



EnergyAustralia™

EnergyAustralia's submission to

Australian Energy
Markets Commission

Review of the
Electricity Transmission
Revenue and Pricing Rules

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Energy

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EXECUTIVE SUMMARY

EnergyAustralia welcomes the opportunity to comment on the AEMC's draft Rule proposal on transmission revenue regulation. EnergyAustralia has found the process to be very consultative and has valued the AEMC's production of an accompanying explanatory paper with the proposed Rules.

While EnergyAustralia understands the time pressures on the AEMC to finalise its review of the transmission revenue Rules under the NEL, we note the short timeframe in which to respond to the draft Rule proposal has necessarily constrained our ability to provide a comprehensive response on this matter.

As a combined transmission and distribution business, EnergyAustralia is most concerned to ensure that any Rules developed for transmission revenue regulation would also be applicable to electricity distribution businesses.

Regulatory processes

EnergyAustralia's primary issues focus on the regulatory processes proposed in the draft Rules. In particular, EnergyAustralia is concerned that the processes outlined in the draft Rules, while characterised as a "propose/respond" model, represent only a marginal improvement over the current "submit/determine" model. As discussed in section 3.5, EnergyAustralia considers that the draft Rules only oblige a regulator to accept aspects of a business's revenue proposal if it considers those aspects to be "reasonable". While the draft Rules include a list of the items to which the regulator must have regard in determining whether those aspects are "reasonable", the draft Rules provide no clear criteria on which the regulator is required to make that assessment. In the absence of such clear criteria, a business is unable to file a revenue proposal with any confidence that the regulator will find it "reasonable".

EnergyAustralia continues to strongly advocate a genuine "propose/respond" model, in which the regulator is obliged to accept a proposal that is compliant with the Rules and the NEM objective.

Information requirements

The choice of a regulatory process model has profound implications on the information requirements associated with the model. EnergyAustralia has consistently argued for clear regulatory information requirements that have been developed through a rigorous investigation and analysis planning process in the context of the "submit/determine" model. EnergyAustralia reiterates these views in this submission in light of the procedural model reflected in the draft Rules.

EnergyAustralia believes a far superior model is the genuine "propose/respond" model as found in the National Gas Code and the Western Australia Electricity Access Code. In both these models, in which the regulator is obliged to accept a Code-compliant proposed Access Arrangement, the onus is on the business to "make its case" that its proposal is indeed Code compliant. In this model, it is possible to specify the regulatory information requirements in more general terms within specific categories, and rely on the business to provide the

necessary information to provide the regulator with sufficient confidence to approve the proposed Access Arrangement as filed.

However, should the “propose/respond” model not be adopted by the AEMC in favour of a model that allows the regulator to “determine” what is “reasonable” (as is the position currently in the draft Rule proposal), it is imperative that the regulator is obliged to articulate its information requirements in sufficient detail to enable the business to meet its requests. This obligation should be contained in the Rules. As a general comment, EnergyAustralia is firmly of the view that the information gathering powers of the AER are potentially invasive, and go far beyond what should be reasonably expected to enable the AER to conduct its functions.

[Scope for AER to develop guidelines](#)

EnergyAustralia supports the construct of the draft Rules in which the regulator is given responsibility for “fleshing out” the detailed application of the Rules. However, consistent with the NEM governance arrangements, EnergyAustralia is most concerned to ensure that these guidelines are not elevated to a “quasi-Rule” status. As discussed in section 3.3, EnergyAustralia is concerned that some of the Rule provisions include mandatory requirements to comply with AER guidelines, which effectively elevates the guidelines beyond the policy intent of the NEM governance framework.

EnergyAustralia therefore recommends that the Rules include provisions requiring all AER guidelines and other procedural tools, such as the Post Tax Revenue Model, be reviewed and approved by the AEMC to ensure the guidelines correctly reflect the Rules and their related policy intent, and also that they do not overstep their role as guidelines.

[Requirement to use PTRM \(and scope for AER to embed policy in PTRM\)](#)

In general terms, EnergyAustralia supports the concept of the regulator conducting its assessment of the revenue proposal using a defined and published financial model. EnergyAustralia considers that this will improve transparency and consistency of treatment across TNSPs and thus increase regulatory certainty through precedent over time.

However, consistent with its comments in section 3.3 on the requirement for the AER to develop guidelines, EnergyAustralia is concerned that the Rules do not provide for any review or oversight of the AER’s development, or management, of the model.

As indicated above, EnergyAustralia is concerned that the Rules, as currently drafted, introduce scope for the AER to make quasi-policy decisions by way of requiring certain inputs to the PTRM, or by the treatment afforded to particular items in the PTRM. To this end, consistent with its comments in section 3.3 on the requirement for the AER to develop guidelines, EnergyAustralia proposes that the PTRM developed by the AER should be subject to a review to ensure that the structure and mechanical operation of the PTRM accurately implement the policy positions of the MCE and the Rules developed by the AEMC.

[Including WACC parameters in Rules](#)

EnergyAustralia supports the certainty afforded by including the procedures and parameters for calculating the Weighted Average Cost of Capital in the Rules. However, EnergyAustralia is concerned with the apparently unconstrained scope for the AER to review and unilaterally

amend those parameters every five years. EnergyAustralia is firmly of the view that the WACC parameters can have such a significant impact on the interests of the service provider that it is not reasonable for the AER to be able to amend these parameters without undergoing a Rule change process.

Should the AEMC not adopt EnergyAustralia's preferred approach of having any proposed amendments to the WACC parameters arising from the AER's review being the subject to a formal Rule change process, EnergyAustralia would seek to ensure that any decisions by the AER would be reviewable decisions. EnergyAustralia has consistently argued that any decision by an administrative body that has the potential to adversely impact the interest of an affected party should be subject to clear and accessible merits review processes.

Capital expenditure

EnergyAustralia supports the position in the draft Rule in favour of a "low powered" capital expenditure incentive regime. In particular, EnergyAustralia supports the AEMC's treatment of return of capital in this scheme. A regime that would institutionalise the potential confiscation of value from the business in the face of its undertaking prudent and efficient capital expenditure could not be supported.

EnergyAustralia also strongly supports the position taken in the Rule Change Report that does not support scope for the regulator to undertake an ex-post review of the prudence and efficiency of capital expenditure. However, as discussed in section 4.2, the Rules appear to be drafted in such a way as to not only allow scope for the regulator to undertake an ex-post review of the prudence and efficiency of capital expenditure, but indeed to *require* the regulator to undertake such a review. In EnergyAustralia's view, this matter requires urgent attention.

The Rules as drafted also do not appear to provide scope for the regulator to rely on its capital expenditure incentive mechanism to avert an ex-post review. EnergyAustralia considers that well-designed incentive mechanisms are more effective tools to achieve regulatory objectives than an ex-post review could ever accomplish.

EnergyAustralia supports the proposal to introduce a capital expenditure reopener process to manage unforeseen increases in capital expenditure. While providing constructive commentary on the framework in section 4.2.5, including amendments to the "trigger" provisions, EnergyAustralia generally supports this mechanism. However, EnergyAustralia objects to the current construct, in which it appears that the business must sacrifice any earned efficiency gains before being able to access the reopener mechanism.

Prescribed and negotiated services

EnergyAustralia remains unconvinced of the workability of the definitions of prescribed and negotiated services being proposed, in particular the implications associated with similar constructs being applied to distribution businesses. For example, the framework applicable to negotiating customer connections would be unwieldy, and unworkable in the context of contestable connection services. A negotiation framework for connection services appears to be a retrograde step compared to the contestability regime for these services currently in place in NSW to deliver efficient outcomes.

EnergyAustralia notes that the AEMC has convened a working group to address these definitional issues, and will contribute to that group to the extent possible.

Pass through mechanism

EnergyAustralia applauds the proposed pass through mechanism, including the materiality definitions incorporated in the glossary. However, EnergyAustralia is concerned that the draft Rule underestimates the time required to analyse the effect of a potential pass through event and prepare a submission to the regulator for approval.



1. INTRODUCTION

EnergyAustralia is pleased to respond to the Australian Energy Market Commission's (AEMC) draft Rule changes resulting from the Review of the Electricity Transmission Revenue and Pricing Rules. The range of issues raised in the Consultation Paper indicated the need for significant amendments to the regulatory principles and procedures in the National Electricity Rules for transmission revenue. For the most part, EnergyAustralia acknowledges the AEMC's efforts in addressing these significant structural elements and we are generally supportive of the regime proposed.

By definition, EnergyAustralia's network contains transmission elements within the predominantly distribution network. The transmission component of EnergyAustralia's network comprises approximately twelve per cent of the total network in revenue terms and has the role of supporting the main transmission grid in NSW. As both a transmission and distribution service provider, EnergyAustralia currently faces two diverse regulatory principles and processes for its transmission and distribution networks.

Transmission and distribution networks are different in a number of operational ways but are comprised in essence of long lived infrastructure assets that are generally indistinguishable. We do not believe there is a compelling case for separate regulatory principles and processes for determining revenue for transmission and distribution, as is the case under the current market design. The intention, in this submission, has been to present proposals that, at least in principle, could be applied to both the transmission and distribution network businesses and thereby facilitate a single regulatory determination process for EnergyAustralia's network business.

EnergyAustralia would be pleased to discuss any of the matters raised in this submission.

2. SCOPE AND FORM OF REGULATION

2.1. SCOPE OF REGULATION

EnergyAustralia applauds the position taken in the draft Rules that not all services should be the subject of detailed regulatory oversight. This is consistent with the scope for some services, particularly connection services, to be conducted under a contestability framework.

2.1.1. Prescribed and negotiated services

EnergyAustralia is not comfortable that the current definition of prescribed and negotiated services will provide sufficient clarity to TNSPs.

EnergyAustralia is comfortable with the definition of negotiated services applying to a large load or generator connection to the transmission network. However, EnergyAustralia is most concerned in the potential for this definition to apply at the connection point from a transmission network to a distribution network.

The current definition appears to imply that the point of connection between a prescribed transmission network and a prescribed distribution network would be a negotiated service, and the related assets would not be included in the regulatory asset base. This approach would not be supported.

EnergyAustralia's combined transmission and distribution business includes transmission exit equipment at several locations that supplies the distribution network. The draft Rules approach would effectively excise the portion of EnergyAustralia's current Regulated Asset Base (RAB), comprising the connection assets between the prescribed transmission and prescribed distribution networks.¹

EnergyAustralia is concerned that the definition of negotiated service, as currently drafted, could inadvertently result in this unanticipated outcome.

EnergyAustralia is also keen to establish arrangements for transmission revenue regulation which to the maximum possible extent are compatible with arrangements which would apply to distribution services. The approach espoused in the draft Rule proposal could not be translated to the 1.5 million customers and 25,000 new connections of EnergyAustralia's distribution business per annum. A negotiated connection regime would not be workable at this level.

Furthermore, customer connections to both the transmission and distribution network are contestable in NSW, where some sixty per cent of EnergyAustralia's new connections are constructed by Accredited Service Providers. Customers are already able to source their connection provider in a contestable regime, thus providing the benefits of competition to these services.

¹ EnergyAustralia acknowledged that the current RAB is to be grandfathered as prescribed assets. However, this construct would appear to apply to any future connections between prescribed transmission and prescribed dist networks.

EnergyAustralia believes that a negotiation regime for the connections between network service providers would be a retrograde step compared with current contestability arrangements, and as such is not supported. In addition, any connection regime should be also appropriate for the requirements of a very large number of distribution connected customers.

EnergyAustralia suggests that the proposed “negotiated service” definition be restricted to the largest customer and generator connections. For smaller transmission connections, and virtually all distribution connections, a capital contribution and contestability regime should operate to allow connecting customers to choose their connection service provider. Under this regime, connection services would remain a prescribed service, but the network operator would not earn a return on or return of capital on the contributed connection assets.

EnergyAustralia applauds the Commission’s proposal to refine this issue through a working group, and will contribute to this group as required.

[Definitions linked to service standards](#)

EnergyAustralia is also concerned that the definitions of prescribed and negotiated services are linked to service standards. This presents a risk of inadvertent misclassification.

For example, the lumpy nature of network investment may result in a service being provided at a level above the required standard in the period immediately following an efficient augmentation. Similarly, in the period immediately prior to an augmentation, the shared transmission network may indeed be providing a level of service below the required standard.

As above, EnergyAustralia will contribute to the working group in refining these definitions.

2.2. FORM OF REGULATION

EnergyAustralia’s network is unique in that it is an integrated network that includes assets which have been classified by the Rules (and previously the Code) as either electricity transmission or distribution assets.

The classification of a small proportion of our network assets (approximately twelve per cent) as transmission has introduced significant regulatory complexity to the business, including the need to:

- classify assets between the two categories, allocate costs between the classes, and manage the transition of some assets between transmission and distribution;
- file two sets of regulatory submissions, to two different regulatory bodies;
- file two sets of regulatory submissions using two regulatory models – a revenue cap for the transmission network and a weighted average price cap for the distribution network; and
- report aspects of network performance (currently) to two regulators

EnergyAustralia’s experience in this regard has indicated that its cost of regulatory oversight is greater than should reasonably be the case given the relative size of our transmission network.

Looking forward, EnergyAustralia seeks an integrated regulatory oversight regime which would conduct any regulatory assessment of the revenues or prices required to operate the meshed transmission and distribution networks together. This would presumably be much more practical under a single national regulator. However, the Rules must allow such a holistic assessment to be undertaken, and it is not clear at this time that they do.

The review of the transmission revenue requirement Rules presents an ideal opportunity to lay the groundwork for such a holistic review to be undertaken. EnergyAustralia acknowledges that a complementary set of Rules will be required when the review of the distribution revenue requirement Rules are reviewed.

While EnergyAustralia advocates a single approach to calculating the regulatory “building block” revenues for its integrated transmission and distribution business, it considers that the form of price control is a separable decision. EnergyAustralia considers that, once the revenue requirement for the integrated network business has been established, the approach to regulatory price control for its distribution business could be a price cap, revenue cap or a form of hybrid.



3. REGULATORY PROCESSES

3.1. SCOPE FOR GUIDED DISCRETION

EnergyAustralia has consistently supported the NEM governance structure which features policy level decisions being taken by the MCE, those policy decisions being translated into Rules by the AEMC as rule-making body, and the Rules being administered and enforced by the AER as economic regulator.

EnergyAustralia also supports the proposed model in which there is scope for defined regulatory discretion; a model with no scope for the reasonable exercise of discretion would be overly prescriptive, complex and unwieldy.

However, to the extent the governance structure leaves the responsibility for policy-making in the hands of the MCE, EnergyAustralia considers that it is entirely consistent that the Rules, reflecting the policy position, should guide the regulator's discretion to ensure policy-consistent outcomes of the regulatory process.

3.2. CODIFICATION OF WACC PARAMETERS

EnergyAustralia supports the inclusion of the approach to determining the Weighted Average Cost of Capital, and the key parameters to that calculation, in the Rules. This will provide a high degree of regulatory certainty and transparency on cost of capital measurement. As stated in our original submission to the AEMC on this review:

"In terms of certainty for investment and in minimising the costs of regulation, there is some attraction in having the Rules specify how the WACC is to be calculated, rather than relying on the AER to set the WACC at each regulatory reset. EnergyAustralia considers that the SRP as finalised by the ACCC in December 2004 likely represents the regulatory "middle ground" on where the debate on WACC parameters in Australia has landed. While network businesses clearly believe the resultant level is considerably too low, customer groups would no doubt argue that the level is too high.

EnergyAustralia is concerned that the SRP, however, is not binding and can be altered by the AER at any time. Therefore, EnergyAustralia believes that it is appropriate for the WACC aspects of the SRP to be incorporated in the Rules.

...

These parameters would then be changed following a periodic review or rule change process conducted by the AEMC.²

² EnergyAustralia's 1 December 2005 submission to the Australian Energy Market Commission's Consultation Paper on the *Review of the Electricity Transmission Revenue and Pricing Rules*. Page 39.

While EnergyAustralia is supportive of elevating the calculation of the WACC to the Rules, we are concerned regarding the scope for AER to review and modify those parameters in five years' time. When considering the importance of WACC for supporting long term investment, the five-yearly review by the AER - should it result in changes to the WACC parameters in the Rules - has the potential to unwind much of the regulatory certainty that would otherwise have been gained by elevating the WACC methodology and parameters into the Rules.

The importance of this issue on investment should not be underestimated. For EnergyAustralia, with a regulatory asset base for its network (transmission plus distribution) business of approximately \$5 billion, a 1 percentage point reduction in WACC would *a priori* result in a reduction of approximately \$50 million of regulated revenues *per year*. Given the significant impact even a small reduction in the allowed WACC would have on regulated revenues, it is essential to provide some guidance on how (or if) the WACC will be amended following each five yearly review. As energy infrastructure assets generally have lives that span many regulatory periods, any uncertainty over how the WACC may be amended could only have a dampening effect on the incentives to invest.

As the methodology and parameters are proposed to be included in the Rules, EnergyAustralia recommends that any suggested changes to the WACC parameters that may arise following the AER's review (in accordance with its guidelines) also needs to be the subject of a formal Rule change process. It is not apparent to EnergyAustralia why parameters that are considered appropriate for inclusion in the Rules initially should then not be subject to a formal Rule change process if revisions are proposed.

3.2.1. Merits review of AER WACC parameter decision

As indicated above, EnergyAustralia's preferred outcome would be for any proposed amendments to the WACC methodology or parameters that may arise following an AER review to be subject to a formal Rule change process. However, should this approach not be adopted by the AEMC, we would seek to ensure that the AER's revisions would be reviewable.

EnergyAustralia is firmly of the view that the AER should not be able to make a decision on changes to the WACC parameters without some form of oversight or review. However, to the extent the Rules are drafted such that any change to the WACC parameters is effected without the rigour of the Rule change process,³ EnergyAustralia is firmly of the view that the AER's decision must be subject to clear and accessible review provisions.

While EnergyAustralia acknowledges that merits review of regulatory decision-making is the subject of a separate consultation process, it is not apparent from the current drafting how there would be any avenues for review of the AER's decision on cost of capital parameters

A decision by the AER on WACC parameters, such as the market risk premium or the rating of benchmark debt, has the potential to have a profound effect on the interests of the network businesses.

Consistent with its submission to the consultation process on this issue, EnergyAustralia is strongly of the view that a decision of the AER on the WACC parameters to be included in the Rules should be subject to clear and accessible review processes, similar to any other

³ See AEMC transcript page 23.

determination by the regulator which affects the interests of the network business. To this end, the Rules should be structured so that the scope for the AER to exercise discretion in relation to the WACC parameters is removed and that the AER's decision could be reviewed to determine whether it complies with the Rules.

3.2.2. Application of AER WACC parameter decision

EnergyAustralia notes that there was some discussion at the 8 March 2006 AEMC public forum on the draft Rule proposal that supported a process under which the WACC parameter decision would become applicable to all regulatory determinations, including those already in force.

EnergyAustralia considers that a process to re-open regulatory determinations to implement changes in WACC parameters part way through a regulatory control period has the potential to seriously undermine the regulatory certainty that was targeted by including the WACC parameters in the Rules.

EnergyAustralia supports the position currently reflected in the Rules, by which the WACC parameters applicable to the network business are those included in the Rules at the time the regulator hands down its determination.

3.3. SCOPE FOR AER TO DEVELOP GUIDELINES AND MODELS

EnergyAustralia considers that it is generally appropriate for the AER to develop guidelines to specify the ways in which the Rules will be applied in practical terms. This required level of detail is inappropriate for inclusion in the Rules – the result would be an unwieldy and inflexible regulatory regime. In this regard, EnergyAustralia supports the use of guidelines to augment the Rules.

EnergyAustralia is very concerned, however, that the proposed Rules do not provide sufficient rigour to ensure that the AER as regulator:

- Will be able to apply the policy intent of the MCE as reflected in the Rules;
- Can correctly interpret the Rules consistent with the AEMC's vision of the policy direction; and
- Does not overstep the responsibilities relegated to the guideline through the Rules.

This concern manifests in two ways. Firstly, there is not always sufficient policy direction within the Rules to guide the AER in the preparation of the guidelines or models. Secondly, some of the guidelines will effectively operate as Rules. Both have implications for assessing or testing the validity of the AER's guidelines and models. Whilst EnergyAustralia does not promote an adversarial or litigious relationship with the regulator, past experience has demonstrated that it is in the interests of both the regulator and businesses that the powers and in particular any discretionary power of the regulators be clearly articulated and proscribed within the relevant law.

3.3.1. Policy limits for Guidelines

An example of these concerns is the guidelines to be prepared by the AER in relation to revenue proposals. Clause 6.12.1(c) requires that the TNSP's revenue proposal must comply with the requirements of all guidelines made by the AER. The Commission's Rule proposal report (at page 40) implies that the revenue proposal guidelines to be prepared by the AER will be confined to information requirements, but this is not borne out by the wording of the rule. Clause 6.1.2(1)(c) clearly requires that a TNSP's revenue proposal "comply with the requirements of ... guidelines made for that purpose by the AER".

Whilst clause 6.1.2.2 sets out the matters which must be specified in the guidelines, it does not in any way limit the matters which can constitute "requirements" or provide policy scope for such requirements. This leaves significant discretion for the AER to determine "requirements" which may not be contemplated or supported by the Rules. The Rules do not even contain a general requirement that the guidelines relate to or address matters which the AER reasonably believes are required to ensure that revenue proposals meet the requirements of the Rules. This would make it very difficult to bring the AER to account should it make guidelines which go beyond that which might reasonably be expected to support a revenue proposal. To address this, it is essential that the Rules provide some indication of the matters which can be the subject of the guidelines.

Similar concerns do not arise in relation to the Model for the roll forward of the regulatory asset base (clause 6.2.3(b), the Service Target Performance Scheme (clause 6.2.10) and the Cost Allocation Guidelines (clause 6.21(b) to be prepared by the AER. The relevant provisions of the proposed Rule are either very specific about the content or contain appropriate direction and principles against which the resulting model or guideline can be assessed. However the provisions in relation to the Post Tax Revenue Model (clause 6.2.1) and the efficiency benefit sharing scheme (clause 6.2.8) should either be more prescriptive or contain policy direction and principles against which the model and scheme can be assessed.

3.3.2. Status of Models and Guidelines

The proposed rule confers power upon the AER to prepare models, schemes and guidelines which will significantly impact upon the revenue proposals and their outcomes. To varying degrees the models, schemes and guidelines will operate as an extension of the Rules and go beyond "fleshing out" the Rules.

Of particular concern is the mandatory nature of the guidelines to support revenue proposals. Failure to comply with the guidelines will result in the revenue proposal being "non-compliant" and subject to a requirement that it be amended and re-submitted. The mandatory nature of the guidelines means that there are, in effect, Rules made by the AER. This offends one of the fundamental principles of the NEM governance arrangements that the rule-making and regulator functions should remain separate.

Any "guidelines" made by the AER should only be able to operate as a guide to meeting and interpreting the substantial requirements of the Rules. If the guidelines contain or require matters that cannot be referenced back to the requirements of the Rules then they effectively operate as a Rule in their own right, which should only be made by the AEMC. Similar concerns do not arise in relation to the cost allocation guidelines to be prepared by the AER under clause 6.21(b). The obligation upon a TNSP is to ensure that its cost allocation methodology gives effect to and is consistent with the Cost Allocation Guidelines.

Similar concerns do, however, arise in relation to the various models and schemes which must be prepared by the AER. These models and schemes will be mandatory in that TNSPs will be obliged to them.

If it is determined that the AER should have the power to make mandatory “guidelines”, models and schemes, then there must be either a readily available mechanism for them to be reviewed or a mechanism by which the guidelines are considered and approved by the AEMC as authorised by the Rules. EnergyAustralia suggests that the guidelines, models and schemes developed by the AER should be subject to a review and approval by the AEMC to ensure the guidelines are consistent with the Rules they are designed to implement, and do not overstep the regulatory boundaries established by those Rules.

3.4. INFORMATION REQUIREMENTS

The MCE Consultation Paper on a National Framework for Energy Distribution and Retail Regulation proposes the following principles for information disclosure should be reflected in the NEL/NGL:

(a) the Rules should require that network businesses collect, compile and provide to the AER information that the AER reasonably requires for the purposes of its regulatory functions; and

(b) the Rules should:

(i) provide that the AER should develop standard, national Statements of Requirements for Ringfencing, which should be consistent between electricity and gas businesses;

(ii) the Statement of Requirements should cover ringfencing between regulated and non-regulated activities, and between different regulated activities; and

(iii) set out the circumstances in which the Statement of Requirements for Ringfencing apply.

(c) the Rules should:

(i) provide that the AER can develop standard national Statements of Requirements for Regulatory Accounts, consistent across electricity and gas businesses; and

(ii) set out the circumstances in which the Statement of Requirements for Regulatory Accounts apply.

EnergyAustralia broadly agrees with the above principles.

As a matter of principle, however, EnergyAustralia believes that the Regulator should only require information necessary to meet the following objectives:

- to support the assessment of the business’ revenue proposal;
 - to monitor compliance with that revenue proposal; and
 - general information to collaborate or support the veracity of other information provided.
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In the context of conducting a pricing review, EnergyAustralia has consistently advocated a considered approach to advance planning. In this process the regulator would:

- identify the critical risk areas in the review;
- develop the analytical tools to address those risks, and
- request information from the business required to support that analysis.

EnergyAustralia supports the process by which the Regulator is required to set out its framework and approach in advance of the review. However, EnergyAustralia has concerns about the propensity for regulators to issue “ad hoc” information requirements that are poorly targeted for the analysis to be undertaken as part of the review process, and the administrative burden these information requests place on the regulated business.

This issue was recently highlighted in the appeal of Alinta Network Services Pty Ltd (“ANS”) against an information request by the Essential Services Commission, Victoria (“ESC”)⁴. In that appeal, the Essential Services Commission Appeal Panel stated:

“[The Appeal Panel] is satisfied that the ESC Notice encompasses a requirement to identify and produce many thousands of documents in different forms in different locations. This would impose an unreasonable burden on ANS. The Appeal Panel is satisfied it would take an unreasonably long time to comply with this request. ...

The Appeal Panel noted that the ESC had not developed any estimate of the likely time needed to produce the documents required nor had it made any enquiries of ANS as to the number of documents and time required to produce them.”

The scope for unplanned information requests may reduce the perceived need for planning discipline in the conduct of the review and encourage the Regulator to conduct its analysis in an unstructured, scatological approach. EnergyAustralia is firmly of the view that a well planned, structured approach to the analysis is critical to enabling the Regulator to cope with the workload, and also to ensure consistency of treatment across regulated businesses. Recognising the AER’s potential mandate to regulate approximately 40 regulated network businesses, the AER will have no option other than to specify and standardise its information requirements as much as possible if it is to conduct its functions in an efficient and effective manner.

Consistent with this view, EnergyAustralia objects to the notion that “the Rules should permit (but not require) the AER to issue Statements of Requirements in relation to other reporting requirements, where such reporting is reasonably required for the purposes of the AER’s regulatory functions”. In EnergyAustralia’s view, this “open-ended” scope for the Regulator to demand information simply paves the way for intrusive micro-management of the business on the part of the Regulator.

⁴ Essential Services Commission Appeal Panel Reference E2/2005, In The Matter Of The Electricity Price Determination 2006-2010 In Respect Of United Energy Distribution Pty Ltd And In The Matter Of The Essential Services Commission Act 2001 Victoria and in The Matter Of An Appeal By Alinta Network Services Pty Ltd, Published on the Victorian Civil and Administrative Tribunal website.

EnergyAustralia also believes that information must be relevant to the purpose required. In this regard, EnergyAustralia believes that the Regulator should be required to disclose the purpose of the information in order that the business can ensure the information provided meets the Regulator's requirements in the appropriate level of detail. Linking the information requirements to the review process, as discussed above, would accomplish this objective.

Also, in recognising the "unreasonable burden" that can be placed on a business in responding to information requests,⁵ and where the principles allow the Regulator to demand information that it believes it "reasonably requires", there must be scope for review of the Regulator's demands for this information. This will be particularly important where the Regulator can impose penalties for failure to provide the information requested.

Further guidance also needs to be provided in the Rules relating to when the AER is able to publish information. The Rules should include an obligation on the regulator to demonstrate how the public disclosure of the information would lead to the attainment of the AER's obligations under the Rules, and that the business is not commercially disadvantaged by its public release.

3.4.1. Extent of information provided should be incumbent on the TNSP

EnergyAustralia is firmly of the view that the extent of information provided must reflect the complexity and materiality of the issue being assessed. Where an issue is non-controversial and not material, there should be scope for the TNSP to provide a less demanding (and less intrusive) breadth and depth of information.

For example, the Schedule 6.9 information requirements require the TNSP to file a certification, by an independent and appropriately qualified expert, that the assumptions underpinning the capital and operating expenditure forecasts, as well as the forecasts themselves, are reasonable. In EnergyAustralia's view, it is incumbent on the business filing the revenue proposal to support its case. If the TNSP does not believe it is necessary to engage an independent and appropriately qualified expert to certify the reasonableness of its assumptions and capital and operating expenditure forecasts, it should not be the role of the Rules to require it to do so.

In addition, EnergyAustralia considers that it is unnecessary for the Rules to require the businesses to provide, in relation to capital expenditure [S6.9.1(e) and (f)] and in relation to operating expenditure [S6.9.1(f) and (g)], "a certification of the reasonableness of the key assumptions by an independent and appropriately qualified expert" and "a certification of the reasonableness of the [capital/operating] expenditure forecasts by an independent and appropriately qualified expert".

EnergyAustralia questions the usefulness of such requirements. Indeed, such certifications would not be necessary if the Rules specified the criteria against which the AER would be required to assess the reasonableness of the revenue proposal.

Moreover, EnergyAustralia objects to the requirement for the TNSP to engage such an independent review in the absence of any obligation on the part of the regulator to accept the views of the independent expert.

⁵ *ibid*

3.4.2. Requirements must be responsive to analysis program

As noted above, EnergyAustralia believes regulators should be obliged to articulate their information requirements, and to not rely on a “shotgun” approach to obtaining information. Given that information requests impose costs on the TNSP in gathering, distilling and analysis, the regulator should bear a responsibility to ensure that information requested is earmarked for a specific purpose. To this end, EnergyAustralia suggests that the information requirements (whether in the Rules or in a guideline) should be the result of a detailed investigation planning process to be undertaken by the regulator, which should include:

- A risk-based assessment of the key areas for focus of the regulatory analysis, focusing on the risks of error and the consequence of error;
- A work program detailing the approach and analysis required to address those risks; and
- A schedule of the specific information required to undertake that analysis.

EnergyAustralia is of the view that, until such time as the detailed work program development has been undertaken by the regulator, it is inappropriate to codify the information requirements in the Rules.

3.4.3. Information sharing and disclosure

EnergyAustralia has consistently argued that information provided to regulators for regulatory analysis has been subject to considerable distillation and analysis prior to being provided. As such, it is generally only relevant to the focused question for which it was prepared.

For example, system wide load growth forecast information is useful for a transmission tariff determination. However, this information may not be helpful to the regulator in assessing the reasonableness of the TNSP’s capital expenditure forecast – the capital expenditure requirements are driven by a combination of a number of factors, including geographical load growth, system configuration and asset condition.

EnergyAustralia therefore continues to be concerned about the scope for regulatory agencies to share information. This presents the real risk that information provided to one agency for a particular purpose could be used by another agency for another purpose to which the information is not suited. The results of a regulatory analysis conducted using inappropriate information has the potential to have a detrimental effect on the business.

This concern adds additional depth to EnergyAustralia’s recommendation that any information requirements related to regulatory analysis must be targeted to be useful to that analysis.

EnergyAustralia is also concerned that the information collection and disclosure powers of the AER under clauses 6.19 and 6.20 are not confined to the economic regulatory functions of the AER. The obligations upon a TNSP to provide information should be confined to the certified annual statements and any additional information required by the AER to enable it to perform its economic regulatory functions under Chapters 5 and 6 of the Rules. Where the AER requests any additional information, it must specify how the information is required to enable it to carry out its economic regulatory functions.

Similarly the power of the AER to disclose information, usually through one of its publications, must be confined to purposes related to carrying out its economic regulatory functions. Currently the Rules provide for the AER to disclose such information, deemed to be confidential under the Rules, against the wishes of the TNSP. This should only be allowed to occur where the disclosure or publication clearly supports and identifiable economic regulatory function.

Currently the provisions are cast far too broadly, partly because when the Code was converted to Rules, the references to the ACCC functions under the Code were merely carried over to refer to the AER's functions under the Rules, without full regard being had to the fact that the AER has a much broader range of functions under the Rules.

3.5. PROPOSE/RESPOND MODEL

EnergyAustralia is an avid supporter of a genuine "propose/respond" model. Under this model, the business bears a responsibility to propose a revenue and price proposal that is consistent with the Rules and the NEM objective. Also under this model, it is the responsibility of the regulator to assess that proposal and, where it finds the proposal to comply with the Rules and the NEM objective, to approve it.

EnergyAustralia's review of the proposed Rule indicates that, while some processes for the conduct of the regulatory review have been amended to follow a "propose/respond" model, the fundamentals of the process have not changed. While the model has clearly been revised from the "submit/determine" model currently in the Rules, it could now be better characterised as a "propose/determine" model.

In particular, EnergyAustralia notes the continued reference of the Rules for the regulator to "determine" outcomes rather than in terms of accepting a revenue proposal or revised revenue proposal. Of note, the language of section 6.11 is still couched in terms of the AER:

... making a determination ... that specifies ... the total revenue cap ... the maximum allowed revenue

The genuine propose/respond model is reflected in S2.16 *et seq* of the National Gas Code:

"... the Relevant Regulator must issue a final decision that: ... approves the Access Arrangement ...; or does not approve the Access Arrangement ...".

Sections 4.12, 4.17 and 4.21 of the WA Electricity Access Code are also couched in terms of "a decision to approve" the proposed access arrangement.

3.5.1. Obligation to accept

The key element missing from the model proposed in the draft Rules is an obligation on the regulator to accept a TNSP's proposal that complies with the Rules and the NEM objective. This was most clearly articulated by Cooper J in [Application by GasNet Australia \(Operations\) Pty Ltd \[2003\] ACompT 6](#) (23 December 2003):⁶

⁶ <http://www.austlii.edu.au/au/cases/cth/ACompT/2003/6.html>

‘However, where there are no conflicts or tensions in the application of the Reference Tariff Principles, and where the AA [Access Arrangement] proposed by the Service Provider falls within the range of choice reasonably open and consistent with Reference Tariff Principles, it is beyond the power of the Relevant Regulator not to approve the proposed AA simply because it prefers a different AA which it believes would better achieve the Relevant Regulator’s understanding of the statutory objectives of the Law. [emphasis added]’

In the proposed Rules, the obligation on the regulator to accept a compliant proposal is considerably less rigorous:

- The regulator is only obliged to accept the TNSP’s forecast of capital expenditure if *“the total of the forecast capital expenditure for the regulatory control period ... is determined by the AER to be a reasonable estimate of the Transmission Network Service Provider’s required capital expenditure for the regulatory control period”* [6.2.6(b)(3)]
- The regulator is only obliged to accept the TNSP’s forecast of operating expenditure if *“the total of the forecast operating expenditure for the regulatory control period ... is determined by the AER to be a reasonable estimate of the Transmission Network Service Provider’s required operating expenditure for the regulatory control period”* [6.2.7(b)(2)]

In summary, then, the only requirement is for the regulator to accept a proposal it finds to be “reasonable”. In EnergyAustralia’s view, this represents only a marginal improvement on the “submit / determine” model currently in place in the Rules. Whilst the regulator’s assessment of the “reasonableness” of the proposal must be considered by the AER “taking into account” a number of issues specified in 6.2.6(3) and 6.2.7(b)(2), the proposed Rules provide no criteria against which “reasonableness” can be assessed. Consequently this leaves significant discretion and scope for a “black box” approach to the issue of reasonableness. Moreover these factors do not aid the TNSP in preparing its revenue proposal to provide information to the regulator to give comfort that the forecast capital and operating costs are indeed “reasonable”.

EnergyAustralia submits that the “propose/respond” model contained in the proposed Rules will not operate as the Commission intends unless a clear and definitive set of criteria against which the AER must assess the TNSP’s capital and operating expenditure forecasts, and clear guidance on the circumstances under which the AER may reject the revenue proposal are included.

In this regard, EnergyAustralia considers that considerable guidance can be drawn from the relevant sections of the Western Australia Electricity Access Code, as follows:

Criteria for approval of a proposed access arrangement

4.28 Subject to section 4.32, when making a draft decision, final decision or further final decision, the Authority must determine whether a proposed access arrangement meets the Code objective and the requirements set out in Chapter 5 (and Chapter 9, if applicable) and:

(a) if the Authority considers that:

(i) the Code objective and the requirements set out in Chapter 5 (and Chapter 9, if applicable) are satisfied - it must approve the proposed access arrangement; and

(ii) the Code objective or a requirement set out in Chapter 5 (or Chapter 9, if applicable) is not satisfied - it must not approve the proposed access arrangement;

and

(b) to avoid doubt, if the Authority considers that the Code objective and the requirements set out in Chapter 5 (and Chapter 9, if applicable) are satisfied, it must not refuse to approve the proposed access arrangement on the ground that another form of access arrangement might better or more effectively satisfy the Code objective and the requirements set out in Chapter 5 (and Chapter 9, if applicable).

{Note: The effect of section 4.28 is to make the Authority's decision in relation to a proposed access arrangement a "pass or fail" assessment. The intention is that, if a proposed access arrangement meets the Code objective and the requirements set out in Chapter 5 (and Chapter 9, if applicable), the Authority should not refuse to approve it simply because the Authority considers that some other form of access arrangement might be even better, or more effective, at meeting the Code objective and the requirements set out in Chapter 5 (and Chapter 9, if applicable).}

4.29 The Authority:

(a) must not approve a proposed access arrangement which omits something listed in section 5.1; and

(b) may in its discretion approve a proposed access arrangement containing something not listed in section 5.1; and

(c) must not refuse to approve a proposed access arrangement on the ground that it omits something not listed in section 5.1.

EnergyAustralia considers that the integrity of the "propose/respond" model espoused in the draft Rules would be strengthened by clear guidance on the grounds under which the regulator may refuse to accept the forecasts of capital and operating expenditure and the revenue proposal in general, and a requirement for the regulator to provide clear reasons for doing so.

3.5.2. Process timelines

EnergyAustralia supports the inclusion of time frames for decision-making in the "propose/respond" processes in the draft Rule. However, EnergyAustralia believes that there is significant work that needs to be done in order for that time frame to be executed.

In particular, EnergyAustralia is keen to ensure that the regulated businesses have sufficient time to prepare their information systems and processes to develop the information required by the regulator to satisfy itself to accept the revenue proposal.

The proposed timetable is reasonable so long as the information requirements are sufficiently well defined in order for a complete revenue proposal to be filed in the first instance. To the

extent the information requirements are incomplete or ambiguous, the process will suffer delays and the timetable will not be able to be met.

As confirmed by the AER's recently released document "*Gas and Electricity Distribution Regulatory Guidelines Scoping Paper - March 2006*", EnergyAustralia will be one of the first businesses scheduled to be regulated by the AER under the new Rules (both for transmission and distribution). The following Table 1 has been reproduced from that document.

Table 1: Timing of reviews for gas and electricity businesses

State, Regulator: Regulated Business(es)	Number of networks	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	
Electricity Distribution															
ACT, ICRC: ActewAGL	1							1							
NSW, IPART: Country Energy; Integral Energy; Energy Australia	3						3								
QLD, QCA: Energex; Ergon	2							2							
VIC, ESC: SPAusnet; AGLE; CitiPower; Powercor; United Energy	5								5						
SA, ESCOSA: ETSA Utilities	1							1							
TAS, OTTER: Aurora	1					1									
Gas Distribution															
ACT, ICRC: ActewAGL	1							1							
NSW, IPART: AGL Gas Networks	1							1							
NSW, IPART: Country Energy Gas	1							1							
QLD, QCA: Energex; Envestra	2								2						
VIC, ESC: SPAusnet; Envestra; Multinet Gas	3					3									
SA, ESCOSA: Envestra	1								1						
Electricity Transmission															
NSW, AER: Energy Australia	1						1								
NSW, AER: TransGrid	1						1								
QLD, AER: PowerLink	1				1										
VIC, AER: SPAusnet	1				1										
VIC, AER: VENCORP	1				1										
VIC, AER: Murray Link	1									1					
SA, AER: Electranet	1					1									
TAS, AER: Transend	1						1								
Gas transmission pipelines, State, pipeline (pipeline owner/system operator)															
NSW, Moomba to Sydney Pipeline (APT)	1							1							
NSW, Central West Pipeline (APT)	1								1						
NSW, Dubbo to Tamworth (Central Ranges Pipeline)	1	Access arrangements not yet in place													
QLD, Roma to Brisbane Pipeline (APT)	1				1					1					
QLD, South West Queensland Pipeline (Epic Energy)	1				1					1					
QLD, Queensland Gas Pipeline (Alinta)															
QLD, Carpentaria Gas Pipeline (APT)	1														
VIC, Transmission network (GasNet)	1					1					1				
VIC, Transmission network (VenCorp - system operator)	1					1					1				
SA, Moomba to Adelaide Pipeline (Epic Energy)	1				1										
NT, Armadeus Basin to Darwin Pipeline	1									1					

The table assumes a 12 month review for regulatory determinations (shaded grey) and a five year regulatory period (yellow and blue).

Accordingly, EnergyAustralia is keen to work with the AER to ensure that the necessary information requirements are complete and clearly specified.

The proposed Rule also assumes that the AER will comply with the timelines set out in the Rules and consequently does not provide for the AER not meeting its obligations. There was a significant delay experienced by TransGrid and EnergyAustralia in relation to its current determination, such that a specific derogation was required to ensure the validity of pricing pending the finalisation of the determination and the final determination. In light of this, the Rules should address this possibility and provide for the consequences should the AER not meet its timelines.

3.5.3. Requirement to use PTRM

In general terms, EnergyAustralia supports the concept of the regulator conducting its assessment of the revenue proposal using a defined and published financial model. EnergyAustralia considers that this will improve transparency and consistency of treatment across TNSPs and thus increase regulatory certainty through precedent over time.

However, consistent with its comments in section 3.3 on the requirement for the AER to develop guidelines, EnergyAustralia is concerned that the Rules do not provide for any review or oversight of the AER's development or management of the model.

EnergyAustralia considers that the PTRM financial model is a tool by which the regulator conducts its assessment as to whether the business' proposal complies with the Rules. EnergyAustralia is concerned to ensure that the PTRM:

- accurately and fully reflects the Rule provisions; and
- does not, through the mechanics of the model, overstep the responsibility assigned to the AER under the Rules.

EnergyAustralia is concerned that the Rules, as currently drafted, introduce scope for the AER to make quasi-policy decisions by way of requiring certain inputs to the PTRM, or by the treatment afforded to particular items in the PTRM.

To this end, consistent with its comments in section 3.3 on the requirement for the AER to develop guidelines, EnergyAustralia proposes that the PTRM developed by the AER should be subject to a review to ensure that the structure and mechanical operation of the PTRM accurately implement the policy positions of the MCE and the Rules developed by the AEMC.

Impact on information requirements

Schedule 6.9.3(d) and (e) also require the TNSP to calculate its revenue proposal using the PTRM and to provide to the AER all information necessary to populate the PTRM, along with associated detail and explanation. As discussed above, EnergyAustralia supports the use of a published financial model to be used by the regulator in assessing the revenue proposal. However, EnergyAustralia considers that the inclusion of these clauses in Schedule 6.9 considerably broadens the scope of the information demanded by the regulator.

Consistent with its comments on information gathering, EnergyAustralia is of the view that it is in the TNSP's best interests to provide sufficient information to the regulator to give the regulator confidence in approving its revenue proposal. It is therefore not necessary to include the PTRM inputs and related commentary among the information requirements in Schedule 6.9.

3.6. COST ALLOCATION

Subsection 6.21(b) requires the AER to develop cost allocation guidelines relating to the preparation of a TNSP's cost allocation methodology.

Cost allocation is, by its nature, a process requiring considerable judgement. In this respect, EnergyAustralia considers that the scope of any guidelines on cost allocation must allow for

differences in record keeping processes within the subject businesses. This suggests a cost allocation guideline would need to be relatively flexible in order to have wide relevance and applicability.

This contrasts with the prescriptive and intrusive requirement in clause 6.21(c)(2) for the AER guideline to specify “the detailed information that is to be included in the Cost Allocation Methodology” and the requirement to submit the cost allocation methodology to the AER for its approval. The AER is also to have powers to amend the cost allocation methodology under clause 6.21(g).

Having reviewed a number of regulatory reporting and cost allocation guidelines, EnergyAustralia takes the view that the approach taken in the National Gas Code is, on balance, the most appropriate. In the National Gas Code, the detailed basis of cost allocation is left to the business to decide, “according to a methodology for allocating costs that is consistent with the principles in section 8.1 and is otherwise fair and reasonable”.⁷

EnergyAustralia considers that a straightforward requirement such as this could be written into the Rules, obviating the need for the AER to develop a detailed guideline.

⁷ National Third Party Access Code for Natural Gas Pipeline Systems, clause 4.1(e)

4. REGULATED REVENUE

4.1. PASS THROUGH MECHANISM

EnergyAustralia supports the inclusion of a cost pass through mechanism in the Rules and is generally comfortable with the methodology adopted by the AEMC in its draft Rule proposal. This approach provides greater certainty to business to accommodate unforeseen changes that have the potential to materially affect the cost of providing the regulated service.

4.1.1. Time to prepare and file application

Clauses 6.2.14(c) and (e) provide that an application to pass through a significant cost change must be made within 60 days of the change event.

In EnergyAustralia's recent experience in dealing with a Service Standard Event imposed by a change to the NSW government license conditions, the time required to assess the impact of the Event can be significant. In the current case, EnergyAustralia would not have been able to fully assess and cost the implications of the Service Standard Event within the 60 business day requirement. Indeed, even meeting the 90 "working" day deadline under the IPART regime was a significant challenge given the complexity and extensive nature of the event.

EnergyAustralia proposes that the time frame for filing a pass through application be extended to 90 days under the Rules. In the alternative, the network business should be able to avail itself of a 30 day extension where it notifies the regulator that a change event has occurred, the impacts of which are under detailed investigation by the network business.

4.1.2. Date of change event

EnergyAustralia considers that events directly affecting the network business, such as a Service Standard Event, a Terrorism Event, or a Network (Grid) Support Event, would become known to the network business immediately upon their occurrence.

However, it is possible, under the current definitions, for an Event, particularly an Insurance Event or a Tax Change Event to occur, the effects of which are not known to the network business until some time after the event occurs. In these circumstances, the network business should be able to file a pass through application within 90 business days of the date at which it becomes aware that an Event would affect the network with such significance as to qualify as a Pass Through Event.

4.1.3. Materiality definition

The definition of the materiality hurdle for the Pass Through mechanism is included in the Glossary section of the draft Rules. EnergyAustralia applauds the clarity in the materiality definition that the hurdle applies to the change in costs as opposed to the revenue impact of the event. EnergyAustralia considers that this definition could be improved only by specifying that the materiality threshold applies to the change in capital or operating expenditures.

With this additional phrase, the definition would clearly indicate that any required capital and or operating expenditure exceeding 1% of the Maximum Allowed Revenue would "trigger"

eligibility for a cost pass through. It is an important distinction between the “trigger” (i.e. based on the level of expenditure) and the amount that would actually be passed through (i.e. an adjustment to the allowed revenues for a given year within a regulatory period).

4.1.4. Additional Information gathering powers

It is not clear why the AER would require additional information gathering powers under proposed clause 6.2.14(g) in relation to a negative pass through event. The AER’s powers under section 28 of the NEL and the proposed clause 6.19(d) should be more than sufficient.

4.2. CAPITAL EXPENDITURE

4.2.1. Low level capex incentive mechanism

EnergyAustralia supports the “low-powered” capital expenditure incentive mechanism included in the draft Rules over the contingent projects arrangements and approach to asset roll forward in the ACCC SRP.

In particular, EnergyAustralia supports the change from the SRP in removing the confiscation of the return of capital associated with capital expenditure overspends. This is accomplished through the combination of clauses 6.2.3(c)(4)(i) and (vi). EnergyAustralia has consistently argued that the confiscation of prudently incurred capital expenditure risks deterring necessary capital investment.

4.2.2. Reliance on incentive mechanism

EnergyAustralia considers that there is one critical element absent from the capital expenditure incentive mechanism: scope for the regulator to rely on the incentive mechanism in approving the actual capex spend rather than reliance on an ex-post review.

Subsection 6.2.3(d) enumerates the matters to which the regulator must have regard in rolling forward the capital base under clause 6.2.4(c)(4). However, this section does not appear to give the regulator scope to rely on the incentive mechanism and dispense with the need to undertake an ex-post review of the prudence and efficiency of capital expenditure.

This process was very effective in the context of the ESCV in its 2006 Electricity Distribution Price Review:⁸

“Accordingly, at the last price review, the Commission used the roll forward method to update the distributors’ regulatory asset bases to the start of the 2001-05 regulatory period, and it foreshadowed continuing to adopt this method in the future. It did not identify and remove stranded assets from the asset base and indicated its intention to retain this position in the future.”

⁸ Essential Services Commission Victoria, Electricity Distribution Price Review 2006 *Consultation Paper No. 1: Framework And Approach*, March 2004, pp 29-30.

Lastly, it relied upon the incentive properties of the price cap regime operating over the first regulatory period to support the presumption that actual expenditure by the distributors would be considered to be efficient [emphasis added]. Accordingly, it did not undertake prudence testing of expenditure undertaken. As discussed, it foreshadowed continuing to rely on the incentive properties of the price cap regime to encourage efficient expenditure in the second regulatory period.

Given the proposed approach indicated in the last price review, and the Commission's view that the position it reached on these matters remains appropriate, few issues remain to be resolved to establish the opening regulatory asset base for each of the distributors at 1 January 2006. The approach to this matter proposed by the Commission for the purposes of the 2006 price review is as follows:

- it will update the regulatory asset base by taking the regulatory asset base at the commencement of the previous regulatory period (adjusted for 2000–see below), adding in capital expenditure incurred at cost, deducting depreciation and disposals, and adjusting for inflation*
- it will not undertake a prudence testing of capital expenditure undertaken over this regulatory period, but rather rely on the presumption that the incentive properties of the price cap/efficiency carryover regime has encouraged the revelation of efficient cost*
- it will not seek to identify and then remove stranded or partly stranded assets from the asset base.”*

EnergyAustralia recommends that the Rules, perhaps in subsection 6.2.3(d), require the regulator to rely on the incentive mechanism in the first instance when assessing the efficiency and prudence of capital expenditure. As discussed further in the following section, the TNSP should be released from the need for an ex-post review of the prudence and efficiency of actual capital expenditure, except in exceptional (and tightly defined) circumstances only.

4.2.3. Ex-post review of capital expenditure

The Rule Change Report and the draft Rules appear to be inconsistent in regard to the scope for the regulator to have capacity, or a requirement, to undertake an ex-post review of the prudence and efficiency of capital expenditure.

Notwithstanding the comment on page 86 of the Rule Change Report that “in rolling forward the RAB, the Rules allow, but do not require for the AER to undertake a prudence and efficiency review”, there does not appear to be scope in the Rules for the AER to dispense with an ex-post review.

The draft Rule appears to require the AER to form some view on efficiency or prudence before it can include any capital expenditure in the opening regulated asset base. Clauses 6.2.3(c)(4)(i) and (ii) require the asset base to be increased by all capex, except to the extent that the capex is determined by the AER not to be prudent or efficient in accordance with clause 6.2.3(d). Whilst there is not mention of a review, it is not apparent how the AER could form a view on prudence or efficiency without conducting a review, particularly given the criteria in clause 6.2.3(d).

EnergyAustralia has consistently objected to the ex-post review of the prudence and efficiency of capital expenditure. Once a project has been assessed through the regulator's ex-ante investigation, it is not appropriate to second-guess the results of those investigations in an ex-post review. EnergyAustralia is not uncomfortable with the regulator undertaking limited analysis to satisfy itself that a project has been efficiently constructed; however it would not be reasonable for such a review to re-visit the need assessment or options testing phases of the project planning.

EnergyAustralia considers that the Rules could be improved by placing clear limits on the scope for the AER to conduct ex-post reviews of the prudence and efficiency of capital expenditure in exceptional circumstances only.

It is noteworthy that at the AEMC's public hearing on the draft Rule proposal, the AER appeared to comment that it does not support scope for an ex-post review of the prudence and efficiency of capital expenditure.⁹

In EnergyAustralia's view, provisions which have no support from either the affected businesses nor the relevant regulator should reasonably be removed from the Rules.

4.2.4. Contingent projects

On balance, EnergyAustralia supports the removal of the concept of "contingent projects" from the capital expenditure incentive mechanism in favour of the capex reopener mechanism as proposed by the AEMC. As indicated later in this section, EnergyAustralia does have some concerns over the threshold recommended by the AEMC for a reopener to be "triggered".

4.2.5. Capital expenditure reopener processes

EnergyAustralia supports the concept of an ability to "reopen" the regulatory determination to allow for significant variation in the levels of capital expenditure. However, EnergyAustralia seeks some additional clarity in the Rules regarding the circumstances in which such a reopener may be triggered.

EnergyAustralia generally supports the reopener approach in the draft Rule proposal that seeks to address the concern that under the current Rules that *"...a TNSP may have an incentive to delay required expenditure in excess of that forecast for the regulatory period, since expenditure in excess of forecast levels will result in the TNSP incurring a penalty"*. However, the current wording in section 6.2.12 is too restrictive as it appears to indicate that the reopener provisions apply only to single projects with a cost greater than 5% of the RAB and that have been subject to the Regulatory Test.

In EnergyAustralia's recent experience, it incurred significant capital expenditure to reinforce its network in the face of unprecedented increases in peak demand. While no one project may have qualified for the reopener provisions, the sum of those projects, all undertaken in response to the same external event, would certainly have qualified.

⁹ See commentary by a senior AER staff member in AEMC public hearing transcript p 54.

A more appropriate approach would be for clause 6.2.12 to apply to one or a number of projects “the total of which represents” the threshold to qualify for the reopener provisions [6.2.12(a)(3)].

It is also not obvious why the measure adopted by the AEMC to “trigger” the reopener (i.e. X% of RAB) should be different from the measure adopted by the AEMC for the materiality threshold for a Pass Through Event. The definition for the latter measure, as provided in the glossary to the draft Rule (page 80), reads as follows:

Materially

For the purposes of the application of clause 6.2.14, an event (other than a *Network (Grid) Support Event*) results in a *Transmission Network Service Provider* incurring **Materially** higher or **Materially** lower costs if the change in costs (as opposed to the revenue impact) that the *Transmission Network Service Provider* has incurred and is likely to incur in any *regulatory year* of the *regulatory control period*, as a result of that event, exceeds 1% of the *maximum allowed revenue* for the *Transmission Network Service Provider* for that *regulatory year*.

Subject to comments in section 4.1.3 of this submission (relating to suggested wording changes to the definition to better reflect what we believe to be the intent), EnergyAustralia suggests that there is no compelling reason why the materially threshold measure for a capital expenditure reopener should be different to the measure to apply to a Pass Through Event.

In addition, the threshold of “5% of RAB” is an excessive hurdle. For EnergyAustralia’s relatively small transmission network, the AEMC’s proposed “trigger” mechanism would require a “project” that is approximately the same value as the *total average capital expenditure* amount allowed by the ACCC for funded projects in the current determination. If AEMC’s proposed reopener “trigger” was applied to larger networks, such as EnergyAustralia’s distribution business, a single project would need to have a value of over \$200m to qualify. We believe this to be excessive.

EnergyAustralia therefore suggests that:

- a more appropriate approach would be for clause 6.2.12 to apply to one or a number of projects “the total of which represents” the threshold to qualify for the reopener provisions [6.2.12(a)(3)];and
- the materiality “threshold” should be consistent with the proposed definition in the draft Rule for “materially” (as is intended to apply to Pass Through Events) whereby: “... *the change in costs (as opposed to the revenue impact) ... in any regulatory year ... exceeds 1% of the maximum allowed revenue ... for that regulatory year*”.

[Impact on capital expenditure efficiency incentive mechanism](#)

EnergyAustralia is concerned that the wording of clause 6.2.12(d) (and comments raised at the AEMC hearing on the proposed Rule¹⁰), imply that the reopener provisions only apply in cases

¹⁰ See Australian Energy Marketing (sic) Commission Public Hearing Rule Proposal Draft - National Electricity Amendment (Economic Regulation Of Transmission Services) Rule 2006 Transcript Of Proceedings At Melbourne On Wednesday, 8 March 2006, AT 9.09 AM AEMC 8.3.06 P-1 pages 13 and 47.

where the incurrence of the non-forecast capital expenditure will cause the total capital expenditure to exceed the amount allowed *in the revenue proposal* by more than 5% of the RAB.

That is, the unforecast capital expenditure must exceed the sum of 5% of the opening RAB and the total amount of capital expenditure efficiencies the TNSP has been able to achieve.

EnergyAustralia considers that this amounts to a confiscation of the capital expenditure efficiency gains made by the business. Furthermore, such an approach could serve to seriously undermine the incentives to pursue capital expenditure efficiencies in the first place, and *a priori* would penalise those TNSP's that have achieved efficiencies compared with those TNSP's that haven't if a reopener was sought.

To preserve the integrity and effectiveness of the capital expenditure incentive mechanism, EnergyAustralia recommends that clause 6.2.12(d) be removed from the proposed Rule.

4.2.6. Commercial stranding

EnergyAustralia has two concerns with the proposals relating to commercial stranding

The first is that the Rule report (page 16) appears to suggest that the responsibility to initiate discussions to offer a discount to customers who might take action that would strand an asset rests on the shoulders of the TNSP. The draft Rule clause 6.2.3(e) is not clear on this matter.

EnergyAustralia is concerned that there is already in place a framework for negotiating discounted tariffs in section 6.5.8 and 6.5.9 of the Rules, and the associated AER Guidelines for the Negotiation of Discounted Transmission Charges. In the absence of a clear policy decision that the TNSP should be actively offering discounts to large transmission customers (the revenue shortfall from which would be recovered from other customers), EnergyAustralia recommends that a phrase along the lines of "in response to an approach by the relevant transmission network user" be inserted in clauses 6.2.3(e)(3)(i) and (ii).

The second concern is that it is not clear if the subject assets change classification from prescribed to negotiated, or from prescribed to non-regulated. Clause 6.2.3(e) of the Rules only addresses removing them from the RAB. However, clause 6.21(a)(7) provides that "costs which have been allocated to prescribed transmission services must not be reallocated to negotiated transmission services". This would suggest that commercially stranded assets become non-regulated. However, there do not appear to be any obvious provisions to bring the assets back into the prescribed category if, at a later date, they are used to provide shared network services.

The National Gas Code addresses this matter by classifying such assets as "speculative investment" in sections 8.18 and 8.19. Under these provisions, investment which is not required to provide the reference service is excised from the RAB for tariff setting purposes. However, the value of this investment is incremented by a cost of capital, pending the time it is re-entered into the RAB under that section.

It may be possible that clause 6.2.3(c)(4)(ix)(B) (page 18 of the draft rule) may be able to be utilised to bring stranded assets back into the RAB. However, this is not clear as it only refers to capex and not the value of assets. EnergyAustralia recommends that the draft Rule be amended, in a manner consistent with the National Gas Code, to clearly allow for assets which

have been previously subject to commercial stranding to be re-admitted to the RAB should they subsequently be used to provide shared transmission services.

4.3. SAVING AND TRANSITIONAL

EnergyAustralia notes and supports the provisions intended to save its current pricing determination. The Commission has indicated in its Rule Proposal Report that the re-opener provisions will apply to existing determinations. EnergyAustralia supports this approach in principle, however the issue also arises as to whether other aspects of the new Rules should apply to the existing determination. Given that some important aspects of the draft rules, such as the distinction between Prescribed and Negotiated services, are still being developed, EnergyAustralia is not in a position to make an informed submission on the full extent of the savings and transitional provisions. Given the policy issues involved and the technical nature of the provisions required, EnergyAustralia requests an opportunity to discuss the nature and effect of the savings and transitional provisions with the Commission once the Rules have been further developed.

The Commission particularly sought EnergyAustralia's views on the drafting of the relevant savings and transitional provisions included in the draft Rule. EnergyAustralia has reviewed clause 11.1(4) and is concerned that this clause may not operate to the extent intended by the Commission. Whilst the clause effectively saves the existing determination through the provisions in clause 9.16.5 of Chapter 9 of Rules (incorrectly referenced in the Report as 9.6.15), it would appear that the determination must continue to operate under the Rules as they applied prior to 1 January 2007. This does not provide for the re-opener provisions, or any of the new provisions under the proposed Rules to apply to the determination. As indicated above EnergyAustralia would be keen to discuss the details of the necessary provisions with the Commission as soon as possible.

5. INCENTIVE MECHANISMS

5.1. OPERATING COST EFFICIENCY CARRYOVER MECHANISM

EnergyAustralia notes that one of the key features of the CPI-X regulatory mechanism is the in-built incentive to reduce operating costs and improve efficiency. Over time, regulatory experts and academics have reviewed this model and (correctly) identified that the amount of the incentive to undertake operating cost reductions diminishes as the regulatory period progresses.

In some regulatory determinations, for example the ESCV's determinations on the Victorian electricity distribution businesses, a carryover model is used to ensure that operating cost reductions taken at any point of the regulatory period earn the same level of incentive reward. Clause 6.2.8(a)(3) of the draft Rules requires the efficiency benefit sharing scheme developed by the AER to include a similar mechanism.

EnergyAustralia applauds the desire of the Commission to ensure that it is appropriately rewarded for undertaking cost saving measures, regardless of the time in the regulatory period in which they are undertaken. However, considering the nature and level of transmission operating expenditure, EnergyAustralia questions whether the benefit of this mechanism justifies the additional administrative and reporting costs associated with it.

In EnergyAustralia's case in particular, the relative level of operating expenditure, and the related scope for operating cost savings, does not warrant the high complexity incentive mechanism.

Importantly, EnergyAustralia submits that any incentive mechanism implemented should not restrict the business's ability to maintain its network (and deliver customer outcomes) by reducing funding in future periods if costs have increased. To ensure that TNSPs are able to maintain service to customers, EnergyAustralia recommends that a key feature of a fair and effective incentive mechanism is a "no negative carryover" mechanism as was originally adopted by the ESCV in its consideration of this matter.

5.2. STANDARDS OF SERVICE

EnergyAustralia has consistently expressed caution on economic regulators implementing incentives to address technical service standards. We are concerned over the scope for the incentives established by an economic regulator (in the form of a monetary benefit / penalty of up to 1 percent of the MAR) to duplicate, "second guess" and or potentially negate the policy intent of a jurisdiction in its setting of the technical standard.

In EnergyAustralia's case, the reliability planning and service standard requirements introduced by the NSW Minister for Energy in August 2005 apply equally to those assets which have been classified as transmission assets under the Rules.

EnergyAustralia therefore recommends caution in imposing a service standards incentive mechanism where there is a comprehensive service standards regime already in place in a jurisdiction.

In such cases, EnergyAustralia believes the role of the economic regulator should be limited to the requirement under the NEL for the economic regulator to recognise the costs of meeting the standards in any pricing / revenue determination.

