14 September 2006

Dr J. Tamblyn
Chairman, Australian Energy Market Commission
Level 16
1 Margaret Street
Sydney NSW 2000

By email – submissions@aemc.gov.au

Dear John

ETSA Utilities' Comments on the AEMC Review of the Electricity Transmission Revenue and Pricing Rules – Draft Rule Report (26 July 2006)

ETSA Utilities wishes to provide the following comments on the Draft Transmission Revenue Rule Report. Please contact James Bennett (ph 08 8404 5261) if you wish to discuss our submission. ETSA Utilities appreciates many of the amendments made by the AEMC on this topic since the Draft Rule Proposal report was issued in February 2006. Our comments below have generally been referred to the Determination reference rather than the Rule Clause.

3.4 Interface Works between TNSP's and DNSP's. The connection interface between TNSP's and DNSP's and the possible choice of transmission and distribution solutions for a given problem is a challenge for transmission (and distribution) revenue setting.

For a given project, there can be a transmission solution at capex representing nearly 10% of a TNSP's RAB (for transmission line and transmission exit work) with only minor distribution expenditure whilst a distribution solution might require perhaps capex representing 2% of a TNSP's RAB but with major distribution expenditure. Such situations are ideal candidates for the conditional projects list, however the alternate distribution solution has a level of capex below the proposed TNSP contingent project threshold. A mirrored approach would also be suitable for DNSP revenues.

Problems can also occur in rural situations where a single customer (not necessarily large) that would be properly connected to a distribution system will require an unexpected (and unable to be predicted) augmentation of the transmission exit with the distributor. This is not necessarily a situation where a single customer dominates a rural connection point. Because TNSP to DNSP connections are to be deemed prescribed (a position ETSA Utilities argued for), the flexibility of revenue from variable levels of work available under negotiated services is lost. The possible treatment of these situations needs to be clear. Will such works be prescribed service (and so at the risk of the TNSP) or can they be considered negotiated service (and so incremental in revenue to the TNSP)? ETSA Utilities does not have a clear opinion at this time, apart from recognising that an issue arises here. It may be that the simplest solution is allowing a small amount of capex in the prescribed expenditures for such unknown customer/DB initiated connection augmentations.

5.1 Codification of Expenditure Forecasts. ETSA Utilities notes the AEMC's efforts to utilise an efficient propose-respond arrangement for transmission revenue proposals. However, some of the discretion allowed to the AER under the proposal and the supporting argument for that position appear likely to result in unnecessary regulatory uncertainty.

ETSA Utilities notes that the AEMC recognises that in many areas of regulation the task is to make a 'reasonable' decision and not the 'best' decision as there may well be no 'correct answer' This leads directly to the desire for the TNSP to submit a 'reasonable' estimate of expenditures, arguably with the AER providing an incentive that rewards such submissions as compared to ambit claim forecasts which would then be replaced by the AER's own forecasts. However, the AER is likely to have a dozen competing factors to consider when reviewing the reasonableness of expenditure forecasts, with the failure on any one of these points could (arguably) allowing the AER to replace the entire forecast with the AER's own forecast. It is likely to be impossible for a TNSP to submit a commercial expenditure forecast and comply with all of these points, so some judgement will have to be exercised by the TNSP on the relevant importance. Once submitted, the AEMC considers that the AER should be allowed to retain discretion to consider each of the factors and to make its decision on the basis according to its view of the relevance of each factor in each particular case. Rigidity in regulatory approach is not valued by the AEMC on this point, nor is the disclosure of the AER's views required prior to the TNSP's revenue proposal submission.

This is in contrast to an earlier point within section 4.4.4 (discretion on decision making framework) where the AEMC considered that the reasonable estimate basis for the determination of capital and operating expenditure forecasts is an example of the Rules providing appropriate decision making discretion to the regulator (given the inherent uncertainty of such forecasts) with specific guidance on how that discretion is to be exercised. ETSA Utilities is unclear on the specific guidance that is provided by listing a dozen competing factors that need to be considered. ETSA Utilities would prefer to see the factors reduced, perhaps using the Gas Code as a guide for the level of prescription.

5.3.3 Propose-Respond Model. ETSA Utilities agrees that the propose/respond model outlined by the AEMC is a step in the right direction for network revenue regulation. The shortened timeframe and the focus of the Regulatory Reset on the network provider's submission rather than another review of the regulatory framework is a sensible outcome.

We expect to make further submissions on this matter for Distribution, to ensure that the issues faced by distributors in different jurisdictions with different cost and performance issues can be effectively accommodated within such a propose/respond model whilst retaining the significant reduction in the time required to conduct a Price Review.

6.2.3 Pricing of Negotiated Services. ETSA Utilities notes the intent of the AEMC to separate contestable activities away from regulation and not to require a TNSP to provide any service apart from prescribed services. ETSA Utilities interprets the Negotiated Service to be a form of half-way house between obligatory prescribed service and voluntary market-priced service.

The AEMC commented on the desirability of negotiated services (whose pricing is proposed to be cost-based, not market-based) to have arrangements whereby customers would receive a discount from that cost-based price in the event that other customers subsequently utilised the assets involved. The AEMC proposals have been silent on the symmetrical outcome, ie should such prices also increase if/when a second party using a negotiated service ceases to use this service. Should the remaining party face a price increase (perhaps back to an original pricing level), should other customers pay or should the TNSP face a loss? This is the difficulty of a non-mandatory service where cost-based pricing is required. If ETSA Utilities has interpreted this area correctly, it needs careful review to ensure TNSP's have the appropriate incentives to compete for such work.

6.7 Contingent Projects. ETSA Utilities appreciates the inclusion of conditional projects into the draft Rule determination but questions the requirement that such expenditure needs to exceed 5% of the TNSP's Regulatory Asset Base (RAB). This appears to be a high hurdle for expenditure which is likely to occur in several different but unpredictable areas. If the hurdle is set too high, then TNSP's will be unable to use the conditional project list and instead will need to consider the probability of such projects when preparing the capital expenditure estimates. Some participants (customers) may find such an approach to be a 'padding' of a reasonable expenditure request when it is really the outcome that a high value conditional project threshold encourages.

ETSA Utilities expects that the conditional project arrangement could be useful for two situations. The first is the expansion of a major transmission corridor. This could be related to interconnector capacity, or to regional development of load or generation. The second is the provision of additional capacity to the local distributor which could be enabled by a high cost transmission/low cost distribution solution, or alternatively a low cost transmission/high cost distribution solution. These two options could be included as competing contingent projects. ETSA Utilities commented on this matter above in our comments on the TNSP/DNSP interface.

ETSA Utilities encourages the AEMC to review the threshold expenditure for a contingent project. Such a threshold as 5% of RAB would also require a downward revision if the mechanism is proposed for distribution revenue.

6.8 Reopener provisions. ETSA Utilities notes the AEMC's desire to ensure their forecasts are as accurate as possible. Such a reopener is necessary to balance the incentive for a TNSP to defer major vital investment where it would result in the TNSP exceeding its capital expenditure. The AEMC provided five preconditions to allowing a project to be a reopener., ie an unforseen event, which is necessary if reliability/system security is not to be compromised, exceeding an expenditure threshold, which is not a contingent project and which cannot be funded from savings.

If the project could not have been foreseen and it requires to be undertaken to ensure reliability or system security, then ETSA Utilities believes that the TNSP should not be required to give up any capital efficiencies generated on the balance of works to have such a significant and important project included in their revenues. It is a complete distortion of the incentive arrangements if efficiency gains can be negated by an unexpected chance outcome. Requiring the TNSP to give up any capital efficiencies will result in an incentive for the TNSP to defer such a project until the next period, which is not in customers' interests.

Our comments above on the need for the AEMC to review the contingent projects expenditure threshold also applies to the reopener provisions. 5% of RAB is too high a threshold for most TNSP's, and is an inappropriate measure for a small asset base TNSP. TransGrid would require projects exceeding $150M for inclusion as contingent projects/reopeners whilst Directlink/Murraylink would have projects exceeding $5M as eligible. A more critical measure would be the amount of revenue that will not be recovered as a result of the unexpected expenditure, perhaps referenced as a % of annual revenue. Any unexpected proposals required in the early stages of a regulatory period are more critical.

ETSA Utilities has had distribution projects related to transmission connection point upgrades listed as pass-through events in our current Price Determination. These projects might incur costs of perhaps $25M which is 1% of our RAB. The revenue requirements will be nearly $3M per annum when implemented perhaps in the middle of this Reset (compared to forecast annual revenue of $450M).

7.1.1 Weighted Average Cost of Capital – Real Post-Tax. The Draft Transmission Rule requires the use of real post-tax returns.

If the use of post-tax real WACC is also mandated to flow through to distribution, ETSA Utilities will have a transition issue as we currently operate on a pre-tax real WACC regime. We would like to comment on the details of how such transitions from one regime to the other will be treated, if and when such information becomes available. It may be that both a pre-tax and post-tax model will be permitted for distribution.

7.3.2.3 TNSP to propose X-factors. The Draft Rule proposes that the TNSP can set the X factor, but also requires the double anchoring of the revenues (year one and five). This arrangement provides limited opportunity for 'proposals' by TNSP's. X factors generally indicate a likely level of price reduction, but not for revenue caps. Transmission prices are more significantly affected by the change in level of settlement residue auction proceeds which can be quite volatile from year to year, which further reduces the benefit of any X factor.

Given the combination of the revenue cap and the auction proceeds volatility, it seems that the concept of an X factor for transmission revenue is largely redundant. ETSA Utilities suggests a simpler approach is to incorporate 5 separate revenue amounts in any revenue determination. The limited flexibility offered to TNSP's in the draft determination would be retained, whilst such an approach would simplify the Rules for allowing any conditional projects that are subsequently triggered to be added to revenue caps.

ETSA Utilities will comment on the volatility and transparency of transmission customer prices (net of settlements residue proceeds) in our response to the Draft Transmission Pricing Rule.

8.4.2 Timetable for the Review Process. ETSA Utilities values the shortened review process timetable commencing 13 months before Reset and concluding 2 months before reset, which reflects the benefits of the propose-respond model and the key stage dates nominated by the AEMC. ETSA Utilities also noted the incentive scheme arrangements to apply (to expenditures and performance in the next Reset Period) will have been announced by the AER at least 15 months before Reset (ie two months before the lodgement of the revenue proposal). This example of regulatory certainty is valued by network service providers.

7.1.3 Performance Incentives Arrangements. ETSA Utilities experience with performance incentive schemes have been with schemes limited to +/-1% of revenue. We also have a related GSL payment scheme with an exposure of possibly 0.5% of revenue (higher in a severe weather year). These arrangements have been a strong incentive for a distribution company, and the method of performance criteria has been closely worked with the Regulator to endeavour to eliminate as much as possible random weather events from the performance.

The AEMC proposal for a +/-5% performance incentive arrangement would be a very strong incentive scheme. It could be a greater incentive than the expenditure efficiency incentives. It may be difficult to find measures that have minimal random weather content and maximum management responsibility that reflect a price that Customers are prepared to pay. The impact of the performance incentive arrangements will depend on how much of the +/-5% range is likely to be utilised which depends on what measures and prices are used.

ETSA Utilities considers that +/-5% of revenue is too strong a performance incentive arrangement for a network service provider, and that care should be taken in the selection of any performance measure to minimise the effect of random weather. These factors are required to ensure the reliability of revenue for an otherwise revenue-capped business whose options to balance cash-flow are limited to expenditure reductions.

9.3.3 Transitional Issues - Easements. ETSA Utilities notes the intention by the AEMC for the AER to review the correct valuation of ElectraNet's easements at their next reset. ETSA Utilities has similar arrangements with the easements valuation. We propose to discuss this matter with the AEMC (and the AER) when the Distribution Revenue Proposal Transitional Issues are discussed.

Eric Lindner
A/CHIEF EXECUTIVE OFFICER