



20 October 2006

Dr John Tamblyn
Chairman
Australian Energy Market Commission
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Dear Dr Tamblyn

**Response to AEMC Draft Rule Change Proposals
Electricity Transmission Revenue Requirements**

This submission is a response to the legal advice from the Australian Government Solicitor on relevant questions and whether the Rules should provide that:

- a. *a TNSP's proposal must be accepted if the AER is satisfied that the proposal for forecast expenditure satisfies the criteria in the Rules;*
or
- b. *the AER should have a residual discretion to substitute its own reasonable estimate of forecast expenditure in those circumstances.*

The legal opinion justifies the position that the EUAA has made to the AEMC in respect of these important issues. It is with great concern that the AEMC has chosen to ignore not only the comments and suggestions made by the EUAA, and the EAG but the findings of the Expert Panel on Energy Access Pricing and a clear decision by the Ministerial Council on Energy to reject the *propose/respond* model in favour of a *fit for purpose* model. The intransigence of the Commission in respect of the proposed Rule changes is compounded by the fact that the Commission has failed to provide evidence to substantiate its position, often asserting that what it is proposing is in the interests of end users when key end users are saying it is not.

The draft rule proposal along with the Rules Proposal Report fails to substantiate the case as to:

- why the proposed Rule changes were necessary;
- how they will act to improve existing regulatory practice or impact on end-users; and
- how the Rule changes would facilitate achievement of the Single Market Objective (SMO) specified in section 7 of the National Electricity Law (NEL).

It also:

- fails to provide the AER with the flexibility that it requires to determine whether what is being proposed is the most efficient means of achieving the required infrastructure needs, access to network owners and related party transactions;
- fails to provide an explanation as to why the network owners need to have major reopening provisions in the draft Rule changes after the release of the draft determination and if they do, why these rights are not also extended to end users.

In short, the legal opinion has made it clear that what is being proposed by the AEMC is a *propose response* model. A propose-respond model, as identified by the Expert Panel, “*would lead to a systematic increase in the returns to regulated entities relative to the consider-decide model*”¹ This opportunity for systematic increase is compounded by the reasonable estimate criteria, which would allow TNSP’s to choose from a range of estimates. How can this meet the SMO? As noted in the legal opinion “*where the AER accepted a total, and users considered that it was an overly generous figure, the proposed Rule would make it quite difficult for users to establish that this acceptance should be set aside in merits review*”.² This difficulty is compounded of course by the asymmetry in knowledge that already exists to the benefit of TNSP’s.

Again we urge the AEMC to explain how the proposed Rule change meets the Single Market Objective

Reasonable Estimates Test

The AEMC’s ‘reasonable estimate’ proposal is a significant and important departure from the current requirements in the Rules that require the AER to assess whether proposals meet the criterion of “*efficient investment given efficient operating and maintenance practices*.”³ The proposal also represents a substantial departure from requirements specified in the Gas Code, for which the “*overarching requirement is that when Reference Tariffs are determined and reviewed, they should be based on the efficient cost (or anticipated efficient cost) of providing the Reference Services*.”⁴

We again point out that the emphasis on efficient costs is consistent with the original intent of energy reforms, whereby regulation was meant to ‘mimic’ the outcomes achieved in a

¹ Draft Expert Panel Report, p 68

² Page 2 Q. 5 Second Paragraph

³ See: Rule 6.2.2(b)(2) and 6.2.3(d)(4).

⁴ p. 47, Clause 8, Reference Tariff Principles, General Principles, *National Third Party Access Code for Natural Gas Pipeline Systems*, November 1997 (as Amended). Clause 8.2(e) also requires that “*any forecasts required in setting the Reference Tariff represent best estimates arrived at on a reasonable basis*”; but that requirement must be consistent with the ‘overarching requirement’ specified above.

competitive market. This was closely aligned with the policy objective of ensuring that energy infrastructure was provided on a competitive basis. It seems to us that a change to an essentially legal term such as “reasonable” without maintaining the primary emphasis on ‘efficiency’ greatly risks skewing outcomes back towards the interests of regulated businesses, allowing them to become less efficient and more profitable at the expense of end users. This would threaten the (desirable) policy objectives of energy reform and would be contrary to CoAG’s energy reform principles, to the MCE’s objectives and would not satisfy the SMO. These are serious concerns and seem to put the AEMC at odds with CoAG, the MCE and the SMO.

Paragraph 53 of the legal advice states that “*the use of the ‘reasonable estimate’ test uncertainty in forecasting, the existing case law in Gasnet and Telstra and the role of the pricing principles in resolving conflict, will result in the AER being required to accept a range of forecasts higher than those it would determine as the most appropriate or best estimate.*”⁵ The nexus with efficiency and the policy intent of network regulation in the NEM is clearly broken. This issue cannot be looked at in isolation from the other proposed changes.

Under the Draft Rules, a TNSP can radically alter their proposal to the extent that they are, in effect, submitting a new Revenue Proposal. There appears to be nothing in the Draft Rules that would prevent a TNSP from taking this course, including in respect of matters that had been accepted by the AER in the Draft Decision or matters not previously considered.

This latitude provides ample opportunity for gaming, an outcome identified by the Expert Panel who noted:

...by allowing the ‘presumption’ of approval not just to apply to the initial consideration by the AER of whether a proposal is acceptable, but requiring it also to be applied in considering the regulated entity’s amended proposal lodged after the release of the draft determination, the AEMC approach does not provide any incentive to reduce regulatory game playing by entities lodging proposals.

*Indeed, the regulated entity has an incentive to make an ambit claim at the commencement of the process in order to discover whether it lies above the regulator’s estimate of a reasonable range, and if it does, to flush a counter proposal out from the regulator in the form of a draft determination. Under the Gas Code and under the AEMC’s draft Rules, this search process is at no bargaining cost to the regulated entity as it retains a capacity to make a final offer in response to the draft determination. Under the current interpretation of the Gas Code (and presumably the same would apply to the AEMC draft Rules), the regulator must accept such an offer if it lies within the regulator’s estimate of a reasonable range. The final offer will not of course be less than that proposed by the regulator.*⁶

The AEMC’s Draft Determination, in addressing these concerns, noted that strategic behaviour was a fact of the regulatory process. This is an extraordinary comment and almost tantamount to an admission of defeat on the key matter of strategic gaming by regulated entities, and would seriously compromise attainment of the SMO. What the AEMC has failed to recognize, however,

⁵ Page 19

⁶ Draft Expert Panel Report, p 76

is that these incentives for strategic behaviour are far greater under an approach where the TNSP can be rewarded for seeking out the regulator's view on outcomes likely to be deemed reasonable through its ability to submit a revised revenue proposal.

Future Regulation of Distribution Services

The issue also arises as to the difference of treatment compared to DNSP's. It is unsatisfactory for service providers undertaking essentially similar services to be regulated in different ways. If the Rule in its present format is implemented it would invariably lead to pressures to implement the same system for DNSP's or would otherwise result in differences in regulatory approach. If the *propose-respond* and reasonable estimate approach were extended to distribution, it would again translate into higher prices for end users. In this case, the impact would be even more serious as distribution costs make up a large proportion of the delivered costs of energy. If a different approach were adopted it would compromise the objective of nationally consistent regulation of network services without any apparent good reason.

In conclusion we consider that the AER should set the allowance for capital and operating expenditure. We do not support the option of a residual discretion for a TNSP to substitute its own reasonable estimate as this remains a propose/respond model. The Rules should also clearly say that efficiency will retain its primacy as part of the 'reasonableness criteria'; and require that demand forecasts be compatible with efficient expenditure forecasts. This would be consistent with the Single Market Objective and assist the AER withstand a legal challenge that the AER's interpretation of 'reasonable' did not breach the 'Wednesbury principle.' If the AEMC does not accept this approach we consider that the Commission should demonstrate unequivocally how what it proposal meets the Single Market Objective and why it chooses to ignore the decisions of Ministers, the legal opinion it has published and the advice provided by the Expert Panel.

Yours Sincerely

A handwritten signature in black ink, appearing to read 'Roman Domanski', with a stylized flourish at the end.

Roman Domanski

Executive Director