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Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box H166
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Email: submissions@aemc.gov.au

Dear Dr Tamblyn

DRAFT NATIONAL ELECTRICITY AMENDMENT (ECONOMIC REGULATION OF TRANSMISSION SERVICES) RULE 2006

Thank you for providing the opportunity to comment on the Australian Energy Market Commission's (AEMC) *Draft National Electricity Amendment (Economic Regulation) of Transmission Services) Rule 2006 (Draft Rule)*. CitiPower and Powercor are Victorian electricity distributors who are customers of transmission network service providers (TNSPs), hence will be directly affected by the outcomes arising from this review.

CitiPower and Powercor generally support the approach being adopted by the AEMC as being appropriate for the transmission sector. The approach taken to implementing a propose-respond model which makes use of 'reasonable estimates' whilst providing greater certainty on cost of capital issue is a positive movement towards a best practice regulatory approach. However, some further improvements are possible and these are outlined in this submission.

RAB roll forward (clause 6A.2.1 and s.6A.2.2)

CitiPower and Powercor support the AEMC's decision to remove the option for the AER to conduct ex post reviews of the prudence of capital expenditure before it is rolled into the regulatory asset base. Clarity on the basis on which the RAB will be rolled forward will provide a more certain basis for long term investment in the sector.

Return on capital and rate of return (clause 6A.6.2)

CitiPower and Powercor support the investment certainty provided by the AEMC codifying cost of capital parameters in the National Electricity Rules (NER) for a period of five years.

Beyond the first five year period however consideration should be given to examining differences in particular risk characteristics faced by both gas and electricity and between transmission and distribution. This may include amongst other things, differences in risk associated with revenue versus price caps.

Expenditure forecasts (clause 6A.6.6 and 6A.6.7)

CitiPower and Powercor support the AEMC's conclusion (consistent with decisions of the Australian Competition Tribunal) that the focus in economic regulation must be for making a 'reasonable' decision and not the 'best' decision. It follows that CitiPower and Powercor agree with the requirement in clause 6A.6.6(b) that the AER must accept any reasonable estimate of the TNSP's required operating expenditure for the regulatory period and the similar requirement in relation to capital expenditure under clause 6A.6.7.

CitiPower and Powercor however continue to believe that the range and number of factors that the AER is required to take into account in determining whether a TNSP's estimates are reasonable in the absence of any associated weighting, has the potential to increase regulatory uncertainty.

The Ministerial Council for Energy Expert Panel has observed that rules requiring the regulator to resolve a range of conflicting factors are likely to create, not resolve, uncertainty. Clear guidance to regulatory decision-making should outline factors which the community considers should be attributed special weight in regulatory judgements, not merely provide a list of competing objectives.

The absence of guidance of relative weightings for each factor places a considerable amount of discretion in the hands of the regulator. Arguably the regulator and regulated business will be able to reach totally different conclusions in relation to a specific expenditure item using the same set of criteria. Such an outcome is highly unsatisfactory as the regulator will be able to justify its position regardless of the merits of the arguments advanced by the regulated business and secondly, it introduces considerable uncertainty in the expenditure decision making process.

It is noted the AEMC's approach to this issue is also appears inconsistent with the Ministerial Council on Energy's agreement to remove similar guiding lists of factors under the *National Gas Code* which it is noted, was also a recommendation of the Productivity Commission *Review of the Gas Access Regime* and endorsed by the MCE Expert Panel. Consequently, what appears to be emerging is a diverging approach being applied by the AEMC and the MCE across gas and electricity sectors in this most fundamental issue regarding the appropriate role for regulatory guidance under the Rules. Further, there does not appear to be a clear policy reason for a differentiated approach.

Clauses 6A.6.6(b)(2)(iv) and 6A.6.7(b)(3)(iv) enables the AER to consider analysis undertaken by, or for, the AER that is provided prior to or as part of a Final Decision. CitiPower and Powercor raised this matter as part of its comments on the Proposed Rule. Enabling the AER to produce consultant reports as part of a Final Decision and rely on those reports in its Final Decision provides the TNSP with no opportunity to respond to the analysis. Such a situation is contrary to the requirements of natural justice and provides the TNSP with no avenue to contest the analysis other than through an appeal process. It is recognised the AER will be required to conduct further analysis between the Draft and Final Decisions. This analysis however needs

to be made transparently available prior to the Final Decision to allow relevant stakeholders the opportunity to comment prior to the finalisation of the review process.

Efficiency benefit sharing scheme (clause 6A.6.5)

Clause 6A.6.5 continues to permit the AER to amend the efficiency benefit sharing scheme from time to time provided notice is given to the TNSP 15 months prior to the amendment coming into operation.

A change in the efficiency benefit sharing scheme can have a profound effect on commercial outcomes. Over a given regulatory period the TNSP will take actions in accordance with the incentives provided to it under a given efficiency benefit sharing scheme. Should, for example, the AER decide to increase the sharing ratio under an existing scheme, a TNSP who realised greater efficiencies would be disadvantaged compared to a TNSP who may not have pursued efficiencies as vigorously.

TNSPs need to be provided with certainty in relation to the efficiency benefit sharing scheme. Changing the scheme with potentially only 15 months notice (per clause 6A.6.5(f)) will tend to 'blunt' the incentives provided to TNSPs reducing the effectiveness of any efficiency benefit sharing scheme. Consequently CitiPower and Powercor believe the AER should be required to give notice of any proposed changes to an efficiency benefits sharing scheme a regulatory period in advance i.e. 5 years notice of any such changes. This will provide all stakeholders with greater certainty and ensure the incentives provided under the scheme operate as intended.

Gamma (clause 6.2.9)

CitiPower and Powercor presented the AEMC and the Essential Services Commission (ESC) with similar packages of information supporting the position that the value of gamma should be set to zero on the basis that market practice should set the benchmark for the value of gamma and market practice is overwhelmingly to apply a gamma of zero. However, the Draft Rule continues to set gamma 0.5.

The basis of the AEMC's decision was that the ESC had already considered CitiPower and Powercor's submission and determined that there was inadequate evidence to support changing the value of gamma from 0.5. The basis of the ESC's decision was that there is a substantial degree of imprecision on the value of gamma and therefore it is appropriate to place substantial weight on previous decisions.

The value of gamma can have a very material impact on the incentive to invest. However, both the AEMC and the ESC have recognised that gamma might not have received sufficient attention.

'the Commission recognises that the value of γ has been subject to less extensive consultation than have the WACC parameters in recent years.' (AEMC Draft Rule Proposal Report, February 2006, p70)

'However, the Commission does not consider that the current regulatory treatment of the value of franking credits necessarily can be considered the most appropriate. The identity referred to as gamma is not well defined in theory and probably more poorly estimated, and it is concerned that making explicit adjustments for the value of imputation credits may no longer reflect standard practice amongst finance practitioners, as the Commission accepted when it first considered the matter in 1998.' (ESC Electricity Distribution Price Review 2006-10 Draft Decision, 22 June 2005, p333)

Previous regulatory decisions have relied on the research of Hathaway and Officer published in 1996¹ in setting the value of gamma to 0.5. Therefore despite the material impact of gamma, and the recognition that gamma has not received an appropriate level of attention, the AEMC is relying on research published in 1996 to lock in a value of gamma of 0.5 for decisions up to 2011. The value of gamma is too important to set based on dated research. The AEMC should set the value of gamma on the basis of a robust assessment of the available market evidence and practice.

Service target performance incentive scheme (clause 6A.7.4)

The Draft Rule continues to provide the AER with considerable discretion in developing a service target performance incentive scheme (**scheme**). The Draft Rule has however also upgraded the power of the scheme such that it now constitutes rewards and penalties capped at +/-5 per cent. The upgrading of the power of the scheme makes it all the more important further guidance is provided as to how a scheme may operate, particularly in relation to the values assigned to individual performance parameters.

Clause 6A.7.4(f) allows the AER to amend the scheme from time to time provided it gives 15 months notice prior to the commencement of the next regulatory period. TNSP will invest in the network based on the incentives provided under the scheme. These investments are typically long lived hence sufficient certainty must exist that the benefits of that investment will be realised under a scheme. Granting the AER the ability to change the scheme with a relatively short 15 month notice period has the potential to strand investments made by the TNSP as the benefits through the scheme that may have contributed to the project being economic, could be taken away. Clause 6A.7.4(f) should therefore be amended to require the AER to give notice of any changes a regulatory period in advance i.e. 5 years.

Cost pass throughs (clause 6A.7.3)

CitiPower and Powercor note the AEMC has reviewed its submission on the Proposed Rule (p. 86-87 of Draft Rule Determination), but notes the AEMC has not provided any reasons as to why they have declined to adopt these submissions. CitiPower and Powercor continue to believe that TNSP should not be penalised for matters that relate to 'safety and technical standards' and 'legislative or regulatory' events and therefore these should be included in the definition of 'pass through event' in the Draft Rule.

If the AEMC considers the 'service standard' event is intended to cover such eventualities, the definition should be amended to make it explicit that matters related to technical specifications, safety and other regulatory induced work practices are included and not just events related to changes in reliability standards.

CitiPower and Powercor have also highlighted concern with the negative pass through process under clause 6A.7.3(g) in its submission to the Proposed Rule. A provision that allows the AER to both initiate and adjudicate a negative pass through application can not be considered a fair process given the AER must have already predetermined a negative pass through event has occurred by initiating the process under clause 6A.7.3(g). Providing the AER the dual role of initiator and adjudicator does not accord with the principles of good governance and further consideration should be given to the separation of these roles.

¹ Hathaway N and Officer R (1996). *The value of imputation credits*. Working paper, Melbourne Business School.

Clause 6A.7.3(j)(3) also continues to envisage a retrospective review of a TNSP's actions to mitigate the impact of a positive pass through event. Such a provision is unnecessary as the actions of the TNSP will be 'sunk' by the time a positive pass through event is identified hence denying recovery will not change a TNSP's behaviour and secondly, denial of recovery could potential threaten the financial viability of the TNSP. Consequently clause 6A.7.3(j)(3) should be deleted.

Propose respond procedures (Part E)

CitiPower and Powercor support the adoption of propose-respond elements in the Draft Rule that allows the TNSP to propose their expenditure programs, depreciation, X factors and inputs values into incentive schemes.

The businesses also support the codification of the 'propose-respond' process that requires the AER to assess whether elements of a revenue proposal are compliant with the relevant rules, and amend areas only where an inconsistency is established. A requirement to provide reasons and specify the changes required to bring a proposal into compliance with the rules is an effective discipline to ensuring price review processes focus on key matters in contention, and utilise, to the extent possible, the direct commercial experience of the TNSP in relation to matters outside of the regulators expertise. A 13 month cap on the entire regulatory process is also supported.

CitiPower and Powercor do however have some concerns that the submission guideline provided for under clause 6A.10.2 could evolve into a prescriptive document that undermines the operation and benefits of the propose-respond process through predefining elements of the revenue proposal.

There is also the potential, given the wide ranging powers available to the AER, that the cost of regulation will increase through the request for excessive amounts of information through the submission guideline. Compiling information is not inexpensive. Considerable resources are expended within regulated businesses managing and collating information requested by regulators. In many instances, the information sought is not readily available or not used for internal purposes within a regulated business. It is also often unclear what the intended purpose for the information being sought is.

Clause 6A.10.2 should therefore be amended to include consideration of the costs of providing the information in the form requested, and require only such information as would be reasonably required to understand how the elements of the proposal were derived and form an opinion as to compliance with the rules.

Should you have any further questions in relation to this submission, please do not hesitate to contact Brent Cleeve on (03) 9683 4465.

Yours sincerely

[signed]

Richard Gross
GENERAL MANAGER REGULATION