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25 October 2012

Mr John Pierce
Chairman
Australian Energy Market Commission
Level 5, 201 Elizabeth Street
Sydney NSW 2000

By email www.aemc.gov.au

Dear Mr Pierce,

Proposed Transitional Arrangements for the Economic Regulation of Network Service Providers

This submission sets out a number of serious concerns around the proposed application of the forthcoming new Rules on the Economic Regulation of Network Service Providers to SP AusNet's upcoming transmission revenue review (TRR) due to commence in February 2013. This follows recent discussions with the AEMC and AER staff concerning the TRR.

SP AusNet has provided a pragmatic transitional arrangement that reflects the immediacy of the TRR. The advantages of adopting this approach are outlined in Part A of this submission. The submission also outlines why the AEMC's proposal in relation to the TRR is unworkable given the proposed timeframes for SP AusNet to develop a complete Revenue Proposal as a financially responsible, listed entity.

Comments are also provided on the transitional arrangements proposed for regulatory resets currently scheduled from 2014 onwards in Part B.

Should your staff have any queries regarding this submission, or require further information on what is proposed, please do not hesitate to contact Tom Hallam, Manager Economic Regulation, on 03 9695 6617.

Yours Sincerely,

Alistair Parker
Director, Regulation and Network Strategy

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Part A: Arrangements for the 2013 TRR

AEMC Proposal

The AEMC's Consultation Paper and Consultation Rules set out the following transitional process for SP AusNet:

- A transitional year from April 2014 to March 2015 where SP AusNet would submit a regulatory proposal to the AER for the interim year at the end of June 2013. The interim determination would apply the new Rules with the exception of the cost of capital. Here, given the timing constraints on SP AusNet, the old Chapter 6A rules on the rate of return would apply for the one year regulatory period.

- The AER would make a Final Decision on the Rate of return (or WACC) Guidelines on 29 November 2013.

- SP AusNet would then submit its full Revenue Proposal for the next regulatory period 3 months later on 28 February 2014.

- A subsequent determination would be made based upon the Revenue Proposal for the regulatory control period of April 2015 to March 2020 using the new Rules in their entirety but with the current determination process applying.

Revenue Proposal Preparation Time

A fundamental problem with AEMC proposal is that it only provides three months for SP AusNet to develop a complete Revenue Proposal following the publication of a final WACC Guideline. SP AusNet wishes to make clear that it is an impossible ask and leaves SP AusNet with insufficient time to prepare its Revenue Proposal.

Normally, SP AusNet requires 12 months to provide the AER with a compliant, complete and high quality electricity transmission Revenue Proposal.

A key consideration in developing capital expenditure plans is the expected method by which the rate of return of return will be determined. It is particularly important to a fiscally responsible private business which needs to arrange funding, perform credit metric analysis and model financial impacts of an expected rate of return in reference to planned capital expenditure.

Even if other parts of the building blocks proposal can be done ahead of the AER's final WACC Guideline, the capital expenditure program, which involves the bulk of the work and resources required, would not be able to be developed in the absence of certainty around the WACC methodology.

To develop a reasonable capex forecast, it takes thousands of hours of intense work from many teams across the business including planning and operational engineers, project delivery, program management, project estimating, IT, legal, regulatory and finance. A process of developing individual projects and programs, justifying them, testing them, and documenting them is necessary to derive a complete and appropriate capital expenditure proposal.

It then takes months to gain internal approval for this proposal and conduct financial assurance of it. The Proposal is repeatedly refined it to make it consistent with commitments made to investors and stakeholders. We also need to arrange appropriate funding and budgeting across the three networks for all planned capital expenditure.

It is unreasonable to assume that this could be done in three months. Even if SP AusNet had sufficient staff to work solidly for the three months, it would be almost impossible to produce the quality of Revenue Proposal which the Rules require. Further, the period in which the work falls would be over the Christmas/ New Year period making the AEMC's timeframe even less realistic.

The problem is amplified by the fact that the AEMC proposal provides SP AusNet with one month between being the AER decision on its interim year and Revenue Proposal submission date. The amount of capital approved in the interim year would have significant impacts on the following capital expenditure program but there would not be any time to redesign the capital expenditure program to accommodate these.

The AEMC has stated that it is important that "any transitional arrangements should be practicable having regard to the regulator's resourcing constraints, as well as the resourcing capacity of other stakeholders."[1]

For the reasons outlined above, it is SP AusNet's view that the AEMC's proposed arrangements for the TRR do not meet objective.

SP AusNet also notes that it would be unreasonable for the AEMC to seek to impose a different regulatory year on SP AusNet as a means to move the submission date. SP AusNet's regulatory year for the transmission business is based on a Singaporean financial year of 1 April – 31 March and our financial and regulatory reporting systems are consistent with this. To change this without SP AusNet's agreement would impose additional burden and cost to the business to amend its current reporting and data collection systems. This would be unacceptable to the business, as well as inherently unfair.

Broader public policy problems in the AEMC's Proposal for the TRR

A number of public policy concerns exist in relation to the AEMC's proposal to apply the new Rules to the TRR. These are discussed below.

Counter to the principles of fairness and natural justice

The intent of the original AER Rule change was always to apply the new rules to reviews undertaken after the 2013 TRR. The acceleration of timetable, while understandable, has a particularly unfair impact on SP AusNet. The originally affected businesses have had the benefit of notice since September 2011, while SP AusNet was only made aware of this possibility a year later, and will only know for certain if the new Rules are applicable to the TRR three months out from our submission date. This prima facie does not appear to afford SP AusNet a fair outcome.

Minimising regulatory costs and burden of implementation

SP AusNet considers that the AEMC's proposal will unnecessarily increase regulatory costs and administrative burden to SP AusNet in the short and longer term, and ultimately, the costs faced by Victorian customers.

[1] AEMC, *Consultation Paper on Savings and Transitional Arrangements*, 14 September 2012, p. 7

In anticipation of a February 2013 submission date SP AusNet has poured significant resources and time into developing its TRR Revenue Proposal including:

- engaged and paid for consultancies to forecast elements of the Proposal including materials and labour costs escalations;

- developed a detailed capex proposal including undertaking resource-intensive risk modelling, asset and plant condition reporting, complex cost benefit analysis for economic evaluations and project cost estimation. Much of this will need to be redone and the whole program redeveloped should submission be delayed;

- developed an opex proposal using a historic base year and developed bottom up estimates of non-recurrent works, insurance, self-insurance and step changes;

- on the basis of the capex proposal, SP AusNet has modelled credit metric impacts, planned funding arrangements and taken the proposed capex into account in internal budgeting and financial planning;

- commenced engagement with the AER on regulatory period length, service performance schemes and the assessment of asset management processes; and

- commenced a due diligence process.

Given the significant amount of preparation done for the TRR as outlined above, we consider that the AEMC's proposal to impose future rule changes on the TRR, in effect, moves the goal posts after the event.

In the next two years SP AusNet will be required to repeat and reiterate preparation for the TRR which is already well advanced. This introduces a significant inefficiency.

Of further concern is that the AEMC's proposal will have serious long term impacts on SP AusNet's regulatory costs and opex efficiency as the AEMC proposal unwinds the carefully planned staggering of resets for each of SP AusNet's three networks. The AEMC proposal causes a significant and problematic overlap between the preparation phase for the Victorian Electricity Distribution Price Review (EDPR) and the live revenue reset phase of the TRR. It will also mean the EDPR live review will completely overlap with preparations for the next Victorian gas distribution access arrangement review (scheduled for 2016). It is expected that SP AusNet will face significant permanent cost increases to accommodate this.

Another problem with the AEMC's proposal is that it fails to take the opportunity to smooth the AER's workload by:

- reducing the number of resets the AER must undertake in 2014. The AER is scheduled to undertake 14 individual resets under the AEMC's proposal, much of these for NSW businesses. Including SP AusNet's TRR in this list only increases the resource pressure on the AER; and

- facilitating alignment of the revenue resets of TNSPs. If it is able to continue to undertake the TRR process under the current Rules, SP AusNet has voluntarily offered to shorten its proposed regulatory period length to fasttrack the application of the new Rules and enable aligned TNSP resets. Imposing the transitional arrangements onto the TRR risks this rare opportunity.

Undermines regulatory and investor certainty

The AEMC's proposal to accelerate the rolling out of the new Rules to capture the TRR is inconsistent with the overarching principle of regulatory certainty and undermines investor certainty in SP AusNet's particular circumstances.

Until the release of AEMC's Draft Rule Determination in August, SP AusNet had assumed that the TRR would be submitted under the currents Rules. This has been our reasonable assumption; given the original AER Rule Change Proposal was based upon a timing which did not contemplate capturing the TRR under new arrangements.

Based on the original rule change proposal made by the AER, SP AusNet has consistently communicated to both its debt and equity investors a view that any new Rules would likely first apply to its business in 2016 (the next Victorian electricity distribution review). It has now amended this advice.

Why is the TRR Different?

SP AusNet reiterates that the TRR is distinguishable from forthcoming resets in 2013 because:

- The submission of the TRR is obviously imminent. A Final Determination issued by the AEMC 3 months out from submission of the Revenue Proposal is blatantly unfair.

- The TRR only includes replacement capex, and not augmentation capex. As such, it is, generally speaking, less controversial in nature than other resets.

- Much of the expected benefits of the new Chapter 6A will not be applicable to the TRR where the expectation is that capex will not be overspent in relation to regulatory allowances.

- SP AusNet owns multiple networks and as such, the scheduling of the TRR is particularly crucial to manage the business's resources and costs.

A further consideration is that transmission prices in Victoria are low, and are expected to continue to be low, while this may not be the case in other jurisdictions.

SP AusNet Alternative

As an alternative, SP AusNet would propose that its current review continue on its original timetable under the existing Chapter 6A Rules. That is, a proposal would be lodged at the end of February 2013 with a Final Decision due in January 2014. However, only a four year, three month regulatory control period would be sought. This would then align perfectly with the next ElectraNet Revenue Review. The advantages of this proposal are multiple and include:

- It still delivers a complete transfer of the transmission sector to the new Rules by July 2018. That is, SP AusNet's arrangement does not delay the complete transition to the new arrangements in any way;

- It reduces the significant workload congestion for the AER in 2014 where it is expected to undertake 14 price and revenue resets;

- It helps smooth the AER's workload in relation to future electricity transmission revenue resets;

- It voluntarily enables the alignment of the transmission sector sought by the AER and recommended in the Transmission Frameworks Review;

- It significantly simplifies the transition process as the current review would continue unchanged followed by the next review completely under the new arrangements;

- Finally, it maintains staggered timing with the Victorian Electricity Distribution Price Review (Final Decision made by October 2016) which is crucial to SP AusNet from a resourcing and opex control perspective. The AEMC proposal causes a significant and problematic overlap between the preparation phase for the EDPR and review phase of the Transmission revenue review.

As you are aware, SP AusNet has made AER staff aware of our alternative proposal.

SP AusNet also observes that our proposal is largely consistent with the original AER rule change proposal with the added benefit of offering voluntary alignment with other TNSP revenue resets.

Other alternatives

Alternative transitional arrangements to our current proposal were sought from SP AusNet based on potential amendments to the AEMC proposal.

With respect to the length of the regulatory period, SP AusNet does not have any internal driver for alignment of TNSP reviews. In the event our transitional proposal was rejected, SP AusNet would continue to propose a six year regulatory control period (1 + 5 accounting for the interim year). This is default even under the proposed rules and affects the strength of the incentive regimes that are applied to the business.

SP AusNet considers that the interim year, if applied:

- Should be fixed at the current revenues in real terms. That is, a simple CPI escalation would be performed on the 2013/14 revenue. This revenue is not materially different to that which would have applied if SP AusNet had received a 7 year determination at the last review.

- Should rollover the existing STPIS targets and parameters for the interim year.

- Should suspend EBSS for the interim year;

- Apply no true up to the interim year revenues subsequently but rather a clean new process for a five year revenue path would be set for 2015/16 through 2019/20 under the new Rules but using existing review timeframes and processes (as per the AEMC proposal).

SP AusNet considers this avoids wasted resources in relation to the interim year and provides SP AusNet with a fair opportunity to re-prepare its Revenue Proposal in the context of the new Rules. It would also go some way to offer investors a degree of certainty, particularly around the interim year, that would be foregone in the earlier transition.

SP AusNet reiterates that, with respect to timing, an interim period of more than a year would materially worsen the already difficult resourcing clash (created by that interim period) with our upcoming electricity distribution review. A two year interim period would see the TRR and EDPR reset processes completely overlap in 2015.

Part B: Transitional Arrangements for Post-2014 Resets

To the extent a one year delay and interim year is necessary for all price/revenue resets currently scheduled for 2014 onwards, including the Victorian electricity distribution price review (EDPR), SP AusNet has considered a number of alternative proposals to the AEMC's which have been suggested to manage the transition process and determine revenues for the interim year. SP AusNet's summary of the key features of certain models are set out in the table below.

Table B-1

Model	Process	Method to set interim year revenue	True up for interim year
AER model	• Single submission • 3 month consultation process and • decision on interim year 2 months before interim year commences	AER placeholder determination based on separate indicative forecasts of: • opex and capex • a summary of overall expenditure plans for the 5 year period • an indicative WACC value • and other inputs necessary to calculate revenues	AER determination made as part of the final determination to true-up revenue across the five years.
Victorian Distributors approach*	Same as AER model	Same as AER model but placeholder would be based on Year 1 of the complete regulatory proposal.	Transitional allowances for capex and opex to be set equal to actual capex and opex in that year for the purposes of the true-up.
TransGrid model	Same as AER model	Negotiated outcome using: • the forecast opening regulated asset base; • current forecasts and historical trends for operating expenditure; • a forecast of tax expense; and • an indicative WACC value	Same as AER model.

Mechanistic Approach	Same as AER model except no public consultation required on placeholder revenue because NSP must submit proposal below the cap and AER would not exercise any form of discretion.	Placeholder revenue must fall below a cap determined by reference to a formula in the Rules.	True up mechanism to account for any difference between the placeholder revenue and the revenue requirement established through the full determination process (in net present value terms).
Hybrid approach	Same as Mechanistic Approach but public consultation only required where placeholder revenue is above cap	Placeholder revenue may be either: – below cap specified in Rules; or – above cap specified in Rules AER would conduct a more detailed assessment of the proposal using the approach set out in the AER proposal	True up mechanism to account for any difference between the placeholder revenue and the revenue requirement established through the full determination process (in net present value terms).

*Prices for all alternative control services (except those regulated under the Victorian AMI Order in Council and public lighting services) will be rolled forward into the transitional year with a CPI + 2% increase. No true up would apply to these services.

SP AusNet's preference is the alternative transitional arrangements proposed by the Victorian Distributors. It has the merit of:

- using the most efficient streamlined regulatory proposal and decision-making process;
- minimising the additional information and resources required for the interim year;
- provides certainty to businesses about the expected revenues and expenditure allowances applicable to the interim year; and
- provides certainty as to the treatment of actual expenditure in the interim year.

Second to this would be the AER's model using the hybrid approach which has the strength of:

- using the most efficient streamlined regulatory proposal and decision-making process;

- is less resource-intensive in relation to information requirements for the interim year than the AEMC proposal; and

- provides the business with some level of certainty around the likely expenditure allowances applicable to the interim year.

SP AusNet considers all of the above models are preferable to the AEMC's proposal.