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Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Attention: Richard Khoe

Dear Mr Pierce

Economic Regulation of Network Service Providers and Price and Revenue Regulation of Gas Services, Consultation paper on savings and transitional arrangements (ERC0134/ERC0135/GRC0011)

Thank you for the opportunity to make a submission in relation to the Commission's Consultation Paper on Savings and Transitional Arrangements (the Consultation Paper) and the associated Consultation Rules published on 14 and 25 September 2012, respectively.

As a preliminary, TransGrid wishes to recognise the efforts made by Commission, as well as AER, staff to engage with TransGrid to identify the most appropriate transitional model.

As you are aware, TransGrid provided the Commission with an alternative model to that outlined in the Consultation Paper. TransGrid's model was developed in consultation with Australian Energy Regulator (AER) staff and a summary of the model appears at Attachment 1. TransGrid's proposals regarding how the relevant transmission incentive mechanisms should apply under that model are set out in Attachment 2.

In summary, TransGrid submits that:

- there are a number of key principles, including those outlined in the Consultation Paper, relevant to the selection of the most appropriate model;
- the model outlined in the Consultation Paper appears unsuitable when assessed against those principles;
- the model proposed by TransGrid is far preferable when considered in this regard;
- the "hybrid" variation outlined by Commission staff at its meeting with stakeholders on 23 September 2012 may provide an appropriate approach — this would be subject to obtaining a clear understanding of how the model provides the best outcomes in terms of process transparency and efficiency including how the proposed cap mechanism would be set; and
- there remains a considerable level of detail and therefore risk associated with finalising the transitional arrangements as part of the Commission's final Rule determination by 15 November 2012 — to address this, TransGrid suggests that the Commission settle the transitional arrangements separately in mid-December and repeats its offer to work with Commission staff to ensure that the final transitional Rule drafting accurately reflects the desired policy intent.

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Principles

The Consultation Paper identified the following four principles for developing appropriate transitional arrangements:

- the new Rules should apply to all Network Service Providers (NSPs) as soon as possible;
- processes under the transitional arrangements should allow sufficient time for stakeholder consultation;
- the arrangements should allow NSPs to recover their efficient costs; and
- the arrangements should be practicable having regard to both the AER's and stakeholders' resourcing constraints.

As previously submitted, TransGrid agrees with these principles and notes two important additional principles that:

- the transitional arrangements should provide certainty for NSPs and other stakeholders; and
- the fact that changes are occurring in the regulatory framework should not disadvantage a stakeholder during the time that the framework is changing.

The Consultation Paper model

When measured against the above principles, it is clear that the model set out in the Consultation Paper is inadequate in a number of key respects.

Crucially, the model does not provide sufficient time for adequate stakeholder consultation, especially in relation to the development of the proposed AER guidelines. This jeopardises certainty for NSPs and other stakeholders, risks determinations being made that do not allow NSPs to recover at least their efficient costs and potentially disadvantages the '2013 group' of NSPs (SP Ausnet, ActewAGL, the NSW distribution NSPs, Transend and TransGrid) compared with NSPs whose proposals are being assessed later.

In particular, under the model, the 2013 group (other than SP Ausnet) would be required to lodge their revenue proposals for the first year of the regulatory period several months ahead of the AER finalising its critical return on capital guideline. Allowing the NSPs six weeks to submit a revised proposal to reflect the final guidelines would be inadequate.

In addition:

- the requirement to undergo two full determination processes would require the AER, NSP and other stakeholders to utilise far greater resources than under the TransGrid model and duplicate a considerable amount of work unnecessarily;
- setting the revenues for the first year separately to those for the remainder of the regulatory period means that the AER would not be able to smooth revenues or prices across the combined period to most effectively minimise customer price shocks and ensure smooth cash flows for the NSPs; and
- the model does not allow the incentive schemes to apply during the first year, potentially preventing both the NSPs and customers from sharing in the benefits of greater than expected efficiencies.

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The TransGrid model

By way of comparison, the TransGrid model offers the following advantages when assessed against the principles. It:

- allows sufficient time for stakeholder consultation as well as completion of the proposed guidelines by the AER;
- minimises the administrative burden and avoids unnecessary cost duplication as the NSPs are only subject to a single determination;
- allows downward pressure to be maintained on consumer prices, including through optimised revenue smoothing;
- does not deny NSPs the ability to recover their efficient costs or to respond to incentive schemes;
- is practicable given the AER's and stakeholders' resourcing constraints and allows a more efficient use of those resources;
- provides necessary revenue and pricing certainty for NSPs and other stakeholders; and
- ensures that NSPs are not disadvantaged during the period in which changes are being made to the regulatory framework compared with other NSPs.

The hybrid model

TransGrid considers that the model it has already provided to the Commission represents the best way to transition to the new Rules.

However, it notes that the "hybrid" variation outlined by Commission staff at its meeting with stakeholders on 23 September 2012 may also provide a feasible approach. This would be subject to obtaining a clear understanding of how that variation provides the best outcomes in terms of process transparency (for the NSP and other stakeholders) and efficiency (regarding how the proposed cap mechanism would be set).

Drafting risk and a way forward

There remains a considerable level of detail and therefore risk associated with finalising the transitional arrangements as part of the Commission's final Rule determination by 15 November 2012. To address this, TransGrid suggests that the Commission settle the final transitional arrangements separately in mid-December. It also repeats its offer to work with Commission staff to ensure that the final transitional Rule drafting accurately reflects the desired policy intent.

With respect to the detail, a particular matter concerns transmission NSPs having access the cost pass through mechanism under cl 6A.7.3 of the Rules during the first year of the upcoming regulatory period. Under the proposed models, the AER would make its decision on pass through categories nominated by the NSP at the end of that year. However, the event itself may occur during that first year. To address this, TransGrid supports a transitional provision that either includes events nominated by the NSP in its placeholder revenue statement being deemed approved for that first year or the temporary "reinstatement" of those categories of events removed as part of the Commission's Cost Pass Through Arrangements for NSPs Final Rule Determination published on 2 August 2012.

Other matters

For clarity, TransGrid supports the proposals in the Consultation Paper:

- not to adopt the extended regulatory determination process for the upcoming round of resets; and
- to allow the AER to agree with each NSP to a shorter upcoming regulatory period in order to assist the regulator to manage its resourcing needs — such agreement would be on the basis that this would allow for a suitably smoothed revenue path within the short period.

TransGrid also notes that the Consultation Paper model includes deferral of the framework and approach paper process that currently applies to distribution NSPs. Grid Australia, of which TransGrid is a member, has previously submitted that the framework and approach paper is unnecessary for transmission NSPs. Should the Commission decide to proceed, TransGrid would consider that the timeframe for finalising the framework and approach paper should be no later than 31 August 2013 rather than the proposed 30 November 2013. TransGrid requires that time to reflect the contents within its reset proposal.

Finally, while TransGrid's model allows the new Rules to apply to all NSPs and their upcoming determinations as soon as possible, TransGrid does not support the retrospective application of those Rules. This would introduce considerable regulatory risk and violate the principle of investment certainty articulated above.

In particular, Grid Australia has already submitted that the best solution to delivering actual expenditure outcomes that are consistent with the National Electricity Objective is to ensure that NSPs are subject to effective ex-ante incentives. TransGrid therefore does not support the Commission's proposed review of past capex efficiency mechanism including the Consultation Paper proposal to apply that mechanism during the transitional regulatory period in respect of investments made during the current regulatory period. Should the Commission nevertheless decide to implement such a mechanism, its first application should be to investments made after the start of each NSPs upcoming regulatory period.

Should you wish to discuss any matter raised in this submission, please contact me on (02) 9284 3148 or anthony.englund@transgrid.com.au.

Yours sincerely,

Anthony Englund
Acting General Manager, Corporate and Regulatory Strategy

Alternative Transitional Model

Economic Regulation of Network Service Providers

TransGrid

Purpose

To outline an alternative model to that proposed by the AEMC for transitioning to the new National Electricity and Gas Rules (Rules) as set out in the AEMC's draft determination of 23 August 2012.

Principles

The AEMC has identified the following four principles for developing appropriate transitional arrangements:

- the new Rules should apply to all Network Service Providers (NSPs) as soon as possible;
- processes under the transitional arrangements should allow sufficient time for stakeholder consultation;
- the arrangements should allow NSPs to recover their efficient costs; and
- the arrangements should be practicable having regard to both the AER's and stakeholders' resourcing constraints.

TransGrid notes two important additional principles that:

- the transitional arrangements should provide certainty for NSPs and other stakeholders; and
- the fact that changes are occurring in the regulatory framework should not disadvantage a stakeholder during the time that the framework is changing.

Features of the Alternative Model

1. One determination for the upcoming regulatory period for each NSP covering all years of the regulatory period.
2. That determination would be made under the new Rules and guidelines. However, as proposed by the AEMC in its consultation paper, the proposals due in May 2013 will necessarily follow the 13 month regulatory determination process rather than the extended process, due to the timing of publication of the final guidelines.
3. The timetable for making the upcoming round of revenue determinations would be delayed by one year to allow the AER adequate time to complete the guidelines envisaged under the new Rules. Those NSPs currently required to lodge their revenue proposals in 2013 would now lodge in 2014.
4. The upcoming regulatory period would commence on schedule with an "appropriate revenue" agreed between the AER and the NSP as a placeholder for year one until the determination is finalised; an adjustment will then be applied to correct for any difference arising between the year one placeholder revenue and the AER's determination.

5. The year one revenue adjustment would be part of the revenue determination for the full regulatory period and would include a net present value neutral “true up” over the remainder of the period for any adjustments arising as a result of the AER’s final determination.
6. Existing incentive schemes would continue to apply for transmission businesses, the detail to make this work consistent with the scheme to be agreed between the NSPs and the AER, and the new capital incentive scheme would apply from year 2 under the AER determination.

Setting the placeholder appropriate revenue for year one

1. The “appropriate revenue” for the first year (2014/15) would be assessed by the AER using a simplified process with the primary objective of matching reasonably expected smoothed Maximum Allowed Revenue in year one of the regulatory determination, to minimise price volatility throughout the regulatory period and be consistent with the National Electricity Objective.
2. The “appropriate revenue” for 2014/15 would be assessed on the basis of information provided by the NSP regarding:
   a. the forecast opening regulated asset base;
   b. current forecasts and historical trends for operating expenditure;
   c. a forecast of tax expense and depreciation; and
   d. an indicative value for the weighted average cost of capital taking into account recently available market information, expected market trends and informed by revenue determinations made in the preceding 12 months and the AER’s guidelines.

   None of this would pre-commit the AER when considering the regulatory proposal and making the revenue determination.
3. If the AER was not satisfied with the information provided by the NSP, it may request the NSP to provide revised information failing which the AER may deem an “appropriate revenue” for the NSP taking into consideration the National Electricity Objective, the expected revenue path over the entire regulatory period taking into account optimal revenue smoothing and the objective of minimising price shocks for customers throughout the regulatory period.
4. The timeline for assessing the “appropriate revenue” for NSPs with regulatory periods’ commencing in July 2014 would commence in early 2014 in time for prices to be notified to customers

   For emphasis, this revenue would be subject to a correction or “true-up” consistent with the determination for the full regulatory period when made.

Reasons for and benefits from the Alternative Model

The Alternative Model:

- ensures the new Rules apply to all NSPs and their upcoming determinations as soon as possible;

- allows the upcoming regulatory period to commence on schedule with an "appropriate revenue" agreed as a placeholder for the first year until the AER has completed its determination process;
- allows downward pressure to be maintained on consumer prices, including through optimised revenue smoothing;
- allows sufficient time for full stakeholder consultation, as well as completion by the AER of the guidelines and methodologies envisaged under the new Rules;
- minimises administrative costs and avoids unnecessary duplication of costs as NSPs are only subject to a single determination;
- does not deny NSPs the ability to recover their efficient costs or to respond to incentive schemes;
- is practicable given the AER's and stakeholders' resourcing constraints and allows a more efficient use of those resources;
- provides necessary revenue and pricing certainty for NSPs and other stakeholders; and
- ensures that NSPs are not disadvantaged during the period in which changes are being made to the regulatory framework.

A number of these benefits are not apparent and would not be realised under the "two determination" model proposed by the AEMC.

Other Aspects of the preferred Alternative Model

The following features should also be considered as part of the transitional rules, consistent with the above principles:

- no retrospective application of the new Rules — in particular, the proposed review of past capex efficiency would first occur as part of the revenue determinations subsequent to the upcoming determinations and only apply to investment made after the start of each NSPs upcoming regulatory period;
- in the interests of minimising price shocks for customers and ensuring stable and sustainable cash flows for businesses, the AER should consider opportunities for revenue smoothing within period; and
- in the interests of aligning revenue determinations, the AER and each NSP could agree to a shorter upcoming regulatory period — the AER should provide a model as to how this might work across the industry for discussion.

Alternative Transitional Model

Transitional Operation of Incentive Schemes

Introduction

In August 2012 the AEMC published a draft Rule under the Economic Regulation of Network Service Providers rule change. Subsequently, the AEMC also published “for consultation” transitional arrangements in conjunction with the new Rule. TransGrid and other industry bodies have provided comments to the AEMC on the transitional arrangements.

The AEMC’s “for consultation” transitional arrangements propose that incentive schemes not apply to the first year of the following regulatory control period. TransGrid’s alternative transitional model proposes that incentive schemes apply to the first year. The alternative transitional model advocates the deferral of submission of the revenue proposal, which has implications for the operation of incentive schemes during the transition.

There are two incentive schemes that presently apply to Transmission Network Service Providers (TNSPs), the Efficiency Benefit Sharing Scheme (EBSS) and Service Target Performance Incentive Scheme (STPIS). This paper proposes how these incentive schemes could apply under transitional arrangements.

Efficiency Benefit Sharing Scheme

The EBSS provides incentives for a TNSP to reduce its operating expenditure, and shares the resulting efficiency gains or losses between the TNSP and transmission network uses. It rewards sustained efficiency by allowing a TNSP to retain the benefits of an efficiency gain for a carryover period, which is generally five years. The EBSS outcomes are measured over a regulatory control period and applied as an adjustment to a TNSP’s maximum allowed revenue in the following regulatory control period.

The EBSS measures the difference between the controllable operating expenditure allowance and actual expenditure in each year of a regulatory control period (the efficiency “gain” or “loss”). The scheme looks at the trend in efficiencies between years, through the incentive carryover being based on the change in efficiency gain or loss from year to year. That is, a TNSP’s incentive result is based on the efficiency gain or loss in a year relative to the previous year, rather than in absolute terms. In this way, the scheme rewards sustainable efficiency gains and penalises sustained efficiency losses.

Because the scheme looks at trends in efficiencies between years, and the incentive adjustment is made in the following regulatory control period, it is appropriate for the scheme to apply from year 1 of the transitional regulatory control period. An efficiency gain or loss in year 1 alone does not itself provide a reward or penalty for a TNSP – rather, the efficiency gain or loss in year 2 (and by inference, future years of the regulatory control period) relative to that in year 1 provides the reward or penalty.

It is therefore practicable for the controllable operating expenditure allowance for year 1 to be set in the final decision in May of year 1, and the EBSS based on this expenditure. Notably a TNSP would have a good indication of the likely allowance when the draft decision is published in November of year 1.

Should the EBSS not apply to year 1 of the transitional regulatory control period, a TNSP would not be required to respond to the incentive in that year. In this case, potential benefits from the operation of the scheme would be forgone for that year.

If the transitional regulatory control period it shorter than five years, as the AEMC has provided for in its "for consultation" transitional arrangements, the EBSS guideline may need to be updated to allow for the possibility of a shorter regulatory control period. In principle, this should be done while retaining the same carryover period as for a standard length regulatory control period in order to maintain the same benefit-sharing ratio.

Service Target Performance Incentive Scheme

The STPIS applies to TNSPs on an annual basis during a regulatory control period. The scheme comprises several parameters, for which targets are set for the regulatory control period in a revenue determination. Performance is measured each calendar year and the incentive result is applied as an adjustment to the following financial year's revenue. For this reason, performance targets must be set in advance of the calendar year in which they apply as the behaviour influenced by the incentive is measured in the calendar year alone.

The Australian Energy Regulator (AER) is currently undertaking a review of the STPIS that will amend some existing parameters and introduce new parameters for future regulatory control periods. The draft decision of the review provides that for some parameters, targets would not be set in a revenue determination but on a rolling average basis.

As the alternative transitional model involves deferral of the revenue proposal and determination timeframe, it would not be possible to set performance targets for year 1 of the transitional regulatory period in advance for parameters where these are set in the revenue determination. For parameters where targets are set apart from the revenue determination, for example on a rolling average basis, this complication does not apply.

Therefore, proposed transitional arrangements have been considered for each component of the scheme individually. These have been included in Grid Australia's submission on the draft decision on the review of the STPIS.

1. As the service component values are set in a revenue determination, it would not be possible to set values for year 1 of the transitional regulatory control period if the revenue determination timeline is deferred. Therefore, the existing service component could continue for year 1 of the transitional regulatory period with existing parameters, weightings, targets, caps and collars. The new service component should apply from year 2.
2. The new market impact component could apply from the start of the upcoming regulatory period, as in the revised scheme its targets are based on rolling average periods, and not set in the revenue determination.
3. The new network capability component could apply from the start of the regulatory period, with the network capability improvement parameter action plan submitted and approved prior to the upcoming

regulatory period. The plan could be ratified in the revenue determination if required, to formalise the incentive.

As performance under the STPIS is measured over calendar years, the transitions could be further simplified by changing the timing to the start of a calendar year, rather than the start of year 2 of the transitional regulatory period, to avoid the situation where performance is required to be measured over two six-month blocks in a calendar year that overlaps regulatory periods. This could be achieved by a variation to the above arrangements, for example:

1. The existing service component to continue for the first six months of the transitional regulatory period. The new service component to apply from the first full calendar year in the period with parameters, weightings and targets based on the draft decision, then for subsequent years with parameters, weightings and targets based on the final decision. If the draft decision applies to the first full calendar year, additional informal consultation between the AER and TNSP in the lead-up to the draft decision would be beneficial as the TNSP would not have the avenue of a revised proposal to address matters raised in the draft decision.
2. The existing market impact component to continue for the first six months of the transitional regulatory period, and the new market impact component to apply from the first full calendar year in the period.
3. The new network capability component to apply from the start of the regulatory control period, as it operates on a regulatory year basis rather than calendar year.

If the AER requires, TNSPs could also start recording data against new service component parameters, including the new ‘reporting only’ parameters, from year 1 of the transitional period.