

Major Energy Users Inc

16 October 2006

Dr. John Tamblyn
Australian Energy Market Commission
P O Box H166
Australia Square
NSW 1215

Dear Dr. Tamblyn,

Major Energy Users' Concerns: 2nd Draft Rule Transmission Revenue

On behalf of the Major Energy Users, I would like to thank you and your colleagues for meeting and discussing with us our serious concerns with the 2nd Draft Rule. These concerns are strongly held and our South Australian members are deeply concerned, as the ElectraNet review would be the first regulatory reset under the new Rule. In addition, the new Rule is expected to largely apply to electricity distribution networks and gas transmission and distribution networks and have far-reaching consequences for major energy consuming businesses.

We have put to you that we believe the AEMC's 2nd Draft Rule is unbalanced and is biased in favour of transmission companies. It further raises rewards to the TNSP's, reduces their risks, and increases their flexibility to game the regulator. It is far too prescriptive, by reducing the independent role of the AER, concomitant with increasing the flexibility of the TNSP's by increasing their ability to maximise returns.

As requested, we attach a short note on our concerns, including a brief commentary on the Australian Government Solicitor's advice to the Department of Industry, Tourism and Resources concerning the "Reasonable Estimate" issue. We share each and everyone of those concerns; note, in particular the likely adverse impacts arising for consumers.

The AEMC's 2nd Draft Rule is said to be "transparent", "creates regulatory certainty", "provides for efficient investment" and so on. However, it has ignored consumer concerns that the whole approach will take regulatory

Suite 504, 80 Clarence Street
Sydney, NSW 2000

Major Energy Users' Concerns: 2nd Draft Rule Transmission Revenue

As discussed at our meeting on 13 October 2006, The MEU and its members have major concerns with the draft determination on transmission revenue and its associated draft Rules. However we do have a fundamental concern with the AEMC process. The view consistently stated in the draft determination refers to the "majority of views" put (which, incidentally came from TNSP's or other vested interests). As we discussed, if the issue is about the numbers of responses received rather than the issues raised, then MEU will request that all of its members formally submit the MEU response to you. In addition, we will seek other consumer groups to do likewise. As mentioned to you at the meeting SACoSS, CoTA and PIAC have similar views to those of MEU, and we will request that they also ask their members to submit the MEU response. As you stated that this is not necessary, we will not do this but we do request that a more balanced approach to assessing the inputs provided, and that these will be assessed on the basis of the "long term interests of consumers". As the MEU response is a consumer response we would expect to see that AEMC would tend to follow the views put by consumers and where the AEMC has a view that the MEU comments are not in the long term interests of consumers, we would expect that the AEMC would devote extensive analysis to demonstrate why the views of consumers should not be accepted.

The AEMC's 2nd Draft Rule on Transmission Revenue is unbalanced and heavily biased in favour of transmission companies. There are 5 major rule change proposals that will allow transmission companies to raise revenues, and hence, prices very substantially (MEU comments on other changes are contained in the handouts provided to the AEMC last week and in our submissions). These proposals are dressed up as providing for "efficient investments", "regulatory certainty", "incentivising TNSP's" and transparency. There is no mention anywhere whether the Rules, as written, provide an outcome in the interests of consumers.

The proposed changes are expected to flow to rules for regulating electricity distribution networks and gas transmission and distribution. Such a regulatory regime for energy networks will make it uncompetitive for major energy using industrial activities in Australia. Proponents of major new investment projects are also concerned about their viability in the face of the proposed energy regulatory regime. Should large consumers reduce their demand for electricity and gas, then the contributions made by them will have to be borne by the remaining consumers, of whom residential consumers are a significant element.

1. Reasonable Estimate on Capital and Operating Expenditure

Every consumer submission opposed the AEMC's proposed rule on the basis that it will favour the transmission company and restrain the

AER in conducting its independent regulatory responsibilities. Indeed, increased uncertainty will result and will lead to increased disputation.

There are the many concerns raised by the Australian Government Solicitors' advice to the Department of Industry, Tourism and Resources and the MEU shares them. Of equal concern is that users, who were disadvantaged by the previous appeals process because of the costs involved in applying for appeals (let alone participate), are further disadvantaged by the new limited merits appeal process because of costs indemnity. Users are therefore very unlikely to apply for appeals against AER decisions.

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 is feared: there is no merit in leaving this issue to future doubt.

2. Ex-Post Review of Capex and Opex

The AEMC proposed rule will bring regulatory gaming to a new level, take away business risks from transmission companies and result in users underwriting their risks. MEU is concerned, against the background that \$27 billion in capex and opex was approved for electricity networks in the latest access arrangements, that there be an audit process to ensure expenditures have been demonstrably prudent and efficient. With prognostications that the next round of access arrangements for electricity networks are likely to be even higher than \$27 billion, energy users demand that an audit process must be in place. The current AEMC draft Rule does not even ensure that its incentives for more investment will even result in investments that are prudent and efficient, let alone in the areas of real need. The AEMC is just hoping that they will work; there is not even a process in place which requires a future review to ensure that the changes made will ever achieve the outcomes desired.

MEU is concerned that the financial engineering practices involving energy infrastructure will bring regulatory gaming on forecast expenditures to a new high level and that this will be further assisted by the new AEMC Rule.

3. Depreciation Schedule

The AEMC rule will allow the transmission company to maximize its revenue by adopting the appropriate depreciation schedule. MEU has shown how the choice of depreciation schedules and the use of the DORC approach for asset valuation can advantage TNSP's.

The DORC approach for return **on** investment in a low inflation environment would appear not to warrant a change. It is the outcome of

the way the DORC approach is applied to depreciation that causes a major concern to consumers.

In the MEU submission, we provided a monograph about the impact of the way depreciation is applied by regulators and the outcomes that arise from it. In plain terms the depreciation that is paid by consumers in the early years is relatively low, but rises dramatically in later years, forcing excessive payments onto the next generation of users. In the monograph using historical values for inflation and bond rates, we demonstrate that in actual money terms, consumers will pay over 40 years some \$3754 for depreciation and \$3157 for return on investment for an asset initially valued at \$1000. Thus to pay back the "loan" of \$1000, consumers will pay nearly 7 times the initial value of the "loan". This requires a fixed payment of some \$173 pa. This is equivalent to a notional interest rate of over 17%, well above the equivalent amount that a bank would require for a home loan.

This matter was not even addressed by the AEMC.

4. Commercial Arbitration

The AEMC Rule will lead to increased costs, will not be effective, and will result in disadvantaging users as there is little incentive for network owners to resolve disputes expeditiously, putting consumers under excessive time pressures.

We consider that the AER/ACCC should be the dispute resolution body because of its relevant expertise in promoting competition.

The current Gas Code provides for the AER/ACCC to be the relevant dispute resolution body of last resort and contains relevant provisions for timely and efficient dispute resolution. In fact the ACCC has already provided this service on a number of occasions.

5. WACC Parameters

The AEMC rule will lead to high WACC's yet at the same time risks to TNSPs are being reduced. The rule is at the high point and applies for too long a period (up to 9 years).

The MEU has proposed 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.

Overall Conclusion

The AEMC's rules for TNSP's revenue will:-

- raise revenues
- reduce risks
- increase flexibility to game the regulator

Accordingly, the AEMC's rules are unbalanced and are biased towards the TNSP's. Of great concern is that there is no evidence of research or empirical analysis to support its major rule changes, and consumer concerns have been ignored.

The AEMC rules will be a poor outcome for energy users.

gaming to a new level and forces consumers to assume the business risks of transmission companies.

Whilst we appreciate that the AEMC is working through its process, we are alarmed by the thrust of its whole approach, particularly when the draft rule on pricing is also considered.

Against this background, you have agreed to meet with us for a discussion of our concerns with the draft pricing rule.

The AEMC should take note of our concerns that a more balanced outcome is required.

Yours sincerely

A handwritten signature in black ink, appearing to read "Mark Gell". The signature is written in a cursive style with a large initial 'M' and a long, sweeping tail.

Mark Gell
Chairman