then be reduced by \$10 million. Therefore, the contingent project would have an allowance for the second regulatory period of only \$90 million. This means that the penalty for overspending would continue (assuming the overspend was permanent) until the end of the second regulatory period, at which time the actual expenditure would be rolled into the RAB.

If the TNSP overspends on the *entire* project in the first regulatory period, it would not be entitled to any forecast expenditure in the second period. Therefore, if the TNSP spent \$160 million in the first period (compared to a total forecast project cost of \$150 million, the \$160 million would be rolled into the RAB at the end of the first period and the forecast allowance for the second period would be zero.

Under the contingent projects regime, in all cases (i.e., all possible combinations of project commencement and actual spend), the incentives to under-spend as well as avoiding overspending are relatively powerful as demonstrated in Box 4.1.

The operation of the Commission's modified contingent project scheme, as set out in the Rule, is outlined in Figure 4.1 below.

Figure 4.1: AEMC's modified contingent project mechanism



In response to the Draft Rule, a number of stakeholder submissions raised concerns about the Draft Rule contingent project provisions. These are discussed further below.

4.2.1.1 Concern regarding the threshold for contingent projects

The key concern raised in submissions regarding the contingent project rule was the requirement that the proposed contingent capital expenditure exceed 5 per cent of the RAB.⁶¹⁶²

ETNOF indicated that it was:

“concerned that an extremely high threshold has been set – 5 per cent of a TNSP’s regulatory asset base – the same threshold proposed to apply to the ‘shipwreck’ clause. As previously pointed out, for the TNSP with the largest regulatory asset base (TransGrid), the project would need to have a cost of around \$200 million (based on the forecast opening regulatory asset base for TransGrid’s next regulatory control period), and even for the smallest (Transend) will set a threshold of about \$30 million per project. These examples demonstrate that the scheme will have very little practical operation and will remove most or all of the benefits of the scheme.”⁶³

In light of these concerns⁶⁴ the Commission has decided to lower, but not eliminate entirely, the threshold for the application of the contingent project provisions.

To determine an appropriate threshold, the Commission examined the anticipated value of projects provided by Powerlink and TransGrid as part of the ETNOF submission.⁶⁵ For Powerlink these were:

- \$35 million - Desalination Plant in South East Queensland;
- \$17 to \$115 million – Upgrade to Bowen Basin coal mining area;
- For TransGrid the anticipated contingent projects were:
- \$44 million – Snowy to Victoria upgrade;
- \$10 to \$15 million – QNI upgrade (to relieve northern line limits);
- \$100 to \$120 million – QNI upgrade with series capacitors;
- \$95 million – Snowy to Victoria upgrade by 180MW;

⁶¹ Rule 6A.8.1(b)(2)(iii)

⁶² ETSA, , September 2006, p.3; Powerlink, September 2006, p.4; The Group, September 2006, p.5; EnergyAustralia, September 2006, p.p.11 & 30; AER, September 2006, pp.24-25

⁶³ EnergyAustralia, March 2006, pp. 10-11

⁶⁴ Other submissions also commented on the threshold. Powerlink argued the threshold should be zero; EnergyAustralia and Integral Energy argued that it should be the lesser of a lower percentage of the RAB or \$10 million.

⁶⁵ ETNOF, September 2006, pp. 10-11

- \$60 million – Victoria to Snowy upgrade; and
- \$20 to \$100 million – Snowy to NSW upgrade.

In addition, the Commission examined the most recent ACCC determinations to consider, both the value of projects that were considered contingent, and the general value of individual capital expenditure projects included in the capital expenditure allowance. For TransGrid six contingent projects were allowed for. They ranged in value from \$49 million to \$136 million.

Finally, the Commission examined a number of options for the threshold to determine how it would vary for each TNSP. These options included variations as a percentage of the RAB or a percentage of the MAR. Using the values of the RAB and the MAR from previous determinations, the range of values if 5 per cent of the RAB was used was around \$150 million for TransGrid to around \$5 million for MurrayLink. If 5 per cent of the MAR was used, then the range is between \$21 million for TransGrid and \$0.6 million for MurrayLink.

On the basis of this analysis and evidence, the Commission decided to lower the threshold to the higher of \$10 million or 5 per cent of the MAR. By aligning the lower bound to \$10 million it has the advantage of being the same amount necessary for the application of the regulatory test to new augmentation investment, while the 5 per cent of the MAR upper bound is more appropriate than the previous 5 per cent of the RAB.

4.2.1.2 Appropriateness of applying the threshold at a regulatory review and when a trigger event occurs

ETNOF considered it not appropriate to apply the threshold for contingent projects, both at the time it is approved by the AER at a regulatory review, and at the time a trigger event occurs and expenditure is sought to be included in the MAR. The concern centered on the scope for projects that pass the test in the first instance, subsequently not passing the test when the trigger event occurs.

The Rule retains the approach taken in the Draft Rule by requiring the threshold to be applied twice. The reason for having a threshold is to allow for the inclusion of expenditure where the scope of a contingent project may not be initially clear. This approach ensures that an appropriate balance is created between incentives for efficient investment, and the administrative burden associated with approving expenditure within regulatory control periods.

4.2.1.3 Applicability of contingent projects where costs are uncertain

The ETNOF also identified a concern that the contingent projects provisions in the Draft Rule only applied to projects where the need for the project was uncertain during the regulatory control period. They indicate that it should also apply to projects where the costs are uncertain, but the need for the project is likely to be more certain.

The Commission believes that it is appropriate for the contingent projects provisions to be capable of application to projects that are likely to occur, but where the costs are uncertain. It has made a number of amendments to the relevant provisions to enable this to occur.⁶⁶

4.3 Provisions Allowing the Revenue Cap to be Reopened

The Revenue Rule includes provisions allowing for the revenue cap to be reopened during a regulatory control period where an event occurs that sufficiently impacts on the financial viability of the business, or its scope to respond to unforeseeable circumstances.

4.3.1 Commission's Analysis and Reasoning

The majority of the submissions were supportive of allowing the revenue cap to be reopened in specified circumstances during a regulatory control period. For instance, in its response to the Proposed Rule, CUAC supported the provision if it contained incentives for ensuring robust and rigorous capital expenditure forecasts.⁶⁷ The NGF submission to the Proposed Rule considered that it would be better to approve projects as they arise rather than at the time of the *ex ante* revenue cap determination.⁶⁸ EPSIC believed that the revenue cap reopening Rules should also exist for projects that are no longer required to ensure that consumers are not paying for capital projects that have not been built.⁶⁹ The MEU stated that reopening should only be allowed when the TNSP has utilised all existing capital expenditure.⁷⁰

Two submissions to the Proposed Rule (the AER and PIAC), did not support the revenue cap reopening Rules. PIAC was concerned that reopening determinations would have a negative impact on prices, while the AER believed that the Proposed Rule did not provide sufficient incentives for TNSPs to efficiently undertake projects included in the *ex ante* cap.⁷¹

Many of the submissions that commented on the revenue cap reopening Rules had concerns with the five per cent of RAB threshold limit. Most submissions considered that the threshold was too high,⁷² with only TRUenergy supportive of the five per cent threshold.⁷³ ETNOF and ETSA considered that two per cent was more appropriate,⁷⁴ while EnergyAustralia was supportive of a one per cent threshold.⁷⁵ EnergyAustralia also believed

⁶⁶ Clause 6A.8.1(c)(5)(ii).

⁶⁷ Consumer Utilities Advisory Centre, 7 April 2006, p.6

⁶⁸ National Generators' Forum, 20 March 2006, p.2

⁶⁹ Electricity Supply Planning Council, 20 March 2006, p.4

⁷⁰ Major Energy Users Incorporated, 22 March 2006, p.56

⁷¹ Public Interest Advocacy Centre, 22 March 2006, p.3; Australian Energy Regulator, March 2006, p.39

⁷² CitiPower & Powercor Australia, 20 March 2006, p.5

⁷³ TRUenergy, 21 March 2006, p.1

⁷⁴ Electricity Transmission Network Owners' Forum, March 2006, p.14; ETSA Utilities, 20 March 2006, p.3

⁷⁵ EnergyAustralia, 20 March 2006, pp.22-24

that the threshold should relate the aggregate of projects that are required to address a trigger rather than being applied to an individual project. Ergon Energy, the ETNOF and AGL were also supportive of a dollar value threshold ranging from \$10 million to \$100 million.⁷⁶

In considering the issues raised regarding the revenue cap reopening Rules, the Commission had regard to the Expert Panel report which commented on the value of allowing a revenue cap to be 'reopened' in certain circumstances:

*"... the incentives and risks inherent in the building block approach to price caps can be ameliorated by incorporating pass through or re-opener clauses, thereby allowing the price control parameters to be adjusted before the end of the designated period if certain trigger events take place."*⁷⁷

As noted above, the Revenue Rule allows a TNSP to apply for the re-opening of its revenue cap in the event it was obliged to invest in a major project (at least five per cent of the value of its RAB) and that investment would cause the TNSP to exceed its capital expenditure allowance for that entire period. It should also be recognised that such an event may, for example, include a demand event. An example of this may be the unforeseen commissioning of a desalination plant. The commissioning of a desalination plant can occur in a relatively quick period of time with a short amount of notice.

This approach provides strong incentives for TNSPs to ensure their forecasts are as accurate as possible. At the same time the proposed arrangement is intended to overcome the incentive for a TNSP to defer major vital investment where it would result in the TNSP exceeding its capital expenditure allowance for the period.

The reopening rule only allows the revenue cap to be reopened if:

- an event that could not have been foreseen by the TNSP has occurred;
- in response to that event, the TNSP must invest in a project without which network reliability or system security would be compromised;
- the project requires capital expenditure exceeding five per cent of the TNSP's RAB in the year of the event;
- the project requires capital expenditure that the TNSP cannot otherwise reasonably fund within the period; and
- there is no existing allowance (including in the contingent projects allowance) for that project.

⁷⁶ Ergon Energy, 20 March 2006, p.6; Electricity Transmission Network Owners' Forum, March 2006, p.14; AGL, 21 March 2006, p.6

⁷⁷ Expert Panel on Energy Access Pricing, 'Report to the Ministerial Council on Energy', April 2006, Chapter 4, Productivity Commission 'Review of the Gas Access Regime', p.102

This approach is intended to ensure that the incentive properties of the ex ante cap and the contingent projects regime are maintained while at the same time limiting the exposure of TNSPs to the full risks and costs of addressing major disruptions to their networks in the process of meeting their regulatory obligations.

EnergyAustralia, in response to the Draft Rule, indicated a concern that it allowed the AER to undertake a detailed examination of a TNSP's capital expenditure program to assess whether there was scope for projects to be deferred in place of reopening the revenue cap (6A.7.1(a)(4)(ii)).⁷⁸

It was never the Commission's intention to allow the AER to undertake such an analysis, and therefore the Revenue Rule has been clarified in this regard. The Revenue Rule includes a presumption in favour of the TNSP's assessment of the scope for modifying the capital expenditure program, unless the AER has sufficient reason not to be satisfied with the TNSP's assessment. This is intended to limit the opportunity for the AER to undertake a detailed analysis, while still ensuring that TNSPs adequately consider alternative approaches to addressing the potential reopening event, without necessitating a reopening of the revenue cap.

4.3.1.1 Application of both a contingent projects regime and re-opener provisions

The AER commented that the inclusion of a contingent projects regime and pass through provisions make a re-opener provision redundant.⁷⁹ The AER noted that the SRP envisaged pass through provisions as an alternative to re-opener provisions and therefore suggest that the re-opener provisions be removed.

In this regard, the Commission's approach has been to retain a relatively high threshold for re-opener provisions (i.e., the 5% of RAB threshold that had previously also been specified for contingent projects in the Draft Rule). This approach ensures that re-openers are only triggered for large, shipwreck-type events and gives weight to the use of pass through or contingent project provisions as the primary means of redress following major unforeseen events.

4.3.1.2 Demand management and re-openers

The TEC⁸⁰ sought greater leniency within the re-opener provisions to motivate take up of demand management. They suggested that TNSPs may be unlikely to take up demand management initiatives due to the underlying risk of potentially still having to commit to investments if expected demand management is not forthcoming.

The Commission is of the view that demand management should be viewed as an efficient alternative to network augmentation. Where this is not a viable or efficient alternative, it will be efficient for TNSPs to pursue supply-side alternatives. In this regard, additional

⁷⁸ EnergyAustralia, September 2006, p.12.

⁷⁹ Australian Energy Regulator, September 2006, pp.22-24

⁸⁰ Total Environment Centre, September 2006, p.4

incentives for demand management may distort the efficient choices of the TNSPs. Absent an explicit policy directive to facilitate greater take up of demand management, it would not be appropriate for the Commission to implement a bias in the manner suggested by the TEC.

4.4 Guidelines

As discussed in Chapter 2 in this Review the Commission has sought to achieve a balance between codification of regulatory decision making processes, methodologies and decision making criteria and the provision of guided discretion for the AER where appropriate. This has drawn on established practices and the elevation to the rules of key aspects of the ACCC's SPR. However the Commission has been cognisant there remain certain aspects of the regulatory framework where it would be inappropriate to fix regulatory practice in statutory rules.

In these areas, the Revenue Rules provide the AER with discretion in the exercise of its regulatory function. Where this approach has been adopted, the Commission has sought to provide additional certainty to both the regulator and industry participants through a requirement for the regulator to consult and develop guidelines.

Specifically, the requirement to prepare guidelines applies to the following:

- the information to be submitted with TNSP Revenue Proposals or within regulatory periods;
- the form of incentive mechanisms for capital and operational expenditure and service performance;
- cost allocation principles;
- the mechanics of rolling-forward the RAB; and
- the form of post tax revenue model (PTRM) to be adopted.

The Revenue Rule also requires the AER to comply with Transmission Guideline Procedures when developing or altering any of the guidelines. These procedures set out a transparent public consultation process, involving a draft and final decision with clear reasons given for the approach. This will provide increased predictability and certainty of the regulatory regime, without excessively hampering the AER when it considers that a change to a guideline is required.

4.4.1 Commission's analysis and reasoning

The codification of requirements for the AER to develop guidelines and the requirements for mandatory compliance with them by regulated businesses has been the focus of significant stakeholder attention and Commission analysis.

Submissions were generally accepting of the Commission's view that guidelines provide greater clarity and certainty in areas where it would be inappropriate to codify regulatory requirements in the Rules and where there is a need for an understanding of process and methodology between the regulator and the TNSP. However, a number of submissions were received from regulated businesses (and their representative bodies) which questioned the appropriateness of allowing the AER to prepare mandatory guidelines for the TNSPs.⁸¹

In particular, these submissions commented that provisions for the AER to make binding guidelines constituted the conferral of rule making power onto the regulator. They also submitted that such power was not within the intent of the separation of rule making and rule administration roles under the governance and institutional framework of the NEM.

AGL also questioned the basis upon which the Commission's Draft Rule required the AER to make binding guidelines, stating that:

*"While there are formal provisions in the NEL under which the AEMC can allow the AER to make its guidelines mandatory, the AEMC has not used them."*⁸²

The Commission considers that the requirement to adhere to guidelines is an important component of the Rules for ensuring stability and transparency in the market. In this regard, it is noted that there are already a number of AER guidelines in place which market participants are required to adhere to, such as for ring-fencing, rebidding and service standards. These guidelines place obligations on market participants in terms of behaviour and information requirements. Therefore, the standing of the guidelines proposed in the Rules is no different to current arrangements.

Section 34(3)(c) of the NEL empowers the Commission to 'confer functions or powers on, or leave any matter or thing to be decided or determined by ...the AER.' The Commission is therefore of the view that, given the NEL explicitly empowers it to make Rules that confer a power on the AER to determine matters, it is clear that the Rules can confer a power on the AER to make guidelines.

Furthermore, the Commission is satisfied that where guidelines are required by the Revenue Rule, these relate to the detailed application or implementation of matters that have been provided for at a more general level in the relevant Rule. Moreover, these Rules fit within the scope of the Commission's rule making powers under section 34(3)(c). That is, the subject matters of the guidelines are consistent with the matters in relation to which the Commission may make, and has made, Rules. As guidelines constitute a matter of detailed application, it is appropriate that the AER is provided with sufficient guidance in the Rules on the formulation of the guidelines, in order to focus the powers conferred on it (ie, the scope of the guidelines). The Revenue Rules ensure that the guidelines are developed in line with the intention of the Rules by placing specific conditions upon the AER's guideline development

⁸¹ AGL, September 2006, part 2; EnergyAustralia, September 2006, pp. 20-21; APIA, September 2006, p.5; and ETNOF, September 2006, pp.23-25; Integral Energy, September 2006, pp. 1-2

⁸² AGL, September 2006, part 2, p.2

and review processes.⁸³ It is apparent that in some instances the guidelines already exist in some form and will not require any significant differences to current practices.

Equally, for the guidelines to be effective in their purpose it is appropriate that they be binding upon the regulated business. The ability to bind the regulated businesses to compliance with guidelines that are not in the Rules flows from the power of the AER to make such guidelines. This is because conferring a power on the AER to make guidelines in the Rules has the same effect as setting out the details of those guidelines in the Rules. Accordingly, mandating compliance with the guidelines in the Rules is effectively mandating compliance with guidelines as if they were set out in the rules.

Concern was expressed in submissions that the process for the development of guidelines should be similar to that applying to the Rules, given the mandatory nature of the guidelines. For example, EnergyAustralia submitted that:

*"If the Commission retains the mandatory nature of guidelines then there must also be some provision for the review of the guidelines given that they have the potential to impact upon a business to the same extent as a regulatory determination. There is currently no provision for a TNSP to initiate a review of an existing guideline or appeal a guideline's outcome, short of a Rule change abolishing the obligation to comply with guideline or a challenge to the legality of the guideline."*⁸⁴

The Commission's view is that the consultation required in relation to the development and amendment of the guidelines should allow for the expression of alternative views, but that the process should be reflective of the nature of the guidelines. That is, their development requires an understanding of process and methodology between the regulator and the TNSP and that the regulator should retain sufficient discretion to ensure the guidelines support the efficient administration of regulatory decision making processes.

The Revenue Rule specifies the requirements that the AER must comply with when it wishes to determine or alter any of the guidelines. The intention of the Rule is to provide certainty and predictability without constraining the flexibility that may be required on certain issues. Under the Revenue Rule the AER is required to publish its proposed guideline, receive submissions, and publish a final guideline with reasons. The Commission anticipates that in developing the proposed guideline the AER would undertake consultation to identify the appropriate issues and obtain preliminary views from interested parties. The requirement to formally seek comment on the proposed guidelines is to ensure that stakeholders can make comment on the drafted version incorporating stakeholder's views before it is finalised and implemented. The Commission considers this process is appropriate and is consistent with the need for guidelines to be flexible and change over time.

The AER also submitted concern regarding the timeline for developing guidelines. In particular it stated that:

⁸³ Clause 6A.20 – the transmission consultation procedures.

⁸⁴ EnergyAustralia, September 2006, p.22

*"While the due dates largely remain unchanged, the timeframe provided for the completion of the guidelines has significantly changed, as guidelines which were to be issued within six months of the Rules taking force under the Proposed Rules, are now to be issued before the rules take effect. This creates both legal and practical difficulties."*⁸⁵

The Commission has considered the concerns raised by the AER regarding the timeline for consulting and developing the required guidelines and has decided to allow until 28 September 2007 for the completion of this process. Transitional arrangements for proposed guidelines to apply to those TNSPs subject to revenue determinations reviews in 2007 are discussed in Chapter 8.

The ETNOF submitted that there should be provisions for TNSPs to apply for specific areas of exemption for non-compliance with aspects of mandatory guidelines issued by the AER. Similarly, AGL stated that cost allocation guidelines should not be mandatory.⁸⁶

In regard to both these points, the Commission maintains the view that the regulator must be afforded reasonable assurance that its guidelines will be complied with and that TNSPs will make all reasonable endeavours to submit Revenue Proposals that comply with any relevant submission guidelines.

The development of mandatory guidelines is consistent with the Commission's overall approach of aligning the *ex ante* incentives for regulated businesses to submit robustly supported Revenue Proposals for consideration and determination by the AER. The use of guidelines support the framework of providing the AER with guided discretion and enhances regulatory certainty both for the regulator and regulated businesses. The Commission has therefore retained the Draft Rule approach.

On the issue of ring fencing guidelines, EnergyAustralia submitted that any mandatory ring-fencing requirements should be contained in the Rules rather than in guidelines. Moreover, EnergyAustralia stated that:

"Clause 6A.2 largely carries over the existing provisions which in turn were carried over from the Code without review. These provisions were not part of the rule proposal published in February and have not been properly reviewed."

*EnergyAustralia has consistently submitted that the Code and now the Rules could not confer the power to enable a regulator to require legal separation of a TNSP business through guidelines."*⁸⁷

The Commission agrees that the substance of the ring fencing guideline requirements has not substantially changed between the Code and the Revenue Rule. The Commission considers that there is insufficient scope within this current Review to consider substantive change to these Rules and that such change would be more appropriately considered within a dedicated rule change proposal.

⁸⁵ Australian Energy Regulator, September 2006, pp.7-8

⁸⁶ AGL, September 2006, p.10

⁸⁷ Energy Australia, September 2006, pp.20-21

5. Transmission Revenue Building Blocks

The previous chapters have discussed the scope and form of regulation, the appropriate level of rules based guidance for the regulator on process, methodology and decision criteria, and some of the key components of the building blocks methodology. This chapter builds upon the preceding chapters by consolidating these elements of the regulatory regime and considering the detail of the remaining components of the building blocks methodology.

The Commission has developed the Rules with a building block revenue cap methodology provided as a complete package. That is, the build up of the maximum allowable revenue (MAR) from the key cost components comprising operating expenditure, capital expenditure, cost of capital financing requirements (return on and of capital) and forecast tax liability.

This chapter commences with an overview of all the elements of the Commission's approach, before describing the Commission's reasoning and responses to stakeholder submissions on the following building block elements of the Rules:

- the adoption of a generic post-tax revenue model (PTRM);
- the Regulated Asset Base and the Commission's roll-forward approach;
- the extent of discretion provided in calculating the return of capital;
- the approach and parameter specification for calculating the return on capital; and
- the estimated cost of corporate income tax.

5.1 Post-tax Revenue Model

The publication of the existing PTRM by the AER has improved the certainty and transparency of the calculation of revenue determinations. The Commission considers that these benefits could be extended by codifying in the Rules the requirement for the AER to publish its PTRM and for TNSPs to adhere to this model when making its Revenue Proposal.

Consequently, the Revenue Rule requires the AER to develop and publish a PTRM, which then forms the basis of the calculation of the Maximum Allowed Revenue (MAR) in both the TNSP's revenue application and the AER's revenue determination. The PTRM relates the building block elements to the MAR determined for the TNSP for each year of the regulatory period.⁸⁸ The publication of a generic PTRM, which must be applied in determining the

⁸⁸ Note that the MAR does not in fact represent the *maximum* revenue that a TNSP may earn in each year of the regulatory period. The service incentive scheme which is required to be developed under the Rule will result in additions (or reductions) in the revenue that a TNSP may earn in any year, on top of the MAR. In addition, there are currently provisions in the Rules for an 'overs- and unders mechanism' to adjust a TNSP's allowed revenue where it has over- or under- recovered allowed revenue in an earlier year. The issue of the maximum revenue which a TNSP can earn as a result of charges for prescribed services will be considered as part of the Commission's review of the rules relating to pricing.

revenue cap of a TNSP, is consistent with the Commission's aims of achieving transparency and consistency. The Commission has set out guidance on what the PTRM should contain and has codified the continuation of the post-tax approach to financial modelling.

5.1.1 Commission's Analysis and Reasoning

The Commission received a number of submissions in relation to the codification of provisions relating to PTRM development by the AER. Most submissions supported increased guidance in the Rules regarding the contents of the PTRM model. However, specific issues were raised relating to the proposed generic nature of the model, the guidance provided in relation to inflation forecasts and the TNSP's discretion to choose X-factors within the model. These issues and the Commission's treatment in the Revenue Rule are considered below.

5.1.1.1 Generic PTRM application

AGL stated that a generic PTRM model would not be suitable for the wide range of regulatory reviews that the AER is required to undertake, particularly in relation to distribution networks.⁸⁹ EnergyAustralia also stated that TNSPs should be permitted to submit their own PTRM for the AER to assess for compliance with the Rules rather than the AER preparing a PTRM model and guideline.⁹⁰ AGL also believed that a post-tax modelling methodology conflicted with the Government's intention for the treatment of accelerated tax depreciation.

The Commission considers that moving away from a generic model would remove the benefits of having a published PTRM. Firm-specific issues are likely to be better dealt with as part of the revenue determination rather than through the mechanics of the PTRM. In addition, an *ex-ante* regime with a requirement for TNSPs to submit a Revenue Proposal to the AER requires that clear and transparent obligations are in place. A generic PTRM which the TNSP is obliged to comply with, provides this clarity and transparency. This is especially the case considering the transparent consultation process required to develop and amend the PTRM. Therefore, the Commission has maintained its approach on this issue for the Revenue Rule. The Commission also notes that the rules in relation to distribution are currently being considered by the MCE and this Revenue Rule only relates to transmission networks.

Regarding AGL's concern about the suitability of a post-tax model given accelerated depreciation provisions,⁹¹ the Commission has considered arguments for and against a post-tax model when developing the Proposed Rule.⁹² The Commission considers that there are substantial benefits from maintaining a consistent approach on this issue and therefore sees no need to move away from the approach adopted by the AER under the SRP. In addition, a pre-tax approach has the potential to overcompensate for tax to the extent that accelerated depreciation continues to apply to some TNSP assets.

⁸⁹ AGL, 21 March 2006, pp.3-4; AGL, September 2006, p.9

⁹⁰ EnergyAustralia, September 2006, pp. 16-17

⁹¹ AGL, September 2006, p.7

⁹² Ibid., p.63

5.1.1.2 Treatment of Forecast Inflation

In response to the Proposed Rule the AER and the ETNOF were concerned with the lack of guidance on the methodology the AER should adopt for forecast inflation over the regulatory period within the PTRM.⁹³ The ETNOF proposed that the Rules should require that the inflation forecast should reflect a 'best' estimate, which in turn would imply that it uses the latest information available, adopts the best techniques and considers reliable evidence. The ETNOF commented that it would be inappropriate for the Rules to prescribe the use of observed inflation-linked bonds (unadjusted) to obtain a forecast of inflation, despite this being the dominant method used by Australian regulators. The ETNOF viewed this approach as inappropriate given the small size of the market for inflation linked bonds and also because the difference between nominal and real bonds will reflect an inflation risk premium, which would overstate expected future inflation.

The Revenue Rule acknowledges these concerns and requires the AER to specify, as part of the PTRM, the methodology that the AER determines is likely to result in 'the best estimates of expected inflation.'⁹⁴ The Commission considers that this approach provides the AER with some discretion while requiring that the inflation forecast be the best available.

5.1.1.3 X Factor Proposal

One of the inputs of the PTRM model is the X-factor which is to be applied to the MAR in each regulatory year (after the first year) in the CPI-X revenue cap formula. The Revenue Rules allow the TNSPs to nominate the X-factors, subject to certain restrictions (discussed below).⁹⁵

A concern raised by the AER was that the TNSPs are unlikely to have an incentive to smooth prices for customers, and so providing the TNSPs with the flexibility to determine the X-factors may result in inappropriate price changes between years.⁹⁶

The Commission has not been presented with any evidence to suggest that its approach would lead to inappropriate prices for users. The Commission considers that the flexibility provided to the TNSP is limited by a number of Rule provisions including that:

- the revenue path for a TNSP is 'double anchored': the MAR is established in year one as a dollar amount and the TNSP is obliged to set a MAR in the last period that is as close as reasonably possible to the annual building block revenue requirement for that year;⁹⁷

⁹³ Electricity Transmission Network Owners' Forum, March 2006, pp.24-25; Australian Energy Regulator, March 2006, p.39

⁹⁴ Clause 6A.5.3(b)(1)

⁹⁵ Clause 6A.6.8

⁹⁶ Australian Energy Regulator, March 2006, p.39.

⁹⁷ Clause 6A.5.3(c)(3) & clause 6A.6.8(c)(2)

- the TNSP is limited to setting X-factors such that the Net Present Value (NPV) of the MAR for each year is equivalent to the NPV of the Annual Building Blocks Revenue Requirement (ABBRR) for each year;⁹⁸ and
- the current provisions in the existing Part C of Chapter 6 of the Rules place additional constraints on the amount that prices can move between years.

The Commission considers that given these provisions, additional restrictions on the X-factors do not appear necessary and a TNSP should have the flexibility to propose the revenue profile over the period that it considers best reflects the needs of its users.

5.2 Expenditure forecasts

The TNSPs' Revenue Proposals are required to include a forecast of both capital expenditure and operating expenditure for each year of the regulatory period. The AER must accept the forecasts, if it determines that they reasonably reflect efficient and prudent costs based on realistic estimates of forecast demand and cost inputs. In making this determination the AER is to also take into account criteria specified in the Rule, and ensure that they are satisfied that the estimates comply with both the Cost Allocation Methodology⁹⁹ and the AER submission guidelines relating to information to be included in Revenue Proposals.

The decision framework for the determination of expenditure forecasts is discussed further in section 4.1 of this Rule Determination. The remainder of this section will discuss some of the other issues raised by submissions in relation to expenditure forecasts.

5.2.1 Commission's analysis and reasons for decision

The ETNOF argued that the framework for the AER to assess a TNSP's revenue proposal allowed it excess scope to reject the proposal. It considered that this excessive scope to reject a proposal allowed for the opportunity for arbitrary decision making.¹⁰⁰ The Commission considers that the concerns of the ETNOF have been addressed by the restructuring and redrafting of the expenditure forecast rules. In particular, the revised drafting has separated the requirement for a proposal from the factors for consideration.

Another issue raised by a number of submissions related to the weighting of the criteria that the AER is to have regard to in making a determination on the expenditure forecast.¹⁰¹ The Commission considers that, to a large extent, the concerns regarding the list of criteria are alleviated by the new drafting of the expenditure forecast rules. The list of criteria from the

⁹⁸ Clause 6A.5.3(c)(1)

⁹⁹ The Cost Allocation Methodology is the basis on which costs for prescribed services are identified separately from those for negotiated services, and are discussed in chapter 4 of this Draft Determination.

¹⁰⁰ ETNOF, 11 September 2006, p.5.

¹⁰¹ CitiPower & Powercor, 11 September 2006, p.5; Australian Pipeline Industry Association, 12 September 2006, p.4.; Country Energy, 11 September 2006, p.4; and AGL, 14 September 2006, p.6.

Draft Revenue Rule have been now more clearly stated as evidentiary factors for determining if the proposal reasonably reflects efficient and prudent costs based on realistic estimates of forecast demand and cost inputs. The Commission considers that this better reflects the appropriate role of these factors in making decisions on expenditure forecasts.

5.3 Regulatory Asset Base

The Regulatory Asset Base (RAB) is a key component of the building block methodology used to determine a TNSP's maximum allowable revenue. The RAB is the asset value used for the purpose of calculating the return on, and depreciation of, the capital invested in the regulated TNSP.

The Commission has determined a Revenue Rule that codifies the methodology for rolling-forward the RAB from one regulatory period to the next, and specifies the initial RAB for each of the TNSPs. This section outlines the Commission's reasons for its decisions regarding the Rules relevant to the RAB and consideration of submissions received.

5.3.1 Commission's analysis and reasons for decision

Submissions from consumer representatives, regulators and regulated businesses have supported the Commission's approach of codifying the methodology for the roll-forward of the RAB and the inclusion in the Rules of initial RAB values for each TNSP.

A number of specific issues were identified in submissions including:

- the approach to inflation in the roll-forward methodology for the first year of a regulatory period;
- the timing of asset recognition in the RAB;
- allowing previously optimised assets to be subsequently included in the RAB when they become used;
- implications for the RAB of grandfathering of connection assets as prescribed services in accordance with clause 11.6.11 (now renumbered);
- allowing TNSPs to propose the roll-forward methodology in accordance with the requirements in the Rules, rather than the methodology being specified by the AER;
- the approach to specifying and 'locking in' the initial asset values for each TNSP in the Rules;
- regulatory arrangements for the review of the prudence of actual capital expenditure before it is included in the RAB; and
- the appropriateness of using actual versus regulatory depreciation in the roll-forward methodology.

A discussion of submissions relating to the ex-post review of capital expenditure and the use of actual versus regulatory depreciation is provided in section 6.3. Consideration of the submissions relating to the remaining issues relating to the RAB is provided below.

5.3.1.1 Treatment of inflation

The AER raised the concern that, because the Australian Bureau of Statistics (ABS) publishes its CPI data almost a month after the end of the relevant quarter, the AER is unable to deliver a revenue cap decision until after the start of the regulatory period.¹⁰²

A similar concern was raised by ETNOF which stated that, by requiring in Rule 6A.5.3(c)(2) that the revenue cap be expressed as a dollar amount in the first year of the regulatory control period, this precludes a CPI-X methodology that adjusts the revenue cap for any difference between actual and forecast inflation in the last quarter of the immediately preceding year. The need to make the adjustment arises because actual CPI in the immediately proceeding year is not known at the time of determination by the AER. This in turn breaches Rule 6A.6.1(e)(3), which requires the approach to inflation of the Maximum Allowed Revenue (MAR) to be equivalent to the approach used for the RAB.¹⁰³

The requirement in Rule 6A.5.3(c)(2) does not, in the view of the Commission, prevent the MAR from being adjusted for outturn inflation, for the most recently available data. If the regulatory year commenced 1 July and ended 30 June, this would mean that the dollar amount would reflect inflation based on the change in the CPI from March to March of the previous year. In other words, the most recent, actual CPI quarter figures could be used for the purposes of setting the MAR. This would also mean that the same approach could be used for inflating the RAB in accordance with the requirement in Rule 6A.6.1(e)(3).

Country Energy expressed concern that the roll-forward methodology specified in Rule Schedule 6A.2.1(f) does not clearly allow for the RAB to be adjusted for inflation in the first year of the regulatory control period.¹⁰⁴ To remove any confusion, the Commission has included a reference to Rule 6A.5.4(b)(1)(i) in Rule Schedule 6A.2.1(f) that provides for the adjustment of the RAB for outturn inflation.

The Rules require that the AER develop a roll-forward model and that the RAB is adjusted for outturn inflation when rolling-forward the RAB from the previous regulatory period to the start of the new regulatory period.

The Commission notes that in relation to the roll-forward of the RAB, what is important is that the methodology for determining outturn inflation in rolling forward the RAB over the previous regulatory control period is consistent with the methodology that is used to index the MAR over that same period. The Commission has included this specifically in the Rule.¹⁰⁵

The effect of this approach is as follows. If the regulatory year starts on the 1 July and ends on the 30 June, then the MAR in the previous control period would be calculated using the change in March to March CPI. The Rule requires the AER to use a *consistent* CPI when

¹⁰² Australian Energy Regulator, March 2006, p.18.

¹⁰³ ETNOF, 11 September 2006, p.31.

¹⁰⁴ Country Energy, 11 September 2006, p.5.

¹⁰⁵ Clause 6A.6.1(e)(3)

rolling forward the RAB over that period, i.e., to use the March to March CPI data to roll forward the RAB in a given year. The use of March CPI data allows the AER to issue its revenue cap decision two months before the start of the regulatory period. Furthermore, if the CPI lag is consistently maintained from one regulatory control period to the next there is no reason to presume that this would result in a biased outcome.

The Commission maintains the view that the approach put forward in the Draft Rule puts beyond doubt the AER's ability to use the latest available actual data on inflation, in conducting the roll-forward of the RAB. The Commission has therefore retained this approach in the Revenue Rule.

5.3.1.2 Timing of asset recognition in the RAB

The ETNOF submitted that the Rules should provide a consistent approach with regard to the timing of recognition of assets in the RAB.¹⁰⁶ That is, whether assets should be included using either an 'as costs are incurred' or 'as commissioned' convention. In this regard, the Commission confirms that the Rules are intended to adopt an 'as costs are incurred' asset recognition convention. This is illustrated in the treatment of contingent projects in clauses 6A.6.7(d)-(h). ETNOF note that:

*"the definition of the regulatory asset base states that assets are only to be included 'to the extent they are used', [6A.6.1(a)] which appears to prescribe an 'as commissioned' convention."*¹⁰⁷

However, the Commission confirms that this clause is intended to confine the regulatory asset base to assets that provide prescribed transmission services base. It does not mandate that capital expenditure is to be rolled in on an 'as commissioned' basis.

5.3.1.3 Treatment of assets previously excluded from the RAB

The initial RAB values specified within the Rules are predominately based on estimates of the depreciated optimised replacement cost (DORC) of the capital assets employed by the business to deliver regulated services. As part of the DORC valuation, assets are optimised and therefore removed from the asset base, particularly if they are not providing services at the time the DORC valuation is undertaken because of changes to use patterns.

In practice, as demand patterns change, these assets may be used to provide prescribed services, at which time it would be appropriate for the TNSP to be able to include the value of these assets in the RAB. This would allow the TNSP to earn a return on, and depreciation of, all assets used to provide prescribed services.

ETNOF identify in their submission that the Draft Rule does not provide for the inclusion of the value of assets previously optimised out of the initial RAB value, but are subsequently used to provide prescribed services. The Commission agrees that in these circumstances the TNSP should be allowed to reinstate assets that have previously been optimised out of the

¹⁰⁶ ETNOF, September 2006, pp.28-29

¹⁰⁷ ETNOF, September 2006, pp.28-29

initial RAB and has therefore amended Schedule 6A.2.1(f). In addition, the Commission understands that this is the approach currently adopted by the AER to the inclusion of previously optimised assets.

5.3.1.4 Ongoing treatment of grandfathered prescribed connection assets

The Draft Rule provided for the grandfathering of connection assets that are currently within the RAB, but which would otherwise be treated as providing negotiated services.¹⁰⁸ This approach recognised that it would be inappropriate to consider these assets as providing negotiated services, given the costs of the assets have historically been shared amongst all network users.

The National Generators Forum (NGF)¹⁰⁹ and The Group¹¹⁰ have sought clarification of the policy intention surrounding the treatment of these assets in the future in circumstances where they are being replaced or reconfigured. They identified that the Rules would require these replaced or reconfigured assets to be treated as providing negotiable services, necessitating the negotiation of a connection agreement with accompanying terms and conditions, including price. The NGF's view is that these costs should not be treated as a negotiated service because the benefits associated with any replacement or reconfiguration would be received by the market as a whole. In this case, they indicated that it would not be appropriate for these assets to be subsequently treated as providing negotiated services.

The Commission's approach has been to define connection services as negotiable, recognising that these services are generally between two commercial enterprises such that a negotiable outcome is preferable to regulation for the achievement of the NEM objective. In this regard, it would be appropriate that any replacement or reconfiguration of a connection asset, grandfathered as providing prescribed services in accordance with clause 11.6.11 of the Revenue Rule, should be treated as a negotiated service asset.

The Rule does however, address the underlying concern of the NGF that where benefits from a replacement or reconfiguration of these assets accrue to the shared network, then these costs should be allocated to the shared network. Clause 6A.19.2(a)(8) provides for costs to be allocated from negotiated to prescribed services on the basis that the costs are either 'directly attributable to the provision of prescribed services or are incurred in providing prescribed services.' This allows costs to be allocated from negotiated to prescribed services on the basis of who benefits from the incurred costs. The Commission believes that these Rule provisions address the concerns identified by the NGF.

5.3.1.5 Allowing TNSPs to develop and adopt a roll-forward model

EnergyAustralia suggests that TNSPs be allowed to develop a roll-forward model compliant with the requirements in the Rules, as an alternative to a model developed by the AER. Within this framework, TNSPs would have the flexibility to choose which roll-forward

¹⁰⁸ Rule 11.5.11

¹⁰⁹ NGF, September 2006, pp.2-3

¹¹⁰ The Group, September 2006, p.4

model to use when calculating the value of the RAB within the building block methodology.¹¹¹

While this approach may provide greater flexibility to TNSPs, the Commission is concerned that it could result in different and inconsistent roll-forward models being used by each TNSP. This is because, while the Rule provides a comprehensive framework for the development of the roll-forward model, there are a number of assumptions that are required to be made, and this detail is left to the AER to determine. There are likely to be considerable benefits from having a common approach to the roll-forward model, similar to the benefits arising from a common PTRM, such that the Commission has decided to retain the Draft Rule provision, requiring the AER to develop the roll-forward model.

5.3.1.6 Specification of the initial RAB values

The Commission has specified the initial RAB values for each of the TNSPs in the Rules, in line with its decision in the Draft Rule. It considers that there are considerable benefits associated with 'locking in' these values, in particular by providing improved investment certainty for TNSPs. Concerns, however, regarding this approach were raised in a number of submissions. Integral Energy and Country Energy were concerned that a consistent approach to asset valuation should be adopted across jurisdictions (including the approach to any review of the prudence of capital expenditure) and supported each jurisdiction specifying an initial RAB and advising the AER of this value.¹¹²

Both Country Energy and the Australian Pipeline Industry Association (APIA) expressed concerns about 'locking in' the values used at previous ACCC determinations because it removed any flexibility to the AER to make adjustments to those values due to any errors in estimation, or assets that were accidentally not included. APIA indicates that a separate review of initial RAB values should be undertaken prior to their specification in the Rule.¹¹³

The AER raised a concern in response to the Proposed Rule that the initial RAB values as set out may need to be revisited due to the Commission's position on Prescribed Services and Negotiated Services.

The Commission has noted during the Review that the initial asset base should only contain costs which are recovered through Prescribed Services, and not costs associated with Negotiated Services. The only exception would be where costs associated with certain services before a certain date (e.g., pre-NEM connection costs) are to be grandfathered as Prescribed Services. The Commission considers that in this instance the opportunity for parties to behave in ways contrary to the intent of the Rules has past and therefore believes that grandfathering is an appropriate outcome.

The Commission understands that the opening RABs as set out in the current regulatory determinations are not intended to recover costs which are recovered through charges for

¹¹¹ EnergyAustralia, September 2006, p.16.

¹¹² Integral Energy, 27 March 2006, p.2; Country Energy, September 2006, p. 5

¹¹³ Australian Pipeline Industry Association, September 2006, p.5

Negotiated Services. During its Review, the Commission did not receive any specific submissions (other than the AER's general concern) identifying whether there are costs currently included in the TNSPs' RABs which should be allocated to Negotiated Transmission Services.

The Commission's understanding is that the RAB established for each TNSP does not reflect the value of assets associated with negotiated or unregulated services. Where assets are used to provide contestable services or non-contestable services under a negotiated contractual arrangement, the existing Rules do not allow revenue in relation to those assets to be recovered via the annual average revenue requirement (AARR), and they are not included in the RAB.¹¹⁴ This is also reflected in the current practice of TNSPs.¹¹⁵

Given the Commission's understanding of current practice, locking in the current RAB values for the TNSPs is consistent with the approach proposed in the Rules to only include the value of assets associated with prescribed transmission services in the RAB,¹¹⁶ since these initial values should not include assets associated with negotiated or unregulated services.

The Commission's decision is that the Draft Rule approach to specifying the initial RAB values is appropriate. The values have undergone considerable scrutiny by the ACCC at each of the previous regulatory reviews. The risks (and thereby costs) associated with these initial values containing errors is therefore low, and likely to be outweighed by the benefits associated with specifying the initial RAB values in the Rule at this time.

5.3.1.7 Initial RAB for MNSPs that convert to regulated status

Schedule S6A.2.1(e) provides for market network service providers (MNSPs) that provide prescribed services to convert to a regulated asset, thereby receiving regulated revenue. It is commonly referred to as the 'safe harbour' provisions.

Of the various MNSPs that were built, the Murraylink and Directlink interconnectors subsequently applied to be treated as regulated assets in accordance with the 'safe harbour' provisions. In both instances, the ACCC for Murraylink and the AER for Directlink, considered that it was appropriate for the assets to be converted to prescribed assets, and undertook the task of determining an appropriate valuation for each asset.

The approach to determine the appropriate valuation was to use the framework provided by the regulatory test, particularly the market limb, as though the assets were new network augmentations.¹¹⁷ If the regulatory test was satisfied and the asset generated the greatest market benefits, then the asset was to be included at its historical cost, less an allowance for depreciation for the period since it was built. If an alternative option, in accordance with the regulatory test, generated the greatest market benefits, then the value of this alternative

¹¹⁴ See clause 6.3 and Schedule 6.2; clause 6.5.3(b) and clause 6.2.4(f) of the existing Rules

¹¹⁵ See for example Transend *Transmission Pricing Policy, Issue V3.0*, October 2005, p.6

¹¹⁶ Plus assets which are to be grandfathered.

¹¹⁷ It is important to note that there was no guidance in the NEC at the time that the ACCC should use the Regulatory Test to determine the asset values.

option would become the basis for determining the value of the asset. Finally, if the regulatory test was not satisfied, then the AER would undertake an economic valuation, based on the optimised deprival methodology, as provided for in the Rules.

In developing the Draft Rule for determining the value of the MNSP's asset for inclusion in the RAB, the Commission sought to remove scope for the AER to substitute the value of an alternative option, in place of the market benefits or efficient cost approaches. The Commission believed that it was preferable for the value included in the RAB to be directly related to the original investment made under the safe harbour provisions for MNSPs, to ensure that the converted MNSP receives a return based only on the efficient costs of the investment, or the benefits the investment provides to the market. The approach adopted in the Revenue Rule is to retain the calculation of the RAB value to the lesser of the efficient costs of the assets, or an economic valuation for any future MNSP seeking conversion.

The approach in the Draft Rule for the treatment of MNSP's seeking conversion in the future was for the initial RAB, upon conversion, to be determined as the lower of:

- the efficient capital costs of the investment – Draft Rule S6A.2.1(e)(2)(i); or
- the NPV of the incremental net benefit derived by the market from the MNSP converting to regulated status plus the NPV of the expected revenue the MNSP would earn if it did not convert, minus the NPV of the expected operating costs over the life of the asset – Draft Rule S6A.2.1(3)(2)(ii).

The first method was designed to ensure that the regulated return that an MNSP receives from converting would not exceed its actual prudent capital expenditure cost. This is the return which a regulated interconnector would expect to receive, if it passed the regulatory test. The Commission argued that this provision is required to ensure that there is a level playing field between regulated and unregulated TNSPs, and that a TNSP cannot get a higher RAB through bypassing the regulatory test process set out in Chapter 5 of the Rules.

The second method was designed to ensure that the amount paid to the MNSP after conversion would not exceed what market participants are currently willing to pay the MNSP (i.e., expected revenue if it does not convert) plus the additional benefit to the market from the conversion, which would usually arise if the capacity of the MNSP was constrained prior to conversion. Provided that the total regulated cost (RAB plus lifetime operating expenditure) is set somewhere between the expected revenue to the MNSP of continuing to act as an MNSP and the maximum value established under the second method, then both market participants and the MNSP are expected to benefit from the MNSP's change in status. This provision ensures that the converting MNSP receives at least its efficient costs or its net benefits plus the revenue it would earn if it didn't convert while consumers are not forced to pay more for the services than the benefits they derive.

The Group¹¹⁸ submitted that the right for TNSPs to convert to regulated status should be abolished. However, the Commission considers that it is still desirable to retain such safe

¹¹⁸ The Group, September 2006, p.6

harbour provisions at this stage of development of the NEM as long as it provides a clear and appropriate signal to investors.

The Tasmanian Government expressed concern that the approach outlined in the Draft Rule limits the market benefits that can be included in the valuation approach.¹¹⁹ In addition, the Tasmanian Government has concerns that the method outlined in the Draft Rule would be difficult to practically apply because of uncertainty in determining the additional market benefits not currently included in existing revenue. The Tasmanian Government was of the view that the Basslink interconnector must be subject to a grandfathering provision to preserve the conditions created for such entrepreneurial investments which applied at the time such investments were made.¹²⁰

In regard to difficulty in forecasting future MNSP revenues, the Commission is not convinced that this is an unreasonable approach. In this regard it is noted that such forecasting is common practice and would ordinarily be undertaken by any investors contemplating investment in market transmission services.

The Commission agrees with the Tasmanian Government that the provisions relating to the conversion of MNSPs in the current Rules is unclear. In addition, it recognises that the existing investment in Basslink was made with a recognition of the previous ACCC treatment of conversion. On that basis, the Commission considers that the most appropriate application of the Revenue Rule in relation to MNSP conversion should be as a signal to new investment rather than to existing MNSPs. Therefore, in response to continued concerns submitted by the Tasmanian Government, the Commission has included specific transitional and savings arrangements that relate specifically to the Basslink MNSP. These are detailed in Chapter 8.

5.4 Depreciation

The Draft Revenue Rule requires the TNSPs to propose depreciation schedules that must comply with the following principles set out in the Rules:

- each asset (or group of assets) is to be depreciated over its economic life; and
- each asset is to be depreciated only once, and the total sum of the allowed depreciation over the asset's life is to equal the initial value at which the asset entered the RAB.

Provided the TNSP's proposed depreciation schedules complied with these two principles, the AER is to use these schedules in calculating depreciation. If they do not, the AER is able to determine schedules that do comply in calculating depreciation allowances.

This approach codifies current practice. The Commission considers that substantial prescription in the Rules in relation to depreciation would reduce the flexibility of the TNSPs and the AER to alter the depreciation approach, where such change may be warranted. The

¹¹⁹ Tasmanian Minister for Energy to Dr Tamblyn of 14 September 2006

¹²⁰ Tasmanian Minister for Energy to Dr Tamblyn of 14 September 2006, p.6.

Commission also considers that the discretion to propose depreciation schedules appropriately lies with TNSPs rather than with the regulator, as it is the TNSPs that have the best knowledge of the condition and likely future utilisation of their assets.¹²¹

In addition, the Revenue Rule requires the AER to undertake the roll-forward of the RAB on the basis of depreciation of actual capital expenditure, rather than the allowance in the previous regulatory determination. This issue is discussed in more detail in Chapter 6.

5.4.1 Commission's Analysis and Reasoning

The AER, Energy Regulatory Authority, South Australian Government and MEU all submitted that the AER should be provided with greater flexibility or retain discretion to consider and alter TNSPs' depreciation schedules in order to protect the long term interests of consumers.¹²² These submission identified concern that the Draft Rule approach would allow TNSPs to either vary their depreciation profiles to obtain desired revenue outcomes, or to depreciate assets more than once.

5.4.1.1 Assets to be depreciated over their economic lives

The Commission has received a number of submissions focused on clause 6A.6.3(b)(1) which required the TNSP to:

"...depreciate the value of each asset or category of assets over the economic life of the asset or category of assets;"

The MEU stated that the Commission must address the fact that consumers are paying in excess of a reasonable allowance for depreciation, and the approach to depreciation significantly increases the amount of funds consumers are required to pay.¹²³ The MEU also considered that to allow a TNSP to set its own depreciation schedule is not in accordance with the basic premise of "competition by comparison" that underpins the regulatory approach used in Australia.¹²⁴

The effect of clause 6A.6.3(b)(1) is to limit the period over which the TNSP is able to depreciate assets but not limit the profile that the TNSP adopts during this period. That is, the TNSP has the flexibility to increase or decrease the level of depreciation in a given year conditional on the asset being fully depreciated by the end of its economic life.

In effect this allows TNSPs to choose the level of building block revenues in a given year by adjusting their proposed depreciation profile. While adjusting the depreciation profile would allow a TNSP to obtain its desired revenue outcomes, it may also result in greater

¹²¹ Australian Energy Market Commission, Review of the Electricity Transmission Revenue and Pricing Rules, Transmission Revenue: Rule Proposal Report, February 2006, p.66

¹²² Australian Energy Regulator, March 2006, p.29; Economic Regulation Authority, Western Australia, March 2006, p.6; South Australian Government, March 2006, p.3; Major Energy Users, September 2006, pp.35-38, October 2006, pp.4-5..

¹²³ Major Energy Users, September 2006, p.38.

¹²⁴ Major Energy Users, September 2006, p.35.

price volatility. This was the concern raised by several submissions which supported either the continued use of straight line depreciation or allowing the AER to review a TNSP's depreciation schedule.

While the potential for revenue manipulation will be somewhat constrained by the transmission pricing rules where there are constraints on allowed annual movements in prices, the Commission agrees with the MEU that there is merit in ensuring depreciation profiles (within the economic life constraint) are realistic with regard to:

- the extent to which the profile of depreciation is commensurate to the economic life of the asset or category of assets; and
- the extent to which the profile is consistent with accepted commercial methodologies for the profiling of depreciation for assets of a particular type or category (e.g., 'back ending' or 'front loading' based on the expected use and risk profile of an asset).

The Commission has therefore revised the relevant criterion to require the depreciation profile to reflect the "nature of the assets or category of assets" within the overall economic life constraint. In this regard, the Commission would expect TNSPs to demonstrate to the AER's satisfaction that their depreciation profiles are consistent with the above conditions.

5.4.1.2 Assets to be depreciated only once

The MEU raised its concern regarding the way the depreciated optimised replacement cost (DORC) approach is applied to depreciation commenting that:

*"This means consumers pay the regulated business 3-4 times the value of the initial investment in depreciation."*¹²⁵

While the Commission's approach does permit TNSPs to propose their own depreciation schedules, the Rules also provide the AER discretion to determine depreciation schedules where a TNSP's proposal does not conform to prescribed criteria.

In light of the responses received, the Commission has given further consideration to the prescribed criteria to be applied by the AER in assessing the appropriateness of TNSPs proposed depreciation schedules. In this regard, the Commission has added a third criterion to ensure that prospective and retrospective depreciation schedules (applying to the same assets or category of assets) are calculated on a consistent basis.

This criterion requires that the asset lives, depreciation methodology and any applicable depreciation rates used to forecast depreciation for a given asset or category of assets are also used when actual depreciation is calculated for the RAB roll forward in the following regulatory period. Importantly, while this approach still affords TNSPs the ability to vary their depreciation approaches, such variation can only be submitted on a prospective basis. This approach therefore improves the consistency and predictability of the regulatory

¹²⁵ Major Energy Users, September 2006, p.55

treatment of depreciation and strengthens the Rules that give effect to the policy intent that assets should only be depreciated once.

The Commission considers that this additional constraint better preserves the symmetric incentives intended by the high powered capital expenditure incentive regime created through the use of actual depreciation for the purpose of the RAB roll forward.

The ETNOF submitted that clause 6A.6.3(b)(2) of the Draft Rule would prevent the regulator giving effect to the policy intention of allowing the roll forward of the RAB on the basis of actual depreciation.¹²⁶ The Commission does not agree with this view. The Commission does not consider that variations between actual and forecast depreciation will mean that clause 6A.6.3(b)(2) cannot be met. Further, the Commission notes that the applicable clause with regard to the RAB roll forward of actual expenditure and actual depreciation is S6A.2.1(f)(5) which unambiguously requires that:

"The previous value of the regulatory asset base must be reduced by the amount of actual depreciation of the regulatory asset base during the previous regulatory control period."

The Commission is satisfied that this RAB roll-forward clause in conjunction with the prescribed criteria for consideration of TNSPs' depreciation schedules will:

- provide high powered capital expenditure efficiency incentives;
- ensure TNSPs receive a full return of their investments while preventing them from receiving multiple returns of the same investment;
- preserve flexibility for TNSPs to propose (and vary) their depreciation characteristics on a prospective basis while allowing variation of actual depreciation amounts in line with actual capital expenditure amounts and forecast depreciation characteristics; and
- ensure depreciation profiles are commensurate with the economic lives of the assets or are at least demonstrated to be consistent with accepted commercial practices for the profiling of depreciation.

Having made these further modifications to the treatment of depreciation in response to stakeholder submissions the Commission is satisfied that the approach adopted in the Revenue Rule maintains the flexibility to the TNSP while ensuring that the AER has suitable guidance in Rules to deliver efficient outcomes that are consistent with the NEM objective.

5.5 WACC

The return on capital invested in transmission infrastructure to be recovered as a component of the regulated revenue is determined by applying an estimate of the weighted average cost of capital (WACC) to the RAB. The WACC is estimated by the regulator during revenue resets based on a well established methodology and procedures that has been employed by regulators across Australia and internationally. This methodology was incorporated into the

¹²⁶ ETNOF, 11 September 2006, p. 30.

ACCC's Statement of Regulatory Principles (SRP) and has been codified in the Revenue Rule through this Review process.

In this context, the Commission's consideration of WACC issues within this Review may be broadly categorised as:

- general WACC approach issues; and
- WACC parameter estimate issues.

These are considered separately in the following sections.

5.5.1 WACC approach

There has been widespread acceptance of the capital asset pricing model (CAPM) as the analytical basis for estimating the regulatory cost of capital. Although there has been ongoing debate about the parameter values used by the regulator to estimate the WACC at each revenue reset, there has been a high degree of stability in the parameter values adopted by the regulator in recent years. Considering these circumstances the Commission believes that the cost and uncertainty associated with continually reopening both the methodology and parameters at each revenue cap review is unwarranted in terms of any potential benefits and the administrative costs.

Providing short term stability regarding the WACC determination reduces an important source of potential variability in regulatory decision making thereby providing a more certain and predictable environment for investment and financing decision making. This is consistent with the approach adopted by the AER under the SRP, however, this was an administrative document which could be departed from at any time. The provisions codified in the Revenue Rule therefore largely represent current practice. However, it is also recognised that the methodology and parameters for the cost of capital are matters that the regulator must be able to review periodically and to exercise discretion and judgement as to whether there is a case for change.

Enabling the AER to review the methodology and parameters periodically and make appropriate changes provides appropriate flexibility and discretion for the regulator to take account of changes in financial market conditions and developments in finance theory and practice. For this reason the Revenue Rule gives the AER the discretion to vary the WACC methodology or parameters at subsequent five-yearly reviews following the consultation process in the Rules.

Consistent with the view that regulatory discretion should be exercised in accordance with appropriate guidance in the Rules, the Revenue Rule includes principles and criteria that the AER must have regard to in making a determination to vary either the methodology or the parameters at subsequent reviews. A number of submissions have suggested that such guidance is appropriate and the Commission agrees with this view.

The following criteria for assessing the WACC parameters and methodology have been included in the Revenue Rule:

- the review should promote an outcome of a forward looking rate of return required by investors, commensurate with prevailing conditions in the market for funds and the risk involved in providing prescribed transmission services;¹²⁷
- the Rules make clear which values and methodologies are to be reviewed by the AER;¹²⁸
- the parameters resulting from the AER's review should remain consistent with the Rules, including that:
 - the return is calculated as a weighted average of the costs of equity and debt, as per the formula set out in the Rules;¹²⁹
 - the cost of debt should reflect the current cost of borrowings for comparable debt;¹³⁰
 - specified parameter values are to be based on a benchmark efficient TNSP (as opposed to reflecting actual decisions or costs);¹³¹ and
 - for parameters which cannot be determined with certainty, the AER should be required to:
- have regard to the need to achieve an outcome which is consistent with the market objective; and
- satisfy itself that current evidence on the value of the parameter is sufficient to justify a change from the value adopted in the last review.¹³²

5.5.1.1 Commission's Analysis and Reasoning

TNSP submissions have generally been supportive of the Commission's approach of codifying the WACC parameters in the Rules and providing for a review of the parameters every five years. For example a number of submissions supported the inclusion of the WACC parameters in the Rules as giving greater certainty for all regulated businesses.¹³³

¹²⁷ Clause 6A.6.2(j)(1)

¹²⁸ Clause 6A.6.2(i)

¹²⁹ Clause 6A.6.2

¹³⁰ Clause 6A.6.2(j)(2)

¹³¹ Clause 6A.6.2(j)(3)

¹³² Clause 6A.6.2(j)(4)

¹³³ Citipower, September 2006, pp.1-2, Integral Energy, September 2006, p.4, EnergyAustralia, September 2006, pp.8-9, Country Energy, September 2006, p.4

Amid the support for the general approach, some submissions noted specific concerns with the Commission's approach.

The AER raised the concern that the codification of five-yearly WACC parameter reviews was unduly restricting and that it was likely to increase uncertainty in the period immediately preceding reviews.¹³⁴ The AER proposed that it review individual WACC parameters as information becomes available, and that a 12 month lead time be implemented between the completion of such reviews and the use of revised parameters in regulatory decisions.

The Commission has considered the proposal put forward by the AER and retains the view that the Revenue Rule approach provides greater certainty to industry participants than that proposed by the AER, thereby providing a more stable investment environment. The Commission does not agree that the five-yearly review cycle will increase uncertainty. Indeed by moving the assessment of WACC parameters outside the arena of individual revenue determinations, the Commission believes that the Revenue Rule approach provides additional certainty to both industry participants and the AER.

With regard to timing of the initial WACC review, the MEU submitted that:

*"the AER be asked to assess the WACC parameters initially (rather than have them set at this time by the AEMC without any review) and then apply them for a maximum of 5 years. Further, to avoid providing advantages/disadvantages to different TNSPs due to the timing of reset reviews, we recommend that the WACC review will result in a change in WACC to all TNSPs regardless of where in the review cycle they maybe. This will be equitable to all involved."*¹³⁵

The MEU also expressed the view that a five-year WACC review schedule would result in parameters being locked in for some TNSPs for up to nine years.¹³⁶

While the Commission maintains the view that the five-yearly WACC review provides additional certainty to industry participants, it is sympathetic to the views expressed by the MEU (above) and the AER (in its dialogue with the Commission) that the first WACC review should be commenced as soon as possible, rather than waiting five years (i.e., until 2012). In this regard, the Commission has decided that the initial WACC review should be completed by 1 July 2009 and that the resulting WACC parameters should apply to all revenue resets determined in the five year period commencing *after* that date.

This approach means that all TNSPs, either via the transitional arrangements or Revenue Rule, will be afforded the same treatment in the next revenue reset with regard to WACC

¹³⁴ Australian Energy Regulator, September 2006, pp. 26-27

¹³⁵ Major Energy Users, October 2006, p.4

¹³⁶ Major Energy Users, September 2006, p.24

parameters.¹³⁷ At the same time, it also ensures the first WACC review is completed within the first two and a half years of operation of the Revenue Rule.

The Commission has not adopted the MEU's suggested approach of applying the outcome of WACC reviews to all TNSPs regardless of where they are within their regulatory control period. This is because such an approach would be contrary to the incentives the Commission is seeking to provide. Specifically, where a TNSP anticipates that a WACC review will result in a higher WACC, it will have an incentive to inefficiently defer capital investments (within its regulatory period) until after the WACC decision. Similarly, capital investments may be inefficiently brought forward (within the regulatory period) where a TNSP anticipates a reduced WACC.

The Commission's approach avoids these inefficient incentive impacts by ensuring that:

- the same WACC is provided throughout a given regulatory control period in order to preserve even investment incentives; and
- all TNSPs are afforded the same WACC parameters for a single regulatory control period. That is, no TNSP is advantaged or disadvantaged by the timing of the WACC review as each TNSP will receive the same codified WACC parameters for a period of no more, and no less than five years.

The Commission does not agree with the MEU's concern regarding the potential for WACC parameters to be effectively locked-in for nine year periods. Except to the extent a TNSP may have a nine year regulatory period, each TNSP will be required to use the most recently reviewed parameters of the AER at its next determination and apply it for five years. Take, for example, a situation where a revenue determination is due in 2011 and the review of WACC parameters occurred in 2009. At the 2011 revenue determination the TNSP will be required to use the WACC parameters and methodology determined at the 2009 WACC review for the length of its determination, assumed to be a five-year period. At its subsequent revenue determination, the TNSP would be required to adopt the WACC parameters from the 2014 review for its 2016 revenue determination. Clearly, each TNSP will only be able to apply the relevant set of WACC parameters for a five year period.

Other issues raised in submissions included:

- concern about the Rules specifying the averaging period for the risk free rate; and
- a proposal to limit the five-year review of WACC parameters to only considering new information since the last review.

Averaging period for the risk-free rate

The ETNOF raised concerns with the Draft Rule approach whereby the averaging period was to be specified by the TNSP in its proposal, and would thereby be known within the market.

¹³⁷ With the exceptions of Murray Link and Direct Link which are both subject to 10 year regulatory control periods expiring in 2013 and 2015 respectively.

The ETNOF considered this to create potential for financial market traders to use this information to exploit the TNSPs being constrained to this period, leading to an increased cost of debt. Consequently, ETNOF proposed that:

the TNSP and AER reach agreement over the averaging period for the risk free rate at the start of the review, and that the TNSP have the option of keeping that date confidential until it has passed (i.e. the date would be published as part of the final decision).¹³⁸

The Commission understands that the current approach with regard to the averaging period is for the AER to keep the period confidential until its Rule Determination, thereby allowing the TNSPs to undertake relevant financial market operations without the averaging period being known in the market. The Commission considers the ETNOF's proposed approach to be consistent with current practice and that such an approach provides sufficient transparency to stakeholders given the publication of the averaging period in the reasons for the relevant determination. The Revenue Rule therefore allows TNSPs the flexibility to keep the averaging period confidential until it has expired.

Limiting five-yearly reviews to new information

Integral Energy, EnergyAustralia and Country Energy submitted that the five-yearly reviews of the WACC parameters should be limited to a consideration of new information on each parameter. This was proposed as an additional means of limiting the administrative burden associated with ongoing dispute of specific WACC parameter issues.¹³⁹

The Commission considers that the additional measures introduced via this Review of codifying certain WACC parameters and the scheduling of periodic reviews thereof, represents a significant enhancement in the regulatory and investment certainty faced by industry participants. In this regard, the Commission is of the opinion that the proposal to limit the five-yearly reviews to an examination of only new evidence relating to each WACC parameter is likely to unduly fetter the AER's scope to undertake a review of the WACC parameters.

It is expected that any changes to WACC parameters will be based on all relevant currently available evidence and information, thereby obviating any need to limit the review in the Rules. In addition, any changes to the WACC parameters or methodology is required to be consistent with the guidance contained in the Rules. The Commission has therefore maintained the review provisions specified in the Draft Rule.

¹³⁸ ETNOF, September 2006, p.27

¹³⁹ Integral Energy, 11 September 2006, p.4; EnergyAustralia, September 2006, p.9; CountryEnergy, 11 September 2006, p.5.

5.5.2 WACC Parameter Commission's Analysis and Reasoning

The Revenue Rule specifies a number of key WACC parameters to apply for the five year period up to the AER's first WACC review (or until a Rule Change proposal has been ruled upon).¹⁴⁰ These parameters are the:

- equity beta (set at 1.0);
- gamma (set at 0.5);
- market risk premium (set at 6.0%); and
- benchmark credit rating of TNSPs (set at BBB+).

Submissions were received on the Commission's approach to each of the above parameters and these are discussed in greater detail below.

5.5.2.1 Commission Analysis and Reasoning

Equity beta

A number of submissions expressed concern regarding the Commission specifying an equity beta of 1.0 in the Rules. The MEU considered that the regulatory framework in the Draft Rule is likely to reduce risks to the TNSPs thereby leading to conditions supporting a lower equity beta assumption than 1.0. The MEU viewed this to be the case particularly due to the removal of any *ex post* review of capital expenditure.¹⁴¹ The SA Centre for Economic Studies submitted that 1.0 is too generous and that the SA appeal panel also upheld this view in its decision on ETSA Utilities' appeal of the Essential Services Commission of South Australia's 2005-2010 Electricity Distribution Price Determination.¹⁴²

While the MEU and the SA Centre for Economic Studies raised concerns about the value for the equity beta, they did not provide any new evidence on the value to be attributed to it. In the absence of new information, the Commission considers that the reasons for its decision in the Draft Rule to adopt an equity beta value of 1.0 are still valid.

Specifically, the Commission notes that the equity beta is the most difficult WACC parameter to estimate, as it cannot be measured accurately from available empirical data. The Commission understands that the value of 'one' that was adopted in the SRP represents a compromise between the difficulties of estimation and the consequent need to err on the side of caution. Regulators have applied equity betas above and below 'one', but 'one' has come to represent the most widely accepted practice.

In the interests of certainty and predictability the Commission has codified elements of the SRP where there is general acceptance. Consequently, the Revenue Rule specifies an equity

¹⁴⁰ Clauses 6A.6.2(b) and (e).

¹⁴¹ MEU, September 2006, p.18

¹⁴² SA Centre for Economic Studies, September 2006

beta of 1.0. Should compelling evidence arise to warrant a change in the assumed equity beta, this can be dealt with, as appropriate, at the time of the AER's five year review of the WACC parameters.

The value of gamma

Citipower and Powercor submitted that the 0.5 value for gamma is based on outdated market evidence, and that it therefore requires updating with new information. Specifically they indicated that:

Previous regulatory decisions have relied on the research of Hathaway and Officer published in 1996 in setting the value of gamma to 0.5. ... [and]

*"The value of gamma is too important to set based on dated research. The AEMC should set the value of gamma on the basis of a robust assessment of the available market evidence and practice."*¹⁴³

During this Review, AGL¹⁴⁴ and CitiPower and Powercor submitted reports indicating that the value of gamma should be in a region between 0 to 0.5.¹⁴⁵ These reports were also presented to the Essential Services Commission (ESC) in the course of the recent Victorian 2006-2010 Electricity Distribution Price Review. At that time the ESC undertook extensive analysis of these reports in making its Rule Determination and in particular on the assumptions of the effective tax rate and the samples used.¹⁴⁶ From this analysis and the evidence of the reports, the ESC determined that there was inadequate evidence to support changing the value of gamma from 0.5.

On this basis the Commission maintains the view that it is not appropriate to change the value of gamma at this stage. However, the Commission notes that the value of gamma is also subject to review by the AER every five years, allowing additional analysis and developments in financial theory to be taken into account at that time.

Market risk premium (MRP)

¹⁴³ Citipower and Powercor, September 2006, pp.1-2

¹⁴⁴ AGL, 21 March 2006, p.5

¹⁴⁵ Gray, S. 'A Framework for Quantifying Estimation Error in Regulatory WACC - Report for AGL in relation to ESC Electricity Distribution Review' Strategic Finance Group, October 2004; Hathaway, N and Officer, R. 'The Value of Imputation Tax Credits: Update 2004', Capital Group, 2 November 2004; Gray, S., 'The Relationship Between Franking Credits and the Market Risk Premium: Implications for the Regulatory Cost of Capital' Strategic Finance Group, 18 August 2005. Partington, G., Peat, M., and Truong, G., 'Cost of Capital Estimation and Budgeting Practice in Australia'; Lonergan, W., 'The disappearing returns: Why dividend imputation has not reduced the cost of capital', JASSA, Issue 1, Autumn 2001; KPMG, 'The Victorian Electricity Distribution Businesses Cost of Capital - Market practice in relation to imputation credits', August 2005

¹⁴⁶ Essential Services Commission, 'Electricity Distribution Price Review 2006-10 Final Decision Volume 1 Statement of Purpose and Reasons', October 2005, pp.400-413

The Revenue Rule specifies a market risk premium of six per cent on the basis of the approach consulted on and adopted in the SRP. Submissions received were supportive of the six per cent assumption.

Credit rating assumption of BBB+

The Revenue Rule specifies a credit rating assumption for the debt margin of BBB+. This is on the basis of the Commission's consideration of analysis contained or referred to in various submissions, previous regulatory decisions, credit rating agency methodologies, model assumptions, and observed credit ratings. The Commission's detailed consideration of this matter was provided in the Draft Rule Report Chapter 5 and the Commission's assessment has not changed in preparing the Revenue Rule.¹⁴⁷

5.6 Tax

The Proposed Rule contained high level guidance on how the cost of tax should be estimated, including that it should be based on benchmark parameters and not a TNSP's actual tax costs. The Commission considers that more prescriptive guidance on the calculation of tax is not warranted in the Rules, and that guidance on the calculation of tax is a matter better left to the discretion of the AER. The Revenue Rule therefore requires the AER to set out the approach for calculating the cost of tax as part of its PTRM.

The Revenue Rule also codifies the value of imputation credits (γ), deeming that value to be equal to 0.5, consistent with the SRP. This value is to be reviewed at five-yearly intervals by the AER, with the resulting value applied to all regulatory determinations between these reviews (consistent with the treatment required for other WACC parameters).

5.6.1 Commission's Analysis and Reasoning

Submissions in relation to the estimated cost of corporate income tax and, in particular, the treatment of tax depreciation and the value of imputation credits raised a number of issues which the Commission has responded to as follows.

5.6.1.1 Tax depreciation

The current practice of the AER is to calculate tax depreciation by:

- setting the initial tax asset value equal to the regulatory asset value; and
- applying the rates of depreciation that are available for tax purposes to be used in taxation calculations.

The Rule Proposal required the use of 'estimated depreciation for tax purposes.' This potentially deviated from the AER approach by requiring the TNSP to calculate tax

¹⁴⁷ Australian Energy Market Commission, 'Draft National Amendment (Economic Regulation of Transmission Services) Rule 2006, Draft Rule Determination, February 2006.

depreciation on the basis of actual initial tax asset values rather than *benchmark* initial tax asset values.¹⁴⁸

The difference in approaches to valuing initial tax assets would in most cases not lead to a difference in the estimated cost of corporate income tax. However, in the following circumstances the use of *actual* rather than *benchmark* initial tax asset values would result in a different level of tax depreciation in a given regulatory year:

- for those initial assets that have tax asset values that are different than their initial regulatory (benchmark) value. For example, where the purchase price of a privatised regulatory business is used for tax purposes rather than the regulatory asset value;¹⁴⁹ and
- where the value of new capital expenditure has been optimised.

In each of these scenarios the value for tax purposes would not equal the regulatory value of the assets.

This raises the question of whether *actual* or *benchmark* initial tax asset values is appropriate when estimating a TNSP's corporate income tax costs. The ETNOF raised the arguments that:

- the use of benchmark tax values is consistent with the current regulatory practice of the AER and the Victorian ESC; and
- the use of actual tax costs is inconsistent with setting revenues independent of ownership decisions.

The Commission concurred with these arguments, and amended the Draft Rule to make clear that the estimate of tax depreciation is to be made in relation to a 'benchmark efficient TNSP'.¹⁵⁰

In response to the Draft Rule, the ETNOF submitted that the estimated taxable income definition should be further modified to explicitly define the taxable income as being for a 'benchmark efficient entity'.¹⁵¹ The Commission notes that its intention was that the calculation of the estimated cost of corporate income tax be based on an appropriate benchmark efficient entity rather than the actual taxable income of the regulated business. Such intent is illustrated in the use of the phrase 'benchmark efficient TNSP' in clauses 6A.6.4(a)(1) and 6A.6.4(a)(2) of the Revenue Rule.

¹⁴⁸ Note that both approaches would require the TNSP to use the applicable rates of depreciation allowed by the Australian Tax Office.

¹⁴⁹ This is the example raised in the Electricity Transmission Network Owners' Forum submission, March 2006.

¹⁵⁰ Draft Rule, clause 6A.6.4

¹⁵¹ ETNOF September 2006, pp. 32-33

The Commission intends its definition to give effect to the codification of current regulatory practice under the SRP. Therefore, for the avoidance of doubt, the Revenue Rule specifies that the estimated taxable income should be that of an efficient benchmark entity as determined in accordance with the PTRM.

6. Incentives in the Regulatory Framework

In addition to providing regulated businesses with the revenues required to provide prescribed transmission services through the building blocks revenue allowances discussed in chapter 5, regulators also need to provide incentives to ensure that absent competitive constraints:

- expenditures incurred by regulated businesses are efficient; and
- regulated businesses face incentives to meet or exceed service and reliability targets and requirements.

This chapter describes the role of incentives in the Commission's proposed framework for the economic regulation of transmission revenues. These incentives are targeted at the provision of prescribed transmission services only, as the incentives associated with negotiated or unregulated contestable services can be agreed through contractual arrangements between the parties.

Given the multi-dimensional nature of the services provided by TNSP's and the range of inputs used to provide these services, the Commission maintains the view that the most appropriate method for regulating TNSPs is to use a range of incentive mechanisms that work harmoniously together. While the incentive properties of each element of the package of incentive mechanisms are important, the more important consideration is the overall effect of the package of measures.

In its consideration of the incentive mechanisms within this Review the Commission has sought to address a number of key issues which have arisen from a number of sources including:

- the requirements of the NEM objective (see section 1.3) and the Commission's obligations under the NEL (see Appendix A);
- stakeholders' views expressed in submissions; and
- the Commission's further analysis.

In particular the Commission's approach to incentive arrangements has sought to reflect the need for economic regulation to provide:

- an appropriate degree of certainty about the regulatory framework and investment environment in order to encourage timely and efficient development of capacity;
- effective incentives to encourage TNSPs to build and operate their systems efficiently;
- incentives for TNSPs to effectively manage the risks that are reasonably within their control; and
- incentives for TNSPs to improve service quality where this is sufficiently valued (collectively) by customers and disincentives for TNSPs to increase profitability by inefficiently reducing service quality.

6.1 Role of Incentives in Economic Regulation

The role of incentives in regulation can be traced to the fundamental objective of regulation. That is, to reproduce, to the extent possible, the production and pricing outcomes that would occur in a workably competitive market in circumstances where the development of a competitive market is not economically feasible.

The Productivity Commission's Review of the National Access Regime pointed out that, notwithstanding the scope for market forces to exert some pressures on incumbent monopolists:

*"Clearly, there will be cases where providers of essential infrastructure services have both the incentive and capacity to behave in ways inimical to achieving efficient market outcomes."*¹⁵²

As discussed in the Commission's Issues Paper, one way to regulate TNSPs is cost-of-service regulation, under which TNSPs are allowed to recover their costs of providing prescribed network services. However, this approach has the drawback that TNSPs may seek to (inefficiently) increase their costs in order to increase their revenues and profits. As noted in the Productivity Commission Review, an important principle for access regulation is that it should provide incentives to reduce costs or otherwise improve productivity¹⁵³.

An alternative to cost-of-service regulation is incentive regulation. While cost-of-service regulation is based on remunerating TNSPs in respect of their *actual* costs, incentive regulation is based on remunerating TNSPs in respect of their *forecast* costs over the regulatory control period (which is typically three to five years). Because TNSPs are able to capture a proportion of the benefits of any unanticipated cost reductions (and must absorb unanticipated cost increases) that occur during a regulatory control period, they are encouraged to make cost savings. At the end of the period, the actual costs in this period may be used as a *basis* for establishing the reasonableness of the cost estimates provided by the TNSP in the subsequent regulatory period. In this way consumers share the benefits of the efficiency gains secured by the TNSP, just as in a competitive market costs savings are ultimately passed to customers as lower prices.

The means of implementing incentive regulation are often controversial. In particular there has been debate over the effectiveness of the incentive arrangements and the presence and effects of unintended consequences of the arrangements. For example, several submissions to the Productivity Commission Review argued that current approaches to access regulation in Australia tended to deter innovation and other efficiency-producing measures¹⁵⁴. On the other hand, as the MCE's Expert Panel on Energy Access Pricing pointed out, strong efficiency incentives for regulated businesses can mean a potential sacrifice of allocative

¹⁵² Productivity Commission, 2004, 'Review of Energy Access Regimes', Report No.17, AusInfo, Canberra, p.58.

¹⁵³ Ibid, Recommendation 12.1, p.xxxix

¹⁵⁴ Ibid, p.67.

efficiency gains caused by allowing prices to exceed costs. On this issue the Expert Panel observed that:

*"The optimal balancing of [productive, allocative and dynamic] efficiency inevitably depends on a judgment about the efficacy of high powered incentives to achieve productive and dynamic efficiency objectives, against the extent of monopoly rents that are considered acceptable."*¹⁵⁵

The alternative to creating incentives to maintain service standards is to simply mandate the required level of service. However, this ignores the willingness of customers to make trade-offs to some extent between TNSPs' costs (and implicitly transmission charges) and service or reliability levels.

A key consideration in designing an incentive regime is the strength of the individual and suite of incentive mechanisms. As noted in the Expert Panel Review:

*"The strength of the incentives under any price control setting method depend on the extent to which the arrangements allows a firm to earn more than the target rate of return applied at the time the price control was determined, and the extent to which those returns are able to be retained by the firm in subsequent regulatory periods."*¹⁵⁶

The extent to which TNSPs are allowed to benefit from the efficiency gains (and bear the risk of efficiency losses) that occur during a regulatory control period determines the strength or 'power' of the relevant incentive regime: a high-powered regime allows TNSPs to retain a relatively large share of the benefits, while a low-powered regime allows them to retain a smaller share.

In developing incentive arrangements it is important to consider the relative power of the different mechanisms on say, operating expenditure and capital expenditure, to ensure that interactions between them do not create distortions which result in inefficiencies. For example, this could occur if TNSPs were encouraged (by the scheme) to inefficiently substitute away from operating inputs in favour of more capital inputs. Thus, the power of the package of incentive mechanisms needs to be balanced. In this context 'balanced' means that the scheme does not cause inefficient substitution between inputs, or between outputs.

The Commission's framework for economic regulation as codified in the Revenue Rule seeks to provide a range of incentive mechanisms that work harmoniously together to provide an overall suit of incentive properties that deliver efficient and desired production and service outcomes. The component parts of the Commission's incentive framework include incentives for:

- efficient capital expenditure;
- efficient operating expenditure;

¹⁵⁵ Expert Panel on Energy Access Pricing, 'Report to the Ministerial Council on Energy', April 2006 Chapter 4, Productivity Commission 'Review of the Gas Access Regime', p.111

¹⁵⁶ Ibid., p.102

- maintaining service standards; and
- management of uncertain project costs or timing.

The remainder of this chapter discusses the Commission's approach to the economic regulation of these incentives. The discussion looks at issues raised in submissions as well as the Commission's response to those issues and its decisions included in the Revenue Rule.

An overarching incentive concern raised by the ETNOF was that the service incentive scheme should only apply to prescribed transmission services and that negotiated services should have their own incentive arrangements set in the contracts between the parties.¹⁵⁷

As noted above, the Commission's intent in codifying aspects of the incentive arrangements is that the incentive framework should seek to replicate a workably competitive outcome though the provision of efficient investment and operating incentives along with desired service reliability incentives. In the interests of not unduly fettering commercial negotiation, or innovative provision of contestable services, it is not desirable to codify in the rules, incentive arrangements for negotiated and non-regulated services. Such incentives are best determined via contractual agreement between the parties.

The only exception relates to incentives around the efficient management of capital assets so as to avoid asset stranding. This has been accounted for via other incentive arrangements (i.e., the RAB roll forward arrangements and optimisation clauses). Thus the Commission has only codified the expenditure and service incentive arrangements that are to apply to prescribed transmission services.¹⁵⁸

6.2 Operating Expenditure Incentives

The Revenue Rule provides for TNSPs to receive regulated revenues that include allowance for forecast operating expenditures. In addition, a benefit-sharing mechanism for operational expenditure is also required in order to provide for a continuous incentive (equal in each year) for the TNSP to make operating expenditure savings throughout a regulatory period. This is intended to ensure that TNSPs have the same incentive to make operating expenditure savings towards the end of a regulatory period as they do at the start of the period.

Under this approach, the AER is to consult and decide how it develops and implements this mechanism in accordance with the Rules. In particular, the power of the operating expenditure incentive mechanism is a matter for the regulator to determine, in accordance with the need to balance the powers of the respective incentive mechanisms.

¹⁵⁷ ETNOF, September 2006, p.16

¹⁵⁸ See for example clause 6A.7.4(b)(2)

6.2.1 Commission's Analysis and Reasoning

While stakeholders have supported the inclusion of a benefit sharing mechanism (or efficiency carry-over mechanism) in the regulatory framework, some concern has been raised regarding certain aspects of its specification. In particular the ETNOF and EnergyAustralia have stated concern regarding the ability for the AER to apply negative incentive mechanism carry-over amounts between regulatory periods. EnergyAustralia believed that any incentive mechanism should not restrict the business' ability to maintain its network by reducing funding in future periods.¹⁵⁹ The ETNOF believed that the AER should be required to consider whether a negative carry-over would meet the NEL requirements where the situation arises.¹⁶⁰

The efficiency benefit-sharing mechanism for operational expenditure aims to provide continuous incentive for TNSPs to make operating expenditure savings in each year of a regulatory period. The Commission considers that providing anything other than a rule framework which provides for the symmetric treatment of expenditure efficiency gains and losses would prevent the incentive mechanism from achieving its objective of providing even incentives in each year.

The Commission is cognisant of the requirement of section 35(3)(a) of the NEL which requires that rules in relation to economic regulation of transmission systems to 'provide a reasonable opportunity for a regulated transmission system operator to recover the efficient costs of complying with a regulatory obligation.' However it does not consider that this requires the Revenue Rule to prescribe a 'no negative carry-over' approach to economic regulation.

The Commission considers that where the AER were not permitted to take into consideration a negative efficiency carry-over in the determination of the MAR for the ensuing regulatory period, the intent and benefit of the incentives scheme would be prevented. In addition, the Commission does not consider that applying a negative carry-over is inconsistent with the NEL requirements. Specifically, the efficiency carry-over incentive mechanism applies only to the operating and maintenance expenditure component of the building block revenue allowance. This means that while TNSPs may incur a negative revenue assessment on this revenue component, they will still be receiving revenues from all other components of the building blocks. Furthermore, in some instances, TNSP's will also be receiving increased revenue through improved performance, via the service incentive arrangements. Therefore, in combination with other elements of the building block and incentive mechanism framework the TNSPs will likely be able to adequately fund their prescribed service requirements.

The Commission considers that this approach is consistent with the guided discretion afforded to the AER in determining the power of the operating incentive mechanism and the need to balance the power of the respective incentive mechanisms. The Commission has

¹⁵⁹ EnergyAustralia, September 2006, p.13

¹⁶⁰ ETNOF, September 2006, p.20

therefore retained a general presumption that any efficiency benefit sharing mechanism will be applied symmetrically to both efficiency gains and losses.

CitiPower and Powercor raised a concern regarding the notice period for changes to the efficiency carry-over guidelines. They considered that the notice period should be extended from 15 months to five years to provide stakeholders with more certainty and to ensure that the incentives provided under the scheme operate as intended.¹⁶¹

The Commission does not support the CitiPower and Powercor proposal to give five years notice on any changes to the guidelines for the efficiency carry-over incentive mechanism. The Commission does not consider that such an extended lead time is consistent with good regulatory practice in that it may impede the efficient review of the guidelines. The Commission forms this decision on the basis that the guidelines being reviewed would be applicable to the efficiency carryover mechanism that would apply in the calculation of the efficiency carryover amounts at the end of the ensuing regulatory period (ie. 15 months plus 5 years or 75 months).

The ETNOF were also of the view that the certainty of the carry-over scheme would be enhanced by requiring the AER to provide in its guideline full details of how the carry-over would be calculated in advance. The ETNOF suggests that this would include categories of operating expenditure that would and would not be included in the carry-over.¹⁶²

The Commission considers that the Revenue Rule requirements regarding the development of guidelines for the efficiency sharing mechanism are sufficiently detailed as to ensure the carry-over is adequately specified on an *ex ante* basis. Moreover, the mechanics of the mechanism are an issue of detailed implementation and should be left to the guided discretion of the AER.

The Rules give sufficient scope for the AER to address these issues in the guidelines should they see the need. In addition, the Rules require the AER to comply with the Transmission Guideline Procedures when developing or altering guidelines. These procedures set out a transparent public consultation process requiring reasons to be given for the adopted approach. It is therefore expected that issues such as the detailed mechanics of the efficiency incentive mechanism would be dealt with in the consultation relating to the guidelines.

6.3 Capital Expenditure Incentives

The Commission believes a reliable and secure transmission system is an important element in the NEM. The effective operation of the transmission grid is central to the operation of a competitive wholesale market. A principal focus of the Revenue Rule is to provide incentives for efficient, adequate and timely investment in new and replacement network capacity. The Commission has sought to do this by reducing the regulatory risk faced by TNSPs when investing in transmission capacity. At the same time the Commission sought to ensure that consumers do not pay more than necessary for transmission services. The

¹⁶¹ CitiPower and Powercor, September 2006, p.3

¹⁶² ETNOF, September 2006 p.21

challenge has therefore been to design an incentive package that finds an adequate balance between encouraging investment in new capacity and ensuring TNSP's undertake such investment efficiently.

A key mechanism for managing the investment risk for TNSPs was to 'lock-in' and roll forward the RAB from one regulatory period to the next. This aimed to give greater security to investors in the transmission system that their investments would be treated in an appropriate way over time. More specifically, the RAB would not be subject to optimisation at regulatory resets to reflect the economic value of the assets to users, which would otherwise present a significant risk to investors.

In terms of the arrangements to encourage TNSPs to develop, operate and price their networks efficiently the Revenue Rule provides for use of a package of mechanisms. Firstly, the arrangements provided for the TNSPs to retain the benefit of any underspend, or incur the cost of any overspend, compared to the capital expenditure forecast for the remainder of the relevant five year regulatory control period (with the benefit or cost being determined by applying the return on capital to, and depreciation on, the amount of under or overspend).

While the Proposed Rule had proposed to allow the AER to conduct an *ex post* review of the prudence of capital expenditure, this has been removed following stakeholder concern that such a review would undermine the incentive powers of the regime.

In general the criticism of the proposed *ex post* prudence review was that it undermined the incentives of the *ex ante* cap and contributed to the investment uncertainty that the remainder of the package sought to overcome. Submissions also raised the legitimate concern that *ex post* prudence reviews are, by their very nature, an intrusive form of regulation. An *ex post* review effectively requires the regulator to put itself in the position of a TNSP at the time that they were undertaking a particular project to determine if the project was undertaken efficiently. Previously, this process has been the subject of controversy when it has been applied to network businesses. For these reasons, the Commission has removed the arrangements for *ex post* reviews and instead focused more on improving *ex ante* incentives.

The Commission has also incorporated mechanisms to reduce TNSPs' risks related to the costs of unforeseen outcomes or difficult-to-predict events. This has included adopting a 'contingent project' regime for large capital projects that are planned but uncertain as to timing or cost. In addition, the Revenue Rule provides for a reopening of the revenue cap determination if the TNSP is obliged to invest in a major project (at least five per cent of the value of the RAB) and that investment would cause the TNSP to exceed its capital expenditure allowance for the entire regulatory period. These measures are intended to avoid encouraging TNSPs to defer necessary major investment where it would cause them to exceed their capital expenditure allowance for the period.

Finally, the Commission has sought to encourage TNSPs to negotiate with large customers whose ongoing operations are critical to the commercial viability of the network. In particular the Revenue Rule provides an incentive for TNSPs to seek to protect their assets against commercial stranding risks by entering into commercial agreements to avoid these situations or to recover losses from these critical customers should their disconnection cause stranding of assets primarily built to serve their needs. Specifically, the Revenue Rule provides for TNSPs to incur the costs of the asset stranding if they fail to take reasonable steps to manage the risk of commercial stranding of transmission assets. The Commission's requirements for managing this risk vary according to whether the asset was new or existing.

For existing assets, TNSPs are shielded from the risk of regulatory asset stranding provided they have made a genuine attempt to negotiate with certain (generally large) customers to ensure the ongoing commercial use of existing assets by these customers. For new assets, the Commission only requires that TNSPs take reasonable steps to protect against the risks of stranding.

6.3.1 Commission's Analysis and Reasoning

The Commission has removed the *ex-post* review of capital expenditure because many submissions expressed concern about the reduction of the incentive power that occurs from the inclusion of a prudency review of within period capital expenditure.¹⁶³ Submissions from TNSPs and their representative organisations have therefore supported the Commission's approach in this regard.

Taking into account the need to ensure the regime provides appropriate incentives for TNSPs to invest in sufficient capacity to maintain service levels amid dynamic demand conditions, the Commission maintains the view that it is not appropriate for an overspend of capital to be subject to a prudency review. If the AER was given the scope to exclude a capital overspend from the RAB the power of the incentive to efficiently incur capital expenditure costs that were not foreseen at the time of the applicable regulatory determination would be reduced.

The Commission considers that where a TNSP overspends on its capital expenditure relative to the allowance provided in the applicable regulatory determination, the approach of rolling this into the RAB on the basis of the actual depreciated amount will maintain the incentive for this overspend to be incurred efficiently.

That is, in line with the need to ensure that the appropriate incentives are provided to the TNSPs, the Commission does not consider it appropriate to remove depreciation from the incentive mechanism. In particular, the Commission is concerned to ensure that there is an appropriate balance between components of the incentive regime and that TNSPs do not face incentives to 'shift' expenditure inefficiently.

For example, in its Draft Rule, the Commission was concerned that a relatively low powered capital expenditure incentive paired with a relatively high powered operational expenditure incentive may distort TNSP use of inputs, thereby creating productive inefficiencies. Therefore, the Commission has increased the power of the capital expenditure incentive by including depreciation.

The Commission received a number of submissions with regard to capital expenditure incentives contained in the Draft Rule. Submissions from CitiPower and Powercor, APIA, the ETNOF, Country Energy and PIAC supported the removal of the *ex post* review of

¹⁶³ ETSA Utilities, 20 March 2006, p.4; ETNOF, March 2006, pp.15-16; CitiPower and Powercor Australia, 20 March 2006, p.2; Energy Networks Association, p.7; Australian Energy Regulator, March 2006, p.22

expenditure.¹⁶⁴ In contrast, EnergyAustralia and the MEU did not support the removal of the ex-post regime.¹⁶⁵ EnergyAustralia believed that regulated businesses should have the capacity to request a review of capital expenditure outcomes where incurred overspends were considered to be prudent and efficient. The MEU did not support the Commission's approach, stating its concern that such an approach would create incentive for the TNSPs to underspend and defer capital expenditure in each regulatory period (particularly towards the end of an given regulatory period) in order to improve profits.

EnergyAustralia and Country Energy also raised concerns regarding the inclusion of depreciation in the capital expenditure incentive.¹⁶⁶

The Commission retains the view expressed in its Draft Rule that a relatively low powered capital expenditure incentive paired with a relatively high powered operational expenditure incentive may distort TNSP use of inputs, thereby creating productive inefficiencies. It has therefore retained the Draft Rule approach in the Revenue Rule.

6.4 Service Performance and Reliability

Consistent with the NEM objective, a key objective for the Commission is the maintenance of service standards provided by TNSPs. It is important that greater efficiencies are not achieved at the expense of service standards. Therefore, a key element of the incentive regime is the arrangements to protect service standards.

The Draft Rule provided for TNSPs' regulated revenue to be subject to a service target incentive regime developed by the AER up to a maximum of plus or minus five per cent of regulated revenue. This represented a change from the Proposed Rule which had capped the service incentive rewards or penalties at plus or minus one per cent.

This change in the reward/penalty limit reflected the Commission's recognition of the need for the various incentive schemes applicable to TNSPs to be balanced in order to ensure TNSPs' decisions are not inappropriately skewed. Moreover, the Commission noted that the joint application of multiple incentive mechanisms requires a degree of flexibility and experimentation to produce optimal outcomes over time. The Commission therefore stated that the AER should have the discretion, with appropriate guidance, to engage in this process.

This adoption of a five per cent constraint was consistent with the Commission's view that an open ended service incentive would create excessive uncertainty, particularly given the relative novelty of the mechanism compared to the more well-known incentive arrangements for capital and operating expenditure.

¹⁶⁴ CitiPower and Powercor, September 2006, p.1; Australian Pipeline Industry Association, September 2006, p.5.; ETNOF, September 2006, p.3; Country Energy, September 2006, p.6; and Public Interest Advocacy Centre, September 2006, p.1.

¹⁶⁵ EnergyAustralia, September 2006, pp.9-10; Major Energy Users, September 2006, p.29.

¹⁶⁶ EnergyAustralia, September 2006, pp.9-10; Country Energy, 11 September 2006, p.6.

6.4.1 Commission's Analysis and Reasoning

6.4.1.1 Limit on service incentive rewards and penalties

A number of submissions to the Draft Rule were concerned with the specification of the limit of the service incentive mechanism. Integral Energy and ETSA proposed that the appropriate limit should be plus or minus one percent.¹⁶⁷ The ETNOF and Powerlink considered that the TNSP should be able to propose the limit, with this proposal then being accepted or rejected by the AER.¹⁶⁸ These submissions considered that such an approach would accommodate a reflection of each TNSP's different appetite and capability of absorbing risk, as well as the uncertainty inherent in the performance benchmarks for the regulatory period ahead.¹⁶⁹ The MEU was supportive of the five per cent limit stating that it adds significant incentive power to improve performance.¹⁷⁰

The Commission, in setting an upper limit on the bounds of the risk and reward of the scheme had the intent of allowing the AER to determine alternative values up to (and including) that limit. However, it is understood that by setting an upper limit, the intent of the AER being able to choose from a variety of values within a specified range was not necessarily clear. Therefore, in order to provide additional clarity in the Rules the Commission has decided to allow the AER to determine the upper and lower bound of the potential risk and reward of the scheme within a range of one per cent to five per cent.

The Commission considers that this flexibility is appropriate due to the interdependent application of multiple incentive mechanisms for TNSPs. In addition, such an approach will allow for experimentation and innovation to produce optimal outcomes over time.

6.4.1.2 Scope of incentives

A number of submissions were received regarding the interpretation of the Commission's approach to specifying service incentives and the intended impact on TNSP behaviours. Specifically, submissions from the ETNOF, MEU, TEC, EnergyAustralia and Country Energy commented on the scope of the scheme.¹⁷¹ The ETNOF considered that the service incentive scheme should be limited to operational and maintenance incentives. They also believed the performance incentive scheme should relate only to Prescribed Services as service levels form part of the negotiation for Negotiated Services. In contrast, the NGF were of the view that the scheme should cover both network operations and investment efficiency.

The Commission acknowledges the ETNOF's view that the primary scope of the Service Performance Target Incentives Scheme should be to ensure that there are incentives to make

¹⁶⁷ Integral Energy, 11 September 2006 p.4; ETSA, 14 September 2006, p.5

¹⁶⁸ ETNOF, September 2006, pp.15-16; CitiPower & Powerlink, September 2006, p.8

¹⁶⁹ ETNOF, September 2006, pp.15-16

¹⁷⁰ Major Energy Users, September, p.40.

¹⁷¹ ETNOF, September 2006, pp.14-18; Major Energy Users, September 2006, p.40; Total Environment Centre, 11 September 2006, pp.3-6; EnergyAustralia, September 2006, pp.13-14; Country Energy, 11 September 2006, p.6.

the network available at times that it is most valued by the market. Incentives in this regard attempt to reward TNSPs for behaving in ways that increase the value that users gain from the network, such as scheduling outages at off-peak times.

As previously noted by the Commission, the ACCC, in developing its service incentives scheme indicated its intention to continue to develop the scheme by:

- raising the 'incentive cap' above the current one per cent of revenue;
- including measures that take into account the amount of energy delivered;
- including the impact of TNSPs' capital programs in setting targets;
- including specific interconnector and connection point performance in targets;
- taking into account critical times and circuits in the scheme; and
- including customer focused incentives such as processing connection enquiries

As the Commission has previously stated, it agrees that the existing scheme could, and should, continue to be developed and improved over time. However, the Commission also believes that exposing TNSPs to the full value of the market impacts of their decisions is inappropriate, and indeed undesirable, given that they do not control all of the factors that affect the magnitude of those market impacts.

While noting these concerns, the Commission does not consider that this means that the scheme should foreclose on opportunities to provide financial incentives for TNSPs to undertake discretionary investments that will improve the performance of the network for the benefit of the market. It is noted that this view is also consistent with one of the Commission's main aims in this Review, which is aligning the interests of TNSPs with that of the market.

While there may be limitations to how far a service incentive scheme can go, the Commission considers that more can be done to focus incentives on encouraging planned outages at times and locations that minimise the cost to the market and network users. Therefore, the Commission believes that the existing incentive scheme should continue to be developed to ensure that TNSPs have effective incentives 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 spot prices.

In this regard the Commission does not support the view that the scheme should be limited in the Rules to only operational behaviours. Under the existing market arrangements there are few incentives for TNSPs to undertake efficient discretionary investments that are not reliability related investments but that may improve the performance of the network. Indeed, where there is an investment that is not required for reliability reasons a TNSP has a financial disincentive to invest in the project. This is because the TNSP is able to obtain a benefit from deferring the expenditure until the end of the regulatory period without risking the reliability of the network.

On this basis, the Commission considers that it is appropriate for the AER to give consideration to the current incentives for a TNSP in relation to non-reliability investments and consider if it is practical to develop financial performance incentives in this regard.

The Commission, however, does support the proposal that the scheme be limited to Prescribed Transmission Services as this supports the intent of the Commission's approach to defining network services. Negotiated Transmission Services are those services that exceed network performance requirements or connection services other than DNSP connections. Therefore, it is inherent in their definition that the level of service will be negotiated between the parties concerned. As a result, the ability to provide a certain level of service will be contained within the negotiated cost of the project and paid for by the party requesting the negotiated service. In addition, because these services are not contained within the scope of Prescribed Transmission Services, the wider market does not obtain benefits from increased levels of service from these services and should not therefore be required to fund incentives that pertain to the performance of these services.

6.4.1.3 Other service incentive issues

Commenting on other aspects of the incentive mechanism, the TEC¹⁷² believed that the service incentive scheme should better accommodate the scope for demand management. EnergyAustralia and Country Energy stated that the scheme should be limited to the jurisdictional service standards already in place, and CitiPower and Powercor sought further guidance on how the scheme may operate in the guidelines.¹⁷³

With regard to the TEC belief that the service incentive arrangements should explicitly deal with demand management options, the Commission considers that the intent of the scheme should be to ensure that the TNSPs take the least cost options for delivering the levels of service sought by the market. Where demand management provides an appropriate means of achieving this outcome the TNSP will have the incentive to pursue this option. The Commission, however, does not consider that it is appropriate to provide an exhaustive list of options that a TNSP can use to achieve its service obligations in the Revenue Rule.

The Commission notes that Country Energy and EnergyAustralia consider that it is not appropriate for the AER to develop service standards where jurisdictional services are already in place. However, this view ignores the different purposes of the jurisdictional standards and the regulatory standards. The jurisdictional standards seek to ensure that the network operates at a minimum standard in order to preserve the integrity of the system. Failure to meet these standards would only be expected in extreme circumstances and the penalty would be a loss of licence for the TNSP.

Service standards set in an economic regulation framework, on the other hand, are part of an incentive regime that seeks to ensure that the service delivery of the TNSP meets the service level sought by consumers and the market. To encourage TNSPs to achieve this standard

¹⁷² Total Environment Centre. September 2006, p.5

¹⁷³ EnergyAustralia, September 2006, p.13; Country Energy 11 September 2006, p.6; CitiPower & Powercor, 11 September 2006, p.4.

financial rewards and penalties are applied so that the interests of a TNSP are aligned with the market. In this regard, the Commission does not consider that the jurisdictional minimum standards are appropriate for the purposes of delivering efficient outcomes in an economic regulation regime.

The Commission has noted CitiPower and Powercor's concern regarding the level of guidance that will be provided in the guidelines to be developed by the AER. On balance, the Commission considers that the Revenue Rule requirements, in particular both the criteria to be taken into account and the consultation process to be followed in their development, provide sufficiently guided discretion to the regulator.

6.5 Pass Through

The Commission recognises that TNSPs operate in a dynamic and uncertain environment where the quantity, nature and timing of the services they are required to deliver can vary due to a range of often unexpected and uncontrollable reasons. The Revenue Rule therefore makes provision to manage many of these uncertainties, particularly in relation to capital expenditure via a regime of pass through provisions and 'contingent project' arrangements.

In addition to the risk management provision described in the 'contingent projects' section (section 4.2), the Revenue Rule also provides an allowance for the pass-through of significant increases (or decreases) in a TNSP's costs resulting from certain categories of unexpected events that may occur during the regulatory period.

The objective of the cost pass-through is to provide a degree of protection for the TNSP from the impact of unexpected changes in costs outside of its control. The Commission considers that such a mechanism provides a reasonable reflection of the operation of a competitive market where efficient costs are eventually passed through to customers, whether they are expected or not. Such a mechanism lowers the risks faced by the TNSP, which would otherwise have to be compensated for in the calculation of regulated revenues.

Given that this mechanism provides for the pass through of unexpected costs not otherwise compensated in regulated transmission revenues, it is important that the definitions applied to identify pass through events are appropriately specified and can not be exploited where existing compensation has been provided.

6.5.1 Commission's Analysis and Reasoning

The majority of submissions from network businesses that commented on the pass-through mechanism supported the Commission's approach. However, a number of submissions raised concerns with the list of included events. For instance, the AER commented in response to the Proposed Rule that it was not appropriate to lock in provisions at this early stage and the Rules should provide for the AER to prescribe guidelines of pass-through events after there has been more experience in this area.¹⁷⁴ AGL supported the AER's view on extending the discretion allowed to the AER on pass-through events.¹⁷⁵ However, the

¹⁷⁴ Australian Energy Regulator, March 2006, p.46

¹⁷⁵ AGL, 21 March 2006, p.6

Commission remains of the view that considering the significance of pass through arrangements the framework for their application should be codified in Rules rather than left to the discretion of the AER.

The CitiPower and Powercor submissions to both the Proposed Rule and Draft Rule stated that a safety and technical standards event and a legislative or regulation event should be included in the list of allowed pass-through events.¹⁷⁶ Integral Energy also submitted that a regulatory change event should be added to the definition of pass through events.¹⁷⁷ SP AusNet also sought the inclusion of a pass through from easement tax changes.¹⁷⁸ Alternatively, the MEU believed that pass-through events should be limited to times when there is a change to the law or taxes which impact the TNSP exclusively. In addition, the MEU considered that un-used revenue should be used before a pass-through mechanism is instigated.¹⁷⁹

Considering the intent of the pass through mechanism is to provide for unexpected changes outside the control of the TNSP, the Commission agrees with submissions that a regulation change event should be included in the scheme. To give effect to this, a regulatory change event has been included in the definition of a pass through event. The Commission has also included an additional cost pass through event, an *easements tax change event*, to allow for any changes to the land tax payable by a TNSP in respect of easements used for the purpose of providing transmission network services. In response to the MEU concern the Commission considers that the framework for the assessment of pass through events is robust enough to ensure that only appropriate pass through events are included and that these are recovered in an appropriate manner.

CitiPower and Powercor considered that the provision for the AER to impose a negative pass-through would increase regulatory risk. In response to both the Proposed Rule and Draft Rule CitiPower and Powercor submitted that it is not appropriate for the AER to be both the proponent and adjudicator for a negative pass through event.¹⁸⁰

The Rules give the AER guidance on the exercise of its power to impose negative pass throughs and it is reasonable to consider that this provides adequate assurance that the application of negative pass throughs will be consistent with the Commission's policy intent. The Commission is satisfied that the potential costs arising from the AER initiating and adjudicating negative pass through events are not likely to be significant enough to warrant applying an asymmetric pass through mechanism. Further, such a mechanism would not be consistent with the NEM objective as it would not be in the long-term interests of consumers with regard to price.

¹⁷⁶ CitiPower and Powercor Australia, 20 March 2006, p.5; CitiPower and Powercor Australia, September 2006, p.4

¹⁷⁷ Integral Energy, September 2006, p.3

¹⁷⁸ SP AusNet, 11 September 2006, pp.2-3.

¹⁷⁹ Major Energy Users, September 2006, p.86,

¹⁸⁰ CitiPower and Powercor, Australia, 20 March 2006, p.5; CitiPower and Powercor Australia, September 2006, p.4

CitiPower and Powercor also considered that it is not necessary to conduct a retrospective review of a TNSPs actions in order to mitigate the impact of a positive pass through event as such actions will involve sunk investment thereby making any review incapable of changing TNSP behaviour.¹⁸¹

However this view fails to take into account a fundamental aspect of this Review which has been the Commission's goal of ensuring that TNSPs face appropriate *ex ante* incentives to efficiently invest in and operate their networks. While there may be no scope to change TNSPs behaviour at the time of the review, it is nonetheless essential that TNSPs have incentive to ensure they only incur efficient costs (even where these costs relate to pass through events that are not part of the existing price cap incentive regime). The credible threat that this retrospective review poses is therefore a necessary element of the regulatory framework particularly.

Another issue raised in submissions related to the materiality threshold. EnergyAustralia stated that the definition should be amended to say that the threshold applies to the change in capital or operating expenditures.¹⁸² Ergon Energy supported the threshold claiming that it will help in limiting the use of the pass-through mechanism.¹⁸³ The ETNOF considered that the one per cent threshold was excessive and recommend that the definition be amended to 'material' amounts.¹⁸⁴

The Commission considers that the threshold for a pass through is important to ensuring the stability and predictability of the revenue cap regime for both the regulator and regulated businesses. Removing the threshold would lead to greater uncertainty and increase the administrative costs for the AER to determine what constitutes a material event.

EnergyAustralia considered that the timeframe applied to the application of a pass-through of 60 days was insufficient to make an application in some instances and that 90 days was more appropriate. In addition, EnergyAustralia believed that the commencement of the 90 day time frame should be when the business becomes aware that an event is having an impact.¹⁸⁵

The Commission acknowledges stakeholder comments which demonstrate that providing a regulatory submission on the extent and costs of a pass through event is a potentially difficult and complex task. Further, the Commission considers that there is considerable benefit in providing sufficient timelines to ensure regulated businesses have adequate time to prepare robust pass through event proposals. Therefore, the Commission has increased the timeframe for pass through application from 60 days to 90 days in the Revenue Rule.

¹⁸¹ CitiPower and Powercor, Australia, 20 March 2006, p.5; CitiPower and Powercor Australia, September 2006, p.4

¹⁸² EnergyAustralia, 20 March 2006, p.19

¹⁸³ Ergon Energy, 20 March 2006, p.9

¹⁸⁴ Electricity Transmission Network Owners' Forum, March 2006, p.32

¹⁸⁵ EnergyAustralia, 20 March 2006, p.19

6.5.1.1 Network support pass through

The MEU submitted that allowing Network Support Payments to be passed through would allow 'double dipping' as customers would likely pay for the TNSP's capital expenditure allowance as well as the payment of capital expenditure deferral benefit to the load provider.¹⁸⁶ The Commission notes that this concern is addressed by the definition which only includes network support payments that are in excess of those forecast and are not substitutes for approved capital programs.

ETNOF and Powerlink¹⁸⁷ requested that the definition of *network support payment* was too restrictive as it limited payments to only generators or customers, thereby excluding payments to demand management aggregators. Powerlink indicated that some of the parties to whom it currently makes network support payments would not be captured by the Draft Rule definition. In line with these concerns, the Commission has amended the definition of *network support payment* to provide for payments to other parties providing these services.

6.6 Commercial Negotiation

In its Proposed Rule¹⁸⁸ the Commission noted that its intention was to reduce the likelihood of stranding of assets by ensuring that those that were able to manage the risk, bore the risk, rather than all users. That is, it is incumbent on the TNSP to enter into commercial negotiations regarding the management of the risk of by-pass or disconnection by large network users. These sentiments were also reflected in the Commission's Draft Rule which did not vary the Commission's decision with regard to commercial negotiation.

The Commission recognised that it is possible under the current Rules for TNSPs to offer prudent discounts, however it was concerned that there may be insufficient incentive to engage in effective negotiations with large customers in relation to such discounts. The Commission therefore sought to provide TNSPs with a meaningful incentive to negotiate with the relevant users instead of relying on all other customers to underwrite commercial risks that the Commission considers are amenable to management through normal commercial arrangements.

The Commission sees no reason to move away from the incentive arrangement for managing commercial stranding as set out in the Proposed Rule and Draft Rule.

¹⁸⁶ Major Energy Users, September 2006, p.30.

¹⁸⁷ ETNOF submission, page 32; Powerlink submission, page 9.

¹⁸⁸ Australian Energy Market Commission, Revenue Rule Proposal Report, February 2006, p.90

7. Regulatory Process

The Commission considers that transparent and timely processes for regulatory determinations reduce regulatory risk, which is a key requirement for effective regulation. Ensuring clarity around a number of procedural issues such as timeframes, information provision and revocation of a revenue cap provides greater certainty to market participants and reduces delays in regulatory decision making.

The Commission has sought to codify key elements of existing practice with respect to regulatory processes for TNSP revenue cap determinations, and to impose stricter requirements in relation to timeframes for regulatory decisions.

This chapter sets out the approach adopted by the Commission, considers issues raised in submissions, and discusses the rationale supporting the Revenue Rule. The issues considered relate to:

- the procedural requirements for making revenue cap determinations;
- the mechanics of the decision making process and in particular, the information requirements for TNSPs' Revenue Proposals and the timeframes mandated in the Revenue Rule;
- the information gathering powers of the AER (including in relation to third parties)
- the information disclosure powers of the AER; and
- the scope for revocation of a revenue cap.

7.1 Process and Timelines

Regulatory decision making involves thorough consideration of regulated businesses' proposals, providing opportunities for the regulated businesses and interested stakeholders to make submissions to the regulator and the opportunity for full and thorough analysis of the submissions and the regulator's intermediate decisions.

The NEL requires that the revised Rules cover the procedures to be followed by the AER in exercising its economic regulatory functions.¹⁸⁹ It specifically requires that the Rules cover, in relation to transmission determinations:¹⁹⁰

- the publication of notices, draft and final determinations, and giving of reasons by the AER; and

¹⁸⁹ Item 17 Schedule 17, NEL

¹⁹⁰ Section 35(1), NEL and Item 24 Schedule 1 NEL

- the making of submissions (by the TNSP and by affected Registered participants) and the holding of pre-determination conferences.

The Revenue Rule includes specific provisions in relation to the process to be followed by the AER in making a transmission determination, which includes a revenue cap determination, a determination relating to the TNSP's negotiating framework or a determination regarding the network transmission service pricing criteria.¹⁹¹

The Commission has sought to increase certainty in relation to the process to be followed in making a revenue cap determination by mandating certain steps in the process and specifying timeframes in the Rules. These Rules codify many aspects of current practice including the procedural requirement for TNSPs to submit a Revenue Proposal to the regulator for consideration and determination. They also impose a definitive timetable for the regulatory process. Codifying the process within the Rules serves to improve the certainty, transparency and timeliness of regulatory processes for revenue cap determinations.

The previous Rules imposed certain procedural requirements, including a requirement on the AER to publish the 'process and timetable for re-setting the revenue cap.'¹⁹² The AER has set out its proposed process for transmission determinations in chapter 3 of the SRP. This includes public consultation and submissions, a draft determination and second round consultation, before a final determination. These process steps are codified in the Revenue Rule.

Thus, the following key elements of the revenue cap determination process are codified in the Revenue Rule:

- a procedural requirement, under which the TNSP must submit a Revenue Proposal to the AER for prescribed transmission services and a proposed negotiation framework. The Revenue Proposal and negotiating framework must comply with AER guidelines;
- the application must be submitted 13 months before the commencement of the next regulatory control period;
- the AER conducts a preliminary assessment of the TNSP's proposal to ascertain whether it complies with the AER's guidelines;
- the AER must publish for consultation the TNSP's Revenue Proposal and proposed negotiating framework (including the proposed Negotiated Transmission Service Pricing Criteria), as well as supporting information;
- the AER may publish an Issues Paper;

¹⁹¹ Clause 6A.2.2.

¹⁹² Existing clause 6.2.4(b)

- the AER publishes its draft determination and must call for submissions. The AER must set out the reasons for its draft determination and conduct a pre-determination conference to explain its decision;
- the TNSP may submit a revised Revenue Proposal and/or revised negotiating framework (subject to certain limitations on the scope of revisions); and
- the AER publishes its final determination.

In codifying these procedural aspects of the regulatory process to be administered by the AER, the Commission explicitly stated that this framework:

“is purely a procedural mechanism and is not intended to extend to the regulatory decision making criteria that apply to different elements of the overall regulatory model”¹⁹³

That is, in codifying the procedural requirement for TNSPs to submit a Revenue Proposal to the regulator for consideration and determination, the Commission sought to provide additional procedural certainty to industry participants. The regulatory decision making criteria are proposed on a ‘fit for purpose’ basis as considered in Chapter 2 .

7.1.1 Commission’s Analysis and Reasoning

The Commission considers that well designed procedural requirements assist in compelling the regulator to administer the regulatory regime in an appropriate manner and for the business to put forward a complete and thorough Revenue Proposal. In this instance, an appropriate manner includes providing opportunities for regulated businesses and interested stakeholders to make submissions to the regulator, and provide an opportunity for full and thorough analysis of the submissions and the regulator’s decision. This manner of transparent decision making is conducive to reducing regulatory risk, reducing the probability of error and decreasing the administrative costs of regulation.

The Commission also considers that it is necessary to impose time constraints within this process to ensure that decisions are efficient and timely. This is reflected in the Revenue Rule imposing an overarching 13 month time limit on revenue determination processes. A number of submissions were received in support of the 13 month overarching review time constraint with less prescriptive timing requirements placed on intermediate stages of the AER’s regulatory decision process.¹⁹⁴ While the AER is provided flexibility within this overarching constraint, it is still required to meet key decision making milestones and allow effective consultation on these.

In regard to the more detailed procedural and timing constraints, the Revenue Rule includes a procedural requirement for TNSPs to submit a Revenue Proposal to the regulator for consideration and determination. This codifies the existing procedural practice and should

¹⁹³ Australian Energy Market Commission, ‘Draft Rule Determination, July 2006, p.110

¹⁹⁴ EnergyAustralia, September 2006; Country Energy, September 2006; ETSA Utilities, September 2006, p.5

not be construed as impacting on the decision making criteria that apply to the regulatory framework.

The benefits of this procedural requirement have been supported in a number of stakeholder submissions and in various recent reviews relating to energy markets. For instance, the MCE Expert Panel recommended that the NEL contain provisions that require the Commission to make Rules with respect to the procedures for making network pricing determinations. In this regard the Expert Panel stated that Rules should be made in relation to several key areas.¹⁹⁵ These areas are listed in Table 7.1 (below) which also provides reference to the clause(s) of the Revenue Rule that are applicable.

Table 7.1 MCE procedural recommendations

MCE Expert Panel Recommendation	Revenue Rule Clause(s)
Entitlement of the regulated entity to submit a proposal within the Rules determined by the AEMC in relation to revenue/pricing;	Clause 6A.10.2
Time constraint within which any such proposal must be made	Clause 6A.10.1(a)(1)
Publication of the proposal and related information	Clause 6A.11.3
Opportunity for stakeholder submissions in relation to the proposal and related information	Clause 6A.11.3(c)
Publication of a draft decision and the giving of reasons by the regulator	Clauses 6A.12.2, 6A.14.1, and 6A.14.2
Entitlement of the regulated entity to make submissions in relation to that draft determination which may include a revised proposal	Clause 6A.12.3
Opportunity for stakeholder submissions in relation to the draft determination and any revised proposal	Clause 6A.11.3(c)

¹⁹⁵ Expert Panel on Energy Access Pricing, 'Report to the Ministerial Council on Energy', April 2006, p.89

In relation to procedures associated with the initial receipt of a Revenue Proposal, the AER submitted that the terms in the Revenue Rule regarding the resubmission by a TNSP of a Revenue Proposal that was found by the AER to be non-compliant with the relevant requirements (ie., any applicable guidelines or Rules) were likely to reduce the overall time available to the regulator to complete its decision making process.¹⁹⁶

Specifically, the Draft Rule required that a Revenue Proposal be resubmitted 'as soon as practicable'¹⁹⁷ after the AER's preliminary examination for compliance with the relevant guideline. The AER proposed that this be explicitly constrained to one month.¹⁹⁸

The Commission considers it appropriate that a 30 day constraint be placed on the resubmission of a Revenue Proposal that is found to be non-compliant with the relevant guidelines and Rules. These guidelines and Rules are known to the TNSPs on an *ex ante* basis and such a constraint will provide additional discipline in the submission of compliant proposals. Furthermore, this 30 day constraint is appropriate given the constraints placed on the AER for preparation of a draft determination and is consistent with the relevant constraint on resubmission following a draft determination by the AER.

With regard to resubmitting Revenue Proposals following a draft determination, the AER submitted that TNSPs only be permitted to revise those elements of their Revenue Proposal that are necessary to address the AER's concerns as identified in the draft determination.¹⁹⁹ In support of such an approach, the MCE's Expert Panel noted that in the absence of such constraints,

*"[T]he regulated entity has an incentive to make an ambit claim at the commencement of the process in order to discover whether it lies above the regulator's estimate of a reasonable range, and if it does, to flush a counter proposal out from the regulator in the form of a draft determination. Under the Gas Code and under the AEMC's draft Rules, this search process is at no bargaining cost to the regulated entity as it retains a capacity to make a final offer in response to the draft determination."*²⁰⁰

The Commission recognises the concerns of both the AER and Expert Panel and notes that a fundamental aim of the current Review has been to enhance the certainty and predictability of the regulatory framework. Achieving this requires sufficient consideration of Revenue Proposals which in turn requires the submission of robust and definitive Revenue Proposals to the regulator by the 13 month deadline (ie, commencement of the entire regulatory decision making process). The Commission considers that such a constraint is necessary in order to provide all stakeholders sufficient time to adequately assess the submitted Revenue Proposal and the regulator's interim decision.

¹⁹⁶ Australian Energy Regulator, September 2006, p.17.

¹⁹⁷ Draft Rule clause 6A.11.2

¹⁹⁸ Australian Energy Regulator, September 2006, pp.17-18.

¹⁹⁹ Australian Energy Regulator, September 2006, p.19.

²⁰⁰ Expert Panel on Energy Access Pricing, Report to the Ministerial Council on Energy, April 2006,

Consequently, the Revenue Rule requires that revisions to TNSPs' Revenue Proposals following a draft determination be restricted to those necessary to substantially incorporate the changes required or address matters identified as being of concern to the regulator in its draft determination.

The AER submitted similar concerns regarding the scope of revision to a Revenue Proposal following notification that an initial Revenue Proposal is non-compliant with the relevant requirements.²⁰¹ For similar reasons to those outlined above, the Commission considers it appropriate that revisions to the Revenue Proposal be limited to those areas identified as being non-compliant with the relevant requirements.

EnergyAustralia submitted that:

*"The 30 day limit on submitting a revised Revenue Proposal is quite short, particularly if the draft determination requires substantial rework to the Revenue Proposal. EnergyAustralia recommends revisiting that time frame or allowing some provision for extension."*²⁰²

Given the deliberately limited timeframe placed on the regulatory decision process regarding the transmission revenue determination, it is not considered desirable to extend this time constraint. Furthermore, the decision to limit revisions to those areas identified by the regulator in the draft determination will likely reduce the time required for revisions.

In summary, the Commission's decisions with regard to timing and procedural constraints reflect its view that robust procedural requirements that consider the rights and responsibilities of all parties and encourage timely decision making through specified timeframes and information provision will assist in ensuring that efficient and effective regulatory decisions can be made.

7.2 Information Gathering Powers

In addition to clear procedural and timing requirements on the process for regulatory determinations, efficient and effective regulation requires the provision of accurate, timely and relevant information. In conducting this Review, the Commission has sought to:

- balance the need for the AER to have access to timely and accurate information from TNSPs with the administrative and cost burden on TNSPs arising in relation to information provision; and
- balance the need for stakeholders to have access to the information upon which regulatory decisions are made with the need to protect confidential information that would commercially harm TNSPs or third parties (such as users).

The Revenue Rule requires the AER to develop submission guidelines in relation to information that must be included in a TNSP's Revenue Proposal, and other accompanying

²⁰¹ Australian Energy Regulator, September 2006, pp.19-20.

²⁰² EnergyAustralia, September 2006, p.18

information. The Rules set out some high level guidance for the AER in relation to the type of information that the guidelines should require in a Revenue Proposal. However, the details on these matters were left to the discretion of the AER to develop. This approach again largely codifies current practice, in that the AER already publishes an Information Requirements Guideline. However the Revenue Rule provides additional guidance to the AER on the contents of the submission guidelines in respect of some matters, such as capital and operating expenditure.

The Revenue Rule retains those provisions from the current Rules which confer broad powers on the AER to gather information from TNSPs, as well as the existing confidentiality provisions.

7.2.1 Commission's Analysis and Reasoning

7.2.1.1 Development of Information Guidelines

The Commission considers that the regulatory process can be improved by ensuring that the regulator's requirements for information are clear at the outset. Appropriate information provision allows the regulator to make better informed decisions regarding the efficient costs of providing transmission services.

Determining what information should be provided by the regulated business will necessarily involve a detailed analysis of the costs and benefits of providing information and its use in the regulatory regime. The Revenue Rule requires the AER to develop submission guidelines in relation to the information that must be provided in the TNSP's Revenue Proposal. The Rule gives both high level guidance for the development of the submission guidelines on some matters, (such as the broad form of information that should be required) and more detailed requirements on others. The introduction of information guidelines into the Rules responds to requests made during consultation for greater clarity surrounding the AER's powers to request and collect information from market participants.

The Commission has maintained the view that the preparation of submission guidelines by the AER will assist in improving the clarity of information requirements at the outset of the revenue cap determination process, resulting in a more efficient and effective regulatory regime.

AGL expressed support for the Commission's identification of the need to clarify the AER's information gathering powers in the Rules.²⁰³ The ETNOF called for the development and amendment of guidelines, including information guidelines, to be subject to a more robust process and greater scrutiny, for example through the publication of an issues paper by the AER, which would be subject to consultation.²⁰⁴

The Commission recognises that it is good regulatory practice for the issues underpinning the development of guidelines and models to be subject to the greatest degree of scrutiny

²⁰³ AGL, September 2006, p.6

²⁰⁴ ETNOF, September 2006, p. 23

possible. In this regard, it is noted that the AER commonly adopts the approach of publishing issues papers when developing guidelines. It is not therefore considered appropriate to prescribe (in the Rules) the release of issues papers by the AER as part of the guideline development process. The *transmission consultation procedure* provided in Rule 6A.20 allows for sufficient consultation when developing or modifying guidelines.

7.2.1.2 Information Collection

The Commission sought to achieve effective regulation by ensuring that the AER has access to timely and accurate information from TNSPs. However, it recognised that information provision needs to be weighed against the cost to the TNSP of providing this information, in part because this cost is ultimately borne by the consumer. The Commission recognises that 'regulatory creep' can be a particular concern when considering the issue of information gathering as regulator requirements can progressively increase and information may be sought for purposes other than the original purpose. This was a concern also raised by the Productivity Commission in its review of the Gas Access Regime.²⁰⁵

The NEL and the existing Rules provide the AER with broad powers to obtain information from TNSPs for regulatory purposes.²⁰⁶ Specifically, the Rules require TNSPs to submit certified annual financial statements to the AER in the form and by a date determined by the AER, and to provide any other information the AER reasonably requires in order to perform its regulatory functions.²⁰⁷ In general, these information gathering powers are circumscribed by the AER's overall powers or functions under the NEL.²⁰⁸

The Revenue Rule maintains the form and function of the broad information gathering powers provided to the AER under the current Rules.

With the exception of powers to obtain information from third parties (considered below), earlier submissions to the Review had generally expressed the view that the current information gathering provisions in the Rules were extensive and sufficient for the AER's purposes.²⁰⁹ The question considered by the Commission was therefore, not whether the AER has adequate information gathering powers, but whether these powers are appropriately circumscribed by the powers and functions of the AER as set out in the NEL. The Commission had some concerns, which have been echoed in a number of submissions, that the information gathering powers currently available to the AER are potentially too wide ranging, and not tied to the function of the AER in a way which would promote regulatory certainty and transparency and minimise the potential burden on market participants.

Further consideration has led the Commission to expressly clarify in the Rules the scope of the information gathering powers of the AER. The Commission has retained those

²⁰⁵ Productivity Commission, 'Review of the Gas Access Regime', June 2004, pp.372 – 373

²⁰⁶ NEL, s. 28; existing, clause 6.2.5

²⁰⁷ Existing clause 6.2.5

²⁰⁸ NEL, s.15

²⁰⁹ Ergon Energy, 16 November 2005, p.20; TransGrid, 16 November 2005, p.37

amendments introduced in the Draft Rule²¹⁰ which ensure that the AER's information gathering powers are limited to performing its role in terms of:

- making future revenue determinations under Chapter 6A of the Rules;
- monitoring, reporting and enforcing compliance with transmission determinations;
- monitoring, reporting on and enforcing compliance with the TNSP's Cost Allocation Methodology;
- monitoring and reporting on the performance of the TNSP with any applicable service target performance incentive regimes; and
- preparing and publishing annual performance statistics in relation to the service standards published by the TNSP.

In developing the Revenue Rule, the Commission has clarified the power to gather and use information as an input into the performance of TNSPs regarding the financial, economic and operational performance of a provider, but also to monitor and report on a TNSP's performance in these areas.

In clarifying the scope of the AER's information gathering powers, the Commission has not sought to reduce those powers, as it recognises that they are vital to the efficient operation of the regulatory process. Rather the approach taken in the Rule is designed to reduce the potential for dispute or delay that may arise out of inadequately defined information provision requirements.

7.2.1.3 Third Parties

Throughout the Review, stakeholders have raised the problem associated with regulators gaining access to useful information about contracts between regulated entities and related third parties. Given the evolving and often complex ownership structures of market participants, and the degree of consolidation or vertical integration in certain areas of the market, there is a perception that dealings between service providers and third parties with some relationship to that provider, in particular contracts for the provision of services, could be struck on non-competitive terms.

Under the NEL²¹¹ the AER's broad information gathering powers extend to third parties or service providers. However, the AER does not have a power, either explicitly or by extrapolation, to compel a third party to maintain information, or to provide it in a useful form (as it does with directly regulated entities).

The Commission recognises that third party contracts are of concern to regulators and some market participants, given the potential for transactions to be distorted by complex ownership and outsourcing structures, primarily in the provision of services that form a

²¹⁰ Clause 6A.17.1(d)

²¹¹ NEL, s.28(1)

component of a TNSP's operating expenses. This results in the ability of the regulator to obtain information on the costs or prices involved being impaired or compromised. This in turn can create situations where the regulator is unable to confidently assess whether the underlying costs or prices are competitive, or if the value of the contract is consistent with the underlying costs of the service.

The MCE's Expert Panel commented that the power of regulators to obtain third party information is an area where clarification is important:²¹²

*"Regulators must satisfy themselves that such contracts were struck on an arm's length basis to be confident that the value of the contract is consistent with the underlying costs of the service. However the extent to which existing powers allow regulators to obtain sufficient supporting information to establish this remains unclear."*²¹³

The Commission considers that the level of concern from market participants and the precedent set by the experiences of regulators across different jurisdictions justifies addressing the issue of information provision from third parties as part of this review.

In the Commission's view there are two avenues that may be taken in addressing this issue:

- the AER can be given greater powers to 'pierce the corporate veil' in order to compel third parties to keep and provide information required; or
- the AER can be given greater discretion in the way it uses information provided by related parties.

The Revenue Rule does not provide the AER with any additional powers to compel compliance from third or related parties to information requests. Some submissions have requested the AER be given greater powers to access information about complex ownership structures and financial arrangements or be empowered to undertake investigations into contract arrangements between related parties. However, extending the AER's powers to compel compliance with information requirements to include third parties is deemed by the Commission to be too intrusive.

In particular, regulated businesses are likely to have extensive and substantial service arrangements with a large number of third parties. A blanket rule that a regulator can compel third parties to retain and provide information would be too intrusive and may have a detrimental affect on the ability of regulated businesses to get the best value from outsourcing arrangements.

The Commission is not persuaded that the possible benefits that may be gained through the imposition of a complex regulatory regime directed at regulating corporate interrelationships or prescribing the form and content of information provided by related parties justifies the associated costs and regulatory burden upon TNSPs.

²¹² Expert Panel on Energy Access Pricing, 'Report to the Ministerial Council on Energy', April 2006, p.130

²¹³ Op.cit, p.126

As an alternative, the Revenue Rule adopts the approach of giving the AER the discretion to consider the extent to which costs are not derived through competitive tendering or arm's length negotiation, when assessing whether proposed operating expenditure and capital expenditure forecasts are reasonably reflect the capital and operating expenditure criteria.²¹⁴ These provisions allow the AER to disregard or give lesser weight to reported costs, where the AER has reason to believe that they were not struck on an arm's length basis. Improving the clarity of the AER's powers with regard to how it uses information gathered from related parties reduces the potential for disputes over the provision of information, without creating additional obligations on unregulated businesses or impinging upon the confidentiality rights of business.

ETNOF criticised this approach as permitting the AER to discount information provided by the TNSPs based upon supposition, rather than evidence.²¹⁵ ETNOF proposed that the AER's discretion in this context be restricted to situations where there is certainty that arrangements have not been struck on an arm's length basis. While the Commission appreciates the need for certainty in this context, as in other matters, it is of the view that this would require the AER to undertake a level of forensic analysis not within the scope of its current powers. As discussed above, the Commission does not support attempting to broaden the AER's information gathering powers to encompass third or related parties.

The MEU reiterated earlier concerns over the 'significant financial engineering' allowed by business structures and the distortion of costs created by the use of related or third party contracts.²¹⁶ In the MEU's view, the issue was not addressed at all in the Draft Rule. The MEU submitted that fees arising from third party contracts be excluded from capital and operating expenditure forecasts. However, the Commission considers that the explicit third party information consideration within the factors for consideration²¹⁷ and discretionary treatment powers afforded to the AER under the Revenue Rule are sufficient for the purposes identified by the MEU.

7.3 Information Disclosure

The Commission recognises the importance of ensuring that the market and consumers are adequately informed about the functioning of the market, but is also aware of the necessity of protecting the confidentiality of certain aspects of the commercial operations of regulated entities. In considering the options for addressing information requirements, the Commission has endeavoured to strike an appropriate balance between these two issues.

The AER is required under the current Rules and the NEL²¹⁸ (which applies the confidentiality requirements of the Trade Practices Act) to treat as confidential, information it

²¹⁴ Clauses 6A.6.6(e)(9) & 6A.6.7(e)(9).

²¹⁵ ETNOF, September 2006, p.7

²¹⁶ MEU, September 2006, p.16

²¹⁷ Clauses 6A.6.6(e)(9) and 6A.6.7(e)(9).

²¹⁸ NEL, s.18. This section imposes confidentiality requirements upon the AER by applying the confidentiality requirements under section 44AAF of the Trade Practices Act for the purposes of the NEL and the NER.

gathers in the performance of its functions or the exercise of its powers. The AER must take all reasonable steps to ensure this information remains confidential, and may only release it publicly with the prior consent of the TNSP, except in accordance with the disclosure arrangements in the Rules.²¹⁹

The Revenue Rule has been amended to make clear the conditions under which the AER can publish confidential information in the absence of written permission by the person who provided that information and clearly links this to its regulatory functions under Chapter 6A.

The information to be published must relate specified purposes set out in clause 6A.17.1(d). The AER must also satisfy one of two other criteria before it can seek to publish confidential information:

- the information will be published in an aggregated form so that particular participant information cannot be identified; or
- the AER must be of the opinion either that the disclosure of the information would not cause detriment to the party that provided it (or a third party) or, if it would cause detriment, that this detriment is outweighed by the public benefit from disclosing that information.²²⁰

This approach differs from the Draft Rule, which required the AER to satisfy each criteria before it could publish protected information in the absence of written consent from the TNSP. The Commission considers that the approach taken in the Draft Rule had the potential to unduly restrict the AER's ability to release information to public scrutiny.

The Commission believes that the revised restrictions will allow adequate information to be available to the regulator and stakeholders, while ensuring appropriate limitations on confidential information. Allowing the AER to publish information that fails the public benefits test only in aggregated form addresses concerns regarding the release of confidential information, while still permitting the AER to provide the market with information that relates directly to its role.

Prior to the release of any protected information after satisfying these conditions, the AER must provide 28 days written notice to the TNSP, or any party that provided relevant information to the TNSP, of the intention to publish the information. This notice must also advise the TNSP of the form and timing of that information to be published.

7.3.1 Commission's Analysis and Reasoning

In response to the Commission's information disclosure approach, ETNOF sought to include a new provision at 6A.10.2 relating to the confidentiality of information provided under submission guidelines. This provision would compel the AER to determine whether the information provided in compliance with the submission guidelines is to be treated as

²¹⁹ Existing clause 6.2.6(b)

²²⁰ Clause 6A.18.3(a)

confidential. ETNOF's proposed amendment included a list of items, similar to that currently included under clause 6.18.3 (a), that the AER must consider when making a determination of non-confidentiality. The Draft Rule's definition of protected information excluded information provided under submission guidelines – ETNOF's amendment would remove this assumption and force the AER to seek permission to publish the information. This was seen by the Commission as an unnecessary restriction on the ability of the AER to publish information.

The Consumer Legal Centre of Victoria, TEC and the AER all expressed strong concerns about the curtailing effect of the Draft Rule on the AER's ability to publish information, and in particular the publication of the AER's annual reports.²²¹

CLCV pointed to the importance of AER reporting, noting that such reporting is fundamental to effective competition and accountability, as well as contributing to public knowledge of key network issues. The CLCV also questioned the assumption of confidentiality stating that 'transmission businesses are monopoly businesses, and, as such, should not have the same need for confidentiality as businesses that operate in a competitive market.' They considered that the presumption of confidentiality, combined with the conditions for the release of protected information (in the absence of TNSP approval), will result in very little protected information being released publicly.

The Commission has addressed concerns regarding the scope for the AER to publish information on the operation of the market, including the publication of the AER's annual reports, by reducing the combined impact of the Draft Rule's 'cascading' conditions for the publication of protected information, the presumption of protected information and ability of the AER to only collate information relating to financial, economic and operational performance of TNSPs.²²²

7.3.1.1 Publication of the PTRM

The AER has raised concerns about what it sees as a limitation on the public consultation process for Revenue Proposals. Under Draft Rule 6A.10.2(b)(3) the submission guidelines to be developed by the AER had to specify which parts of a TNSP's Revenue Proposal, if any, will not be publicly disclosed. In addition, Draft Rule 6A.10.2(c)(2) prevented certain aspects of a TNSP's revenue proposal from being publicly released without prior consent from the TNSP, specifically the PTRM, roll forward model and the information in these models.

While the Commission is mindful of the importance of ensuring adequate public consultation during the revenue determination process, it is wary of the possible dilution of the right of TNSPs, the customers of those TNSPs and unrelated third parties to keep aspects of commercial arrangements confidential. The Commission has some concern that the publication of certain aspects of a TNSPs revenue proposal, specifically fully populated models, could inappropriately reveal the details of negotiations between a TNSP and its customers.

²²¹ CLCV, September 2006; TEC, September 2006; AER September 2006

²²² Clause 6A.18.3.

The Revenue Rule maintains the approach taken in the Draft Rule, with one amendment whereby the AER is not permitted to publish populated models without prior consent, unless that information is released in aggregate form, or is available elsewhere.²²³ This will protect the right of TNSPs and third parties to prevent the inappropriate disclosure of commercially sensitive information, while still permitting the AER to release sufficient information so as to facilitate consultation on revenue proposals.

7.3.1.2 Publication of submissions by the AER

The AER drew attention to what it considered an issue of procedural fairness regarding the publication and confidentiality requirements under Draft Rule 6A.16(c) and (d). These clauses require the publication of submissions received following publication of a Revenue Proposal and the AER's draft determination, unless the submission is subject to a claim to confidentiality.

In the AER's view, this risks denying a TNSP the chance to respond to the contents of a submission to which the AER must have regard. The Commission agrees with the AER that ensuring revenue cap determinations are subject to an open and transparent consultation process is a fundamental consideration, but is also mindful of the importance of ensuring that participants in the consultation process have access to appropriate confidentiality arrangements.

It is essential that there is a degree of transparency surrounding the contents of all submissions considered by the AER in the course of making its decision, and the opportunity for comments contained in submissions, in particular those critical of a TNSP, are able to be responded to. To this end, the Rule gives the AER, in the course of its decision making, the discretion to give lesser or no weight to submissions it is prevented from publishing under Draft Rule 6A.16(d). This approach mirrors that taken elsewhere in the Rule with respect to third party or related party arrangements that form part of expenditure forecasts or which may identify confidential third party user information.

7.4 Revocation of a Revenue Determination

Finally, the Revenue Rule largely retains the existing Rule provisions in relation to the circumstances when the AER may revoke and remake a revenue cap determination. Specifically the Revenue Rule provides that:

- the AER may revoke a revenue cap determination only where the revenue cap determination is set on the basis of false or materially misleading information; or where there is a material error;
- where the AER revokes a revenue cap, then it must make a new revenue cap determination in substitution for the revoked revenue cap, to apply for the remainder of the regulatory period; and

²²³ Clause 6A.10.2(c)(2).

- where the revocation is as the result of a material error, the new determination must only vary from the revoked determination to the extent necessary to correct the relevant error. (Rule 6A.15).

The Commission has maintained the view that that the circumstances under which the AER may revoke and remake a revenue cap determination should be clearly set out in the Rules in order to increase the certainty and transparency associated with the regulatory framework, and to maintain the incentives built into that framework.

The Commission considers that the current provisions in relation to revocation in the Rules adequately capture the circumstances under which a revenue determination should be revoked and remade. However, the Commission considered that the existing provision requiring the AER to obtain written consent from the TNSP prior to revocation was likely to not be in the long term interest of consumers of electricity as required by the NEM objective.

Specifically, while the current provision would not hinder the correction of a material error that was in the TNSP's favour, in instances where revocation causes the TNSP to be in a worse position, the TNSP would have little incentive to provide written consent to the AER for the decision to be revoked. If written consent was not provided in this situation, it would mean that the TNSP would be over-recovering compared to what would have otherwise been approved. The Commission does not consider that customers should be required to pay more for a service because of a material error in making the determination.

Therefore the Revenue Rule does not require the AER to obtain TNSP approval prior to revoking a determination.

8. Managing the Transition to the New Revenue Regime – Savings and Transitional Rules

This chapter explains the Commission's approach in preparing the Revenue Rule to ensure a clear and smooth transition from the existing transmission revenue regulatory arrangements to the new regime under Chapter 6A. The Commission is mindful that substantial investment in long term assets should not face unnecessary regulatory risk from a lack of clarity or certainty about the transition to the new regime. The Commission has sought to manage the transition to the new Rules efficiently and with as little upheaval as possible.

The National Electricity Rules have the force of law under the NEL, so that when rules are revoked or amended, transitional rules are necessary to ensure continuity. The NEL enables the Commission to make rules of a savings and transitional nature consequent on the amendment or revocation of a Rule.²²⁴ This ensures that the amendment of Chapter 6, and the creation of the new Chapter 6A, do not affect or undo actions and decisions taken or commenced under the old Chapter 6.²²⁵ The careful management of transitional issues is particularly relevant in the context of transmission revenue regulation because regulatory control periods for determinations are set for five year periods, and the revenue reset process itself requires an extended lead time.

The savings and transitional rules are contained in Schedule 5 of the Revenue Rule (Rule 11.6).

8.1 The Rule Proposal

At the time of the preparation of the original Rule Proposal, the Commission was aware at a preliminary level, of a number of areas where transitional issues were likely to arise. As a result of consultation and ongoing discussions with affected parties the issues for specific transitional rules have been finalised.

The Commission maintains its earlier expressed views relating to the retention of asset valuations and revenue outcomes of existing revenue determinations. Similarly, the need to ensure continuity of process for TNSPs and the AER where resources are already committed to a regulatory process, is reflected in the Revenue Rule. This applies in relation to Powerlink's transitional revenue reset process, and the upcoming revenue determination processes of SP AusNet, ElectraNet and VenCorp, commencing in 2007.

The Commission acknowledges that the TNSPs have been operating under existing incentive regimes. Consultation (discussed in more detail below) indicated that in some circumstances arrangements made under existing determinations may have carry-over effects into the first regulatory control period under Chapter 6A. Where these arrangements are likely to lead to different outcomes to those proposed in the new Chapter 6A rules, the Commission believes it is appropriate to give some general recognition to such arrangements in the transitional rules for the purposes of the first revenue setting process under the new Chapter 6A Rules.

²²⁴ NEL, s. 35(3)(p)

²²⁵ NEL, clause 33 Schedule 2

The Commission considered a number of submissions regarding the need for savings and transitional rules. These ranged from matters of general application to ensure a smooth transition for all to the new Chapter 6A Rules, through to specific issues for individual TNSPs.

Powerlink requested that the revenue determination process under way at the same time as the revenue rule review (for the regulatory control period commencing on 1 July 2007) should be governed by the existing Chapter 6, including the SRP arrangements²²⁶. The Commission has had ongoing correspondence from, and discussions with, Powerlink and the AER, to provide rules to support the process for the making of the Powerlink 'transitional' revenue determination. This matter is discussed in more detail below.

ElectraNet requested a provision be inserted into the savings and transitional rules to preserve the AER's discretion to revalue ElectraNet's easements. The intent is that the easement revaluation if granted be rolled into ElectraNet's RAB.²²⁷

Transgrid sought additional clarity on referencing as between the new and old Rules and particular consideration of depreciation and efficiency carry-over transitional and savings arrangements.²²⁸

In considering issues raised by stakeholders, the Commission's general policy approach has been not to interfere with actions previously taken or decisions made under the old Chapter 6, where such matters may continue after the commencement of the new Chapter 6A rules. The Commission's approach to specific issues raised by individual TNSPs is set out in the following sections.

8.2 Existing revenue determinations

The existing revenue determinations that apply to each of the TNSPs were made by the ACCC under the old National Electricity Code and recognised as determinations under the initial Rules via the savings and transitional arrangements in the NEL that commenced on 1 July 2005. Similarly, for the transition to the new Chapter 6A, the general approach is for existing revenue determinations to continue to operate as if the new Chapter 6A had not been made.²²⁹ However, EnergyAustralia has submitted that its existing revenue determination is capable of being subject to key aspects of the new Chapter 6A Rules,²³⁰ and the Commission considers it appropriate to do so.²³¹

²²⁶ Australian Energy Regulator, March 2006 p.60, Major Energy Users Incorporated, 22 March 2006, p.68, VENCORP pp.1-2

²²⁷ ElectraNet, 20 March 2006, pp.1-2

²²⁸ Transgrid letter to DR Tamblyn dated 21 September 2006

²²⁹ Clause 11.6.2

²³⁰ EnergyAustralia, September 2006, p.21.

²³¹ See clause 11.6.18

8.2.1 Revenue determinations immediately following existing determinations

As the Revenue Rule reflects substantially the same regulatory principles and incentive mechanisms as the SRP, TNSPs who have revenue determinations made under the SRP should smoothly make the transition to the first determination made under the new Chapter 6A Rules.

Other TNSPs will have existing revenue determinations which were made subject to arrangements which preceded the SRP. These determinations are likely to be subject to different regulatory and incentive frameworks to that proposed in the new Chapter 6A rules. The Commission recognises that it is important that TNSPs operating under a legacy framework are not prejudiced in the transition to the new Rules.

For example, TNSPs operating under legacy regulatory arrangements may have been subject to:

- possible *ex post* optimisation of capital expenditure additions at the end of the regulatory control period to determine the closing asset value at the end of the period (and therefore the opening value at the beginning of the next period);
- roll forward of the regulatory asset base less *forecast* depreciation (rather than *actual* depreciation as stated in the SRP and the Revenue Rule);
- adjustment of RAB to reflect any foregone revenue from actual expenditure above the forecast or additional revenue from forecast expenditure above actual; and
- carry over of capital expenditure and operating expenditure efficiencies which the TNSP could demonstrate was a management induced efficiency.

The Commission is aware of such arrangements that contemplate adjustments during the life of the existing revenue determinations and which may have carry-over implications for the first regulatory reset under the new Chapter 6A Rules.

The Commission consulted with each of the TNSPs, inviting them to provide information in relation to these matters. The Commission also consulted with the AER (as the successor to the ACCC) seeking its views on the arrangements that apply to each TNSP from the Regulator's perspective.

The Commission has determined that a general provision in the transitional Rules is appropriate. Clauses 11.6.9 and 11.6.10 of the Revenue Rule give formal recognition to arrangements agreed between the AER and the TNSP and permits adjustments as appropriate.

8.2.2 ElectraNet - revaluation of easements²³²

ElectraNet requested in its submission that the rules expressly permit the AER to revalue ElectraNet's easements in accordance with its letter of 3 August 2004, and for the revaluation of ElectraNet's easements to be included in the regulatory asset base for the first revenue determination made under the new Chapter 6 for ElectraNet.

The Commission accepts that the current determination for ElectraNet contemplates that the AER may give consideration to revaluation of ElectraNet's easements and for any revaluation to be included as part of ElectraNet's RAB for the next regulatory control period. The potential for revaluation of easements is also confirmed by the AER by letter to ElectraNet dated 3 August 2004.

The Commission considers that ElectraNet has a legitimate expectation that the AER will give due consideration to the question of revaluation of easements at the next revenue reset process and has prepared draft clause 11.6.13 for this purpose.

ETSA Utilities submitted that it be provided similar treatment for the revaluation of its South Australian distribution easements.²³³ However, the Commission considers that this is a matter not within the scope of the transmission revenue rule change review.

8.2.3 Grandfathering existing prescribed transmission services

The Commission's approach has been to grandfather existing assets used (or committed to be constructed) for the provision of prescribed transmission services as at 9 February 2006 for the purposes of the new definition of prescribed transmission services under the new Chapter 6A. This provision includes specific support for SPI AusNet which recognises the particular circumstances in Victoria. This is reflected in the Revenue Rule.²³⁴

8.2.4 Powerlink's revenue determination process

Powerlink's current revenue determination ends on 30 June 2007, and since late 2005, Powerlink has been engaged in the process for reset of its revenue determination, which commences on 1 July 2007 (the transitional revenue determination). The concurrent revenue reset process and the review of the transmission revenue rules has presented significant challenges for all parties.

Powerlink's transitional revenue determination is made pursuant to the old Chapter 6 rules (and the SRP), with some modification to support the transitional nature of this determination. The AER is required to make the transitional revenue determination under the existing arrangements, but the regulator is also aware of the general approach proposed by the Commission for the new Chapter 6A rules, and, in the interests of promoting a smooth transition for Powerlink, is able to have regard to the approach reflected in the Revenue Rule for the regulation of revenues for TNSPs in the future.

²³² Clause 11.6.13

²³³ ETSA Utilities, September 2006, p.5

²³⁴ Clause 11.6.11.

The Commission's general policy approach is that Powerlink should neither be in a better or worse position than other TNSPs as a result of the concurrence of its reset process with this review of the revenue rules. As a result, the Commission has specified savings and transitional Rules relating to Powerlink in order to achieve the following:

- the process for setting a revenue determination will be governed by the current arrangements reflected under existing Chapter 6 of the Rules and the SRP.
- opening RAB will be as determined by the AER in accordance with existing Chapter 6 and the SRP. Unlike the other TNSPs whose transitional opening RAB value is derived from existing revenue determinations, Powerlink's opening RAB is to be based on the transitional revenue determination that commences on 1 July 2007.
- with respect to contingent projects, Powerlink's revenue cap will be adjusted for contingent projects in the first revenue reset under the new Chapter 6A Rules for projects that were approved by the AER during the transitional regulatory control period under the transitional revenue determination.
- in calculating the weighted average cost of capital for Powerlink's regulatory control period commencing 1 July 2007 the AER is to apply the methodologies and benchmarks of the new Chapter 6A regime in relation to the following components;
 - (1) the nominal risk free rate including the maturity period and the source of the benchmark;
 - (2) the debt risk premium including the maturity period and source of the benchmark;
 - (3) the equity beta;
 - (4) the market risk premium; and
 - (5) the ratio of the market value for debt as a proportion of the market value of equity and debt; and
 - (6) the use of an average gamma of 0.5²³⁵²³⁶
- network support costs to be passed through under the applicable Rule in the new Chapter 6A regime.
- Application of the efficiency benefit sharing scheme in the new Chapter 6A during the transitional regulatory control period.
- Application of the re-opener provision in the new Chapter 6A to the transitional revenue determination.

²³⁵ Powerlink, letter to Dr Tamblyn of 21 September 2006, p.2

²³⁶ Ckauses 11.6.12 (d) and (e).

8.2.5 Reliance on draft guidelines for SPAusNet, ElectraNet and VenCorp revenue reset processes

The AER is due to commence the processes for revenue reviews for SP AusNet and VENCorp in Victoria and ElectraNet in South Australia in the early part of 2007. The AER will not have finalised the package of guidelines, models and methodologies required under the Revenue Rule to guide the regulator's discretion in its regulatory decision making role.

In this regard, the AER submitted that:

*"Following further consultation with businesses that are required to lodge revenue resets in 2007, the AER anticipates the transitional guidelines being finalised by the end of January 2007 for the purposes of facilitating these revenue proposals. The transitional guidelines will also form the basis or starting point for consultation on the more enduring guidelines during 2007."*²³⁷

The Commission believes that guidelines that apply to the first revenue reset processes to commence in 2007 should be the proposed guidelines that will be consulted upon with all stakeholders. The Commission does not support the development of separate, interim guidelines that apply only to those TNSPs who are due for reviews in 2007. The proposed guidelines will be published no later than 31 January 2007, and will be binding upon those TNSPs that are required to submit Revenue Proposals in 2007. Appropriate transitional arrangements are included in clauses 11.6.17-18 of the savings and transitional rules.

8.2.6 Basslink MNPS future conversion

During the Review, the Tasmanian Government²³⁸ submitted that to apply the Commission's new approach to the treatment of market network service providers converting to regulated status in the new Chapter 6A to existing market network services, would not maintain the existing rights of the entrepreneurial investors in the network assets.

Specifically, the Tasmanian Government stated that the Draft Rule provisions:

*"...inappropriately seek to limit the market benefits allowable in the calculation of the regulated asset base (RAB) of a converting market transmission service to a subset of those that were taken into account by the ACCC and AER in the conversion of Murraylink and Directlink...."*²³⁹

This statement is based on the concern that because the Commission's approach presumes that the value should be the lesser of the efficient costs, or the sum of current revenue plus additional market benefits, it does not afford Basslink the same treatment that the ACCC and AER (respectively) employed in considering the Murraylink and Directlink former market network services (FMNS) conversion applications. In these decisions, the regulator's

²³⁷ AER, September 2006, p.9

²³⁸ Tasmanian Government, April 2006, September 2006 and October 2006

²³⁹ Tasmanian Government, September 2006, p.1

approach adopted an initial RAB value based on the efficient costs, or the cost of a better alternative option, or an economic valuation.

The Commission's approach reflects its view that it is preferable for the RAB to be directly related to the original investment made under the safe harbour provisions for MNSPs. This is in order to ensure that the converted MNSP receives a return based only on the efficient costs of the investment, or the benefits the investment provides to the market. It therefore removes the AER's ability to substitute in the value of an alternative option.

While the Commission has retained this approach in the Revenue Rule to apply to the conversion of future MNSPs, it has accepted that in the case of Basslink, a general transitional provision for the treatment of a potential conversion application is appropriate.

Basslink is the largest single MNSP in the NEM and, as a consequence of the Murraylink and Directlink conversions, is also now the sole remaining MNSP. The Tasmanian Government submitted that to apply the new Revenue Rule conversion provisions to Basslink would be inconsistent with the stated policy intent of the MCE. In particular, the MCE stated in its 2003 report to the Council of Australian Governments that 'code changes would recognise and protect the rights of existing investors in market transmission services.'²⁴⁰

Consequently, the Tasmanian Government proposed a transitional provision to allow:

*"...the AER to apply the methodologies, objectives and principles contained in those previous regulatory determinations [i.e., Murrlink and Directlink] to any future application by Basslink to convert its status."*²⁴¹

The Tasmanian Government identified that its proposed solution constitutes a 'minimalist approach' and indicated that:

*"It is neither necessary nor appropriate to attempt further description or definition in the transitional provision of the content of those previous regulatory determinations."*²⁴²

The Commission is cognisant of the incentive benefits of affording investors in market transmission services rights and treatments that are consistent with those in existence at the time of committing to the investment. In light of this, and given Basslink's status as the sole remaining MNSP established under the existing NER, the Commission has accepted the need for a transitional provision.²⁴³

8.2.7 Energy Australia – applying Chapter 6A to existing determination

EnergyAustralia raised a number of specific transitional issues relating to pass through, re-opener provisions and contingent projects under their existing revenue determination.²⁴⁴

²⁴⁰ MCE, Report to the Council of Australian Governments, 11 December 2003

²⁴¹ Tasmanian Government, October 2006, p.3

²⁴² Tasmanian Government, October 2006, p.3

²⁴³ Clause 11.5.21

²⁴⁴ EnergyAustralia, 11 September 2006, pp.22-24.

Clause 11.6.19 enables the re-opener and cost pass through provisions of the new Chapter 6A to apply to Energy Australia's existing revenue determination. The rules also provide for treatment of contingent projects under Energy Australia's existing revenue determination with a similar regime as applies to TransGrid (under a participant derogation) and Powerlink, for the transitional revenue determination.

8.3 Other general savings and transitional rules

8.3.1 Old Part C and Part F of Chapter 6

The Commission is reviewing transmission pricing rules which, under the old rules, were governed by Part C (Transmission Pricing) (including Schedules 6.2, 6.3, 6.4, 6.7 and 6.8) and Part F (Interconnectors) of Chapter 6.

The Commission has decided to locate the old pricing-related provisions in the savings and transitional rules. In effect, the pricing-related rules would continue to be relevant to TNSPs for the purposes of allocation and recovery of costs for prescribed transmission services for the duration of the existing revenue determinations. These clauses may be found as clauses 11.6.3 and 11.6.4 of the Revenue Rule.

8.3.2 Consequential amendment of Chapter 6 for Distribution Matters²⁴⁵

Chapter 6 of the Rules is to be dedicated to economic regulation of distribution services. The amendments in Schedule 4 of the Revenue Rule transfer transmission related rules and schedules out of Chapter 6, and renumber and relocate the distribution-related rules. No changes have been made to distribution rules other than those necessary to separate transmission and distribution matters. The savings and transitional rules (clause 11.6.6) ensure that distribution related matters remain unaffected by the renumbering and relocation of the Chapter 6 rules.

The Commission considers that the separation of transmission and distribution into separate Chapters of the Rules will simplify the rules for easier understanding and therefore contribute to greater transparency. In addition, stand-alone rules for distribution services will facilitate the implementation of the review foreshadowed in the Australian Energy Market Agreement by the MCE and allow any amendments to proceed without the need to further unsettle the new transmission rules.

8.3.3 Consequential amendment of terms in the Chapter 10 Glossary²⁴⁶

Schedule 3 of the Revenue Rule divides the amendments to the Glossary in Chapter 10 of the Rules into three groups:

- amendments to remove existing definitions that are no longer required;
- amendments to add new definitions that are required for the new Chapter 6A; and

²⁴⁵ Schedule 4, Revenue Rule

²⁴⁶ Schedule 3, Revenue Rule

- amendments that substitute new or amended definitions for existing definitions that are necessary as a result of the making of the Draft Rule.

8.4 Other consequential amendments to the Rules²⁴⁷

8.4.1 Rules to assist with interpretation

The Commission is committed to the ongoing clarification and improvement of the National Electricity Rules as it carries out the Rule making functions. With the significant amendments necessary to implement the new Chapter 6A Rules, the Commission has included two new rules of interpretation in Chapter 1 to support consistency of internal and external cross-referencing for the new Chapter 6A. These new interpretation rules will be implemented in all future Rule changes. Rule 1.3 adopts a consistent nomenclature for referring to provisions of the Rules, and rule 1.4 clarifies that relocating or renumbering provisions does not of itself affect anything done under those provisions.

8.4.1.1 Chapter 5 amendments

Amendments to Chapter 5 are consequential on the creation of the category of negotiated transmission services, and on the separation of transmission and distribution services. Rule 5.4A now provides for transmission network user access and Rule 5.5 now provides for distribution network user access.

8.4.1.2 Jurisdictional derogations

There are consequential amendments to jurisdictional derogations which are relatively minor except for the Victorian derogation. The Revenue Rule makes a series of amendments that the Commission considers to be necessary to correct the Victorian derogation so that it is, as far as possible, consistent with the new Chapter 6A. The Commission is mindful that it is only appropriate for these amendments to reflect equivalent policy positions under the existing derogation, as these have previously been agreed.

The Commission notes the submission received from VENCorp which provided alternative drafting that would provide a stand alone regime for VENCorp for both prescribed transmission services and the new category of negotiated transmission services. However, the Commission does not consider it appropriate or within power to essentially expand the Victorian derogation in the way requested. Substantive amendments to jurisdictional derogations may only be sought by the relevant Victorian Minister (in consultation with other Ministers of participating jurisdictions) under s.91(3) of the NEL.

However, the Commission is aware that the proposed amendments are unlikely to provide a comprehensive framework for the purposes of the next revenue reset process for VENCorp. The new Chapter 6A introduces a new category of negotiated transmission services and an accompanying regime for determining a negotiating framework for prices for those services. The current Victorian derogation does not extend to this new regime, and VENCorp would therefore be obliged to satisfy both the regulatory regime for revenue setting under the

²⁴⁷ Schedule 2, Rule Rule

derogation and the some of the new requirements of Chapter 6A. The Commission therefore considers it appropriate that the Victorian jurisdiction may wish to put forward amendments to the jurisdictional derogation in due course to address any outstanding matters..

8.5 Treatment of transmission assets owned by distribution network service providers

In response to the Draft Rule and Determination, EnergyAustralia raised concern about the regulatory treatment of transmission assets owned by distribution network service providers (DNSPs). EnergyAustralia indicated they are subject to two regulatory processes because some assets owned by EnergyAustralia fall within the definition of providing prescribed transmission services.²⁴⁸

This problem has been of ongoing concern for distribution businesses. For example, EnergyAustralia was subjected to separate regulatory determinations in both 2004 and 1999 with the transmission assets being regulated by the ACCC and distribution assets by the Independent Pricing and Regulatory Tribunal (IPART). EnergyAustralia indicate that the value of transmission assets that it owns exceeds that of Transend and represents around 75 per cent of Electranet's assets. However, the value of these assets to EnergyAustralia is around 12 per cent of the regulatory asset base.²⁴⁹ This suggests that the issue is not trivial and will require some detailed consideration to ensure the NEM Objective is promoted.

8.5.1 Commission's analysis and reasoning

Draft Rule 6A.1.5(b) provided some guidance on the approach to be taken to assets that might otherwise be treated as providing transmission services, but are owned by DNSPs. The rule allows for parts of a transmission network that do not operate in parallel to, and also does not provide support to, the higher voltage transmission network, to be deemed to be subject to distribution service pricing, at the discretion of the relevant transmission network service provider.

As EnergyAustralia pointed out, this approach does not address their identified concern because it excludes assets that do operate in parallel to, or provide support to, the transmission network, even where these assets might be more appropriately regulated within the distribution network arrangements.²⁵⁰

In response to the Draft Rule, EnergyAustralia outlined their preferred approach to addressing the issue by proposing an alternative Rule 6A.1.5. EnergyAustralia's proposal provides for a DNSP to apply to the AER to have transmission services subject to the distribution rules. The AER must accept the proposal if the transmission services are incidental to, or a consequence of the provision of distribution services, the services do not

²⁴⁸ EnergyAustralia Supplementary Submission September 2006, p.5.

²⁴⁹ Ibid, p.2.

²⁵⁰ Ibid, p.4.

materially impact on the operation of the wholesale market or operation of the network and it would not negatively impact on customers.²⁵¹

Integral Energy, in response to EnergyAustralia's proposal, indicated its support for one regulatory process for transmission assets owned as part of providing distribution network services. However Integral Energy stated:

*"that the wording changes proposed by EA are not immaterial and may have implications for other distribution businesses that may also own transmission assets. As the implications require further examination, we therefore request the AEMC to seek wider consultation on the EA proposed changes through a separate Rule change process before making a decision on the matters raised."*²⁵²

In addition to the approach proposed by EnergyAustralia, there are a number of alternative approaches to resolving this problem. For example, clause 9.32.1 provides an alternative definition of a transmission network for Queensland, specifically excluding any assets that would otherwise be considered as transmission assets, but are owned by DNSPs.

The Commission acknowledges the importance of the issue identified in EnergyAustralia's supplementary submission and its relevance to the Revenue Rule. However, there is a need to consult more widely on the appropriate approach to resolving this issue, particularly given there is a range of alternative approaches possible. This is not possible given this Rule Determination is the final stage of the Revenue Rule review process. The Commission has therefore decided to retain the drafting of Draft Rule 6A.1.5 for the Revenue Rule, but would welcome a specific rule change proposal in the future to allow it to consider an appropriate change to the rules to address the problem identified by EnergyAustralia. This would also allow other interested parties to provide submissions in response to a specific rule change proposal.

²⁵¹ Ibid, p.6

²⁵² Integral Energy Letter to Dr Tamblyn of 28 September 2006.

Appendix A Schedule 1 to NEL items 15-24

- 15 The regulation of revenues earned or that may be earned by owners, controllers or operators of transmission systems from the provision by them of services that are the subject of a transmission determination.
- 16 The regulation of prices charged or that may be charged by owners, controllers or operators of transmissions systems for the provision by them of services that are the subject of a transmission determination, and the methodology for the determination of those prices.
- 17 Principles to be applied, and procedure to be followed, by the AER exercising or performing an AER economic regulatory function power.
- 18 The assessment, or treatment by the AER, of investment in transmission systems for the purposes of making a transmission determination.
- 19 The economic framework and methodologies to be applied by the AER for the purposes of item 18.
- 20 The mechanisms or methodologies for the derivation of the maximum allowable revenue or prices to be applied by the AER in making a transmission determination.
- 21 The valuation, for the purposes of making a transmission determination, of assets forming part of a transmission system owned, controlled or operated by a regulated transmission system operator, and of proposed new assets to form part of a transmission system owned, controlled or operated by a regulated transmission system operator, that are, or are to be, used in the provision of services that are the subject of a transmission determination.
- 22 The determination by the AER, for the purpose of making a transmission determination with respect to services that are the subject of such a determination, of:
 - a. a depreciation allowance for a regulated transmission system operator; and
 - b. operating costs of a regulated transmission system operator; and
 - c. an allowable rate of return on assets forming part of a transmission system owned, controlled or operated by a regulated transmission system operator.
- 23 Incentives for regulated transmission system operators to make efficient operating and investment decisions.

- 24 The procedure for the making of a transmission determination by the AER, Including
- a. the publication of notices by the AER; and
 - b. the making of submissions, including by the regulated transmission system operator to whom the transmission will apply and by affected Registered participants (within the meaning of section 16 (3); and
 - c. the publication of draft and final determinations and the giving of reasons; and
 - d. the holding of pre-determined conferences.

Appendix B Submissions Received

B.1 First round consultation – Proposed Rule

AGL

Australian Energy Regulator

Australian Energy Regulator Supplementary Submission

Australian Pipeline Industry Association Ltd

CitiPower And Powercor Australia

Consumer Utilities Advocacy Centre

ElectraNet SA

Electricity Supply Industry Planning Council

Electricity Transmission Network Owners Forum

Electricity Transmission Network Owners Forum Supplementary Submission

Electricity Transmission Network Owners Forum Supplementary Submission 2 -
ACG Benchmark Credit Rating May2006

Energy Networks Association

Energy Users Assoc. Of Aust. Revenue Submission

EnergyAustralia

Ergon Energy

Ergon Energy Distribution

ETSA Utilities

Government Of South Australia

Hydro Tasmania

Integral Energy

IPART Submission

Major Energy Users Incorporated

Major Energy Users Incorporated Supplementary Submission

Murraylink Transmission Company

NGF

NRG Flinders

Office Of Energy Planning And Conservation Tasmania

PIAC Revenue Submission No. 2

Powerlink Queensland

Public Interest Advocacy Centre Revenue Submission

Queensland Government

Stanwell

Total Environment Centre Inc

TRUenergy

VENCorp

Western Australian Economic Regulation Authority

B.2 Second Round Consultation – Draft Rule

AER

AER Supplementary Submission

AGL

Australian Government Solicitor Advice To DITR

CitiPower And Powercor

Consumer Law Centre Victoria

Country Energy

Electricity Transmission Network Owners Forum

Energy Action Group And Energy Users Association Of Australia

Energy Networks Association
Energy Networks Association
EnergyAustralia
EnergyAustralia Supplementary Submission
ETSA Utilities
Flinders Power
Government Of South Australia
Integral Energy
Major Energy Users Inc
National Generators Forum
NEMMCO
Powerlink Queensland
Public Interest Advocacy Centre
Queensland Government - Dept Of Mines And Energy
SA Centre For Economic Studies
The Australian Pipeline Industry Association
The Group
The Tasmanian Government
Total Environment Centre
United Energy Distribution

B.3 Supplementary Second Round Consultation – AGS advice

AGL
Australian Council Of Social Service
Australian Energy Regulator

Australian Pipeline Industry Association Ltd
CitiPower And Powercor
Consumer Action Law Centre
Consumer Utilities Advocacy Centre
Electricity Transmission Network Owners Forum
Energy Australia
Energy Networks Association
Energy Users Association Of Australia
ETSA Utilities
Major Energy Users Inc
Public Interest Advocacy Centre
Queensland Government Department Of Mines And Energy
The Group
United Energy Distribution

Appendix C AER Guidelines, Schemes and Models

Under section 34(3)(c) and (e) of the NEL, the Commission has the power to confer a function on the AER to make or issues guidelines, tests, standards, procedures or any other document in accordance with the Rules. The documents that the AER is required to prepare under the Revenue Rule are summarised in this Attachment, and the listed guidelines, schemes and models referred to as “the Guidelines”.

The Guidelines must be prepared in accordance with the Transmission Guidelines Procedures, which provide for the consultation approach the AER must follow in developing the new documents and any future amendments to the Guidelines.

Each of the documents listed in the Table must be prepared by 28 September 2007, subject to a regime in clause 11.6.17 for the first proposed Guidelines to be released on or before 31 January 2007.

Table C.1: The Guidelines

Name of document	Revenue Rule Reference
<p>Submission Guidelines contain requirements for:</p> <ul style="list-style-type: none"> • Form of TNSP revenue proposal or negotiating framework. • Information audit or verification requirements. • Consent for public disclosure of information. • Capital expenditure information. • Operating expenditure information. • Additional information and matters (RAB, depreciation schedule, X factors, length of control period). 	Clause 6A.10.2
<p>Cost Allocation Guideline:</p> <ul style="list-style-type: none"> • Guide to TNSP for preparation of its Cost Allocation Methodology. • TNSPs cost allocation methodology must also be consistent with the AER’s existing Transmission Ring-fencing Guidelines. 	Clause 6A.19.2
Service Target Incentive Scheme	Clause 6A.7.4

Efficiency Benefit Sharing Scheme	Clause 6A.6.5
Post-tax Revenue Model	Rule 6A.5
Roll Forward Model (for Regulatory Asset Base)	Clause 6A.6.1
Information Guidelines	Clause 6A.17.2