

19 October 2006

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

Dear Dr. Tamblyn

**Economic Regulation of Transmission Services:
Treatment of forecast expenditure**

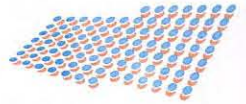
Thank you for the opportunity to further participate in what is now the fifth round of consultation relevant to the review of Rules for Transmission revenue regulation. We have appreciated the AEMC's transparent process and believe that the open dialog with all market participants has delivered reasoned and practical Rule reform.

The greatest of divides separates your processes and that offered by the MCE. To date, the latter approach has failed to follow (by any reasonable measure) a best practice process in terms of openness and transparency. What results from processes characterised by a lack of consultation and transparency is skewed policy development, dominated by the philosophical views of one or two stakeholders at the expense of the market as a whole.

The approach to the treatment of forecast expenditure is a perfect case in point. The Commission's current position follows four rounds of consultation from a wide cross section of participants. The reforms initiated by the Commission in the Rules package reflect a balance of concerns raised by industry, customers and regulators alike. The Rule change process has subjected the Commission to procedural discipline by being required to respond in an open and transparent manner to comments or concerns of its positions.

In contrast, we are unable to ascertain the purpose of the legal advice sought by the Department of Industry, Tourism & Resources (DITR), and whether it was even sought to address the proposed Rules for Transmission networks, or as policy input for the development of Rules for Distribution networks. Given that the reasonable estimates concept has been preferred since February 2006, we can only deduce the latter is the case. Nevertheless, we continue to remain in the dark on policy directions the MCE is taking in regard to distribution Rules and how, or if, this advice fits into the Rule development process.

Upon reviewing the legal advice, EnergyAustralia believes the alternative approach it raises has no merit and is indeed far inferior to the approach the Commission has taken to date which broadly supports a propose-respond regulatory framework. We believe the issues associated with adopting a "best" estimate approach were appropriately addressed, and dismissed by the Commission, in its draft determination. We agree with the Commission that there is no further evidence in this advice or any other submission to warrant reconsideration in approach.



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Therefore, EnergyAustralia hopes that the Commonwealth, in assessing the value of the advice provided to it, will recognise the superior process and rationale of the Commission, and will likewise not consider pursuing the option proposed by the advice.

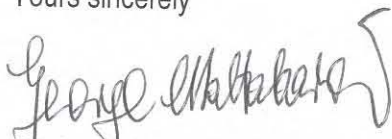
I have attached for your information a more thorough analysis of the AGS advice and a specific response to the questions you raised. What lies at the heart of this issue however is the ongoing philosophical debate of whether the TNSP is best placed to be *responsible* and *accountable* for their own expenditure forecasts (propose-respond) or whether the TNSP should be held accountable for expenditure forecasts determined by the regulator (consider-determine).

The Commission's current approach to regulatory discretion and decision-making has been a cornerstone of the Rules package. A consider-determine decision framework is a totally inappropriate fit with the total AEMC "package" which also provides a strong incentive mechanism for forecast expenditure and high hurdles for compliance with Rules and guidelines. Further, history has shown that overly intrusive regulation, which ignores the advice of the network businesses, can and will lead unnecessary and costly regulatory errors. We attach a case study that highlights just such an experience under a consider-determine model.

We accept the Commission had little choice other than to release this opinion for a further round of consultation, in order to maintain its open and transparent processes for considering all views on these critical issues. However, any significant shift in the position held since February should be in the context of the overall regulatory package and, we believe, subject to significantly more robust analysis and consideration than a one week consultation.

If you have any queries or comments regarding these or any of the detailed issues discussed in our submission please do not hesitate to contact me on (02) 9269 2111, or Mr. Harry Colebourn, Manager – Network Regulation and Pricing on (02) 9269 4171.

Yours sincerely



GEORGE MALTABAROW

Managing Director

Attachment 1: Specific Response to Australian Government Solicitor Advice and Commission's Questions

The advice from the Australian Government Solicitor provides two perspectives:

- a) A legal perspective on the current draft rule which, while limited in its focus, largely substantiates the Commission's reasonable estimate approach; and
- b) A policy perspective which provides unsubstantiated commentary on the implications of adopting a reasonable estimates approach.

We note that you have requested specific comments regarding the discretion of the AER in respect of forecast expenditure. We assume the Commission has (appropriately) not considered the concept of replacing a "reasonable estimates" decision with "best estimates reasonably possible".

EnergyAustralia believes the alternative "best estimate" approach discussed in the advice has no merit and is far inferior to the approach the Commission has taken to date. We believe the issues associated with adopting a "best" estimate approach were appropriately addressed, and dismissed by the Commission, in its draft determination. We agree with the Commission that there is no further evidence in this advice or any other submission to warrant reconsideration in approach. Therefore, EnergyAustralia hopes that the Commonwealth in assessing the value of the advice provided to it will recognise the superior process and rationale of the Commission, and will likewise not consider pursuing the option proposed by the advice.

We note the Commission has identified three questions raised by interested parties that are fuelling the debate surrounding the treatment of forecast expenditure. We provide comment on these questions below:

Does the draft wording of the Rules impose an "onus of proof" on the TNSP and the AER?

We believe a formal onus of proof is neither established, nor required, in the Rules. The concept of onus of proof is a formal legal concept which is not appropriate or necessary in this type of regulatory framework. Instead, the Rules contain a comprehensive framework which places a very significant obligation upon TNSPs (equivalent to an evidentiary burden) to:

- a) comply with the Rules and relevant guidelines in respect of the submission of its revenue proposal - note the significant material required to satisfy Schedule 6A.1;
- b) comply with any further requirements provided under the AER's information gathering powers and associated guidelines; and
- c) provide sufficient information that justifies its forecasts so that the AER can determine the reasonableness of the TNSPs estimates.

The burden placed on TNSPs to submit a compliant and convincing proposal was not addressed in the AGS advice. However it was addressed by the Commission in its draft determination (p5):

"The AER's capacity to deal with exaggerated proposals will be strengthened by the requirement for the TNSPs to make a complete proposal (in conformity with AER guidelines) including information and evidence consistent with the assessment criteria in support of their expenditure forecasts. The Commission also considers that the decision making process to be followed by the AER in assessing the expenditure forecasts is likely to provide an incentive to submit well documented and supported expenditure forecasts"

We believe that if anything, the burden is weighed too heavily in favour of the AER. We believe that the AER should not be responsible both for preparing guidelines for the contents of a revenue proposal and for assessing whether the proposal meets those guidelines. Under this approach as it currently stands, the AER has the authority to mandate the provision of any and all information that it could possibly require to develop a detailed and well evidenced opinion of whether the estimates included in proposals are indeed unreasonable.

Is it necessary for the AER to form a view that a TNSP's proposal was "unreasonable" before it could reject it?

We believe the draft Rule requires the AER to accept a forecast where it considers that forecast to be a reasonable estimate and only permits it to reject an estimate if it determines that it is not reasonable. We believe it is entirely appropriate for the AER, if it rejects a proposal as unreasonable to not only state the factors it considered in rejecting the forecast, but what it considers to be a reasonable estimate. This ensures that forecasts are not rejected where the revised estimate is likely to be immaterial and removes the tendency for regulators to provide "on balance" assessments of forecasts.

As stated above we believe that the information and analysis required to be included as part of a proposal, together with the information gathering powers of the AER are more than sufficient to facilitate the AER's assessment of the reasonableness of the network's proposal, and to articulate and quantify its concerns should the AER arrive at the assessment that any elements of the proposal are unreasonable.

Do the Rules create a presumption in favour of acceptance of the TNSP's proposed forecast expenditure?

We believe that in an environment where:

1. Rules specify a significant substantiation and verification burden on the TNSP to deliver a compliant and convincing revenue proposal;
2. forecasts are subject to a large degree of uncertainty; and
3. the regulatory framework requires a regulated business to spend at or below its forecast to earn an efficient rate of return;

The Rules must allow for a presumption in favour of the TNSP's forecasts so long as these forecasts were derived on a reasonable basis. The contrary position is absurd – the regulator, while acknowledging the forecast is reasonable, substitutes its own forecast on the regulated business, who must face the risk of inefficient returns or breach of licence if the regulator's forecast is too low. Furthermore, the DNSPs performance and performance incentives would also be based on the Regulator's forecast.

The Commission has also invited comment on 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.

Following on from the third question above, the only instance where the proposed Rules do not allow the regulator to substitute its own forecast is where the regulator believes the TNSP's forecast is a reasonable estimate. Amending the Rules to allow the regulator to disregard a reasonable estimate in favor of its own undermines the purpose of having a comprehensive

Rules framework in the first place. A TNSP is better placed in a consider-determine framework where the evidentiary burden is not as strong.

The Commission may be concerned that a reasonable estimates approach offers a broad range of outcomes and may be swayed by the AGS contention that a best estimate approach will provide a narrower range of outcomes.

There is no dispute that a reasonable estimate is a point estimate along a continuum between parameters outside of which lie unreasonable estimates. However, there is no analysis to support this contention. We would argue that a best estimate approach will not reduce the range of possible forecasts (we would argue that it merely shifts the goalposts of the range to include forecasts lower than an efficient level of expenditure). The approach will also guarantee that the AER rejects every draft (and possibly final) proposal on the basis on the presumption that the regulated business will never present a forecast that represents the "best" estimate (ie. will adopt an estimate that allows for superior returns).

A regime which allows for the substitute of one reasonable estimate for another has the potential to widen the range of possible estimates and is at a higher risk of regulatory error of judgment and inefficiency.

EnergyAustralia contends that any move to a framework which allows the substitution of one reasonable estimate with another is inferior to the current AEMC position. Revisiting this aspect of the framework would require a revisit of other elements of the framework which inter-relate (incentive mechanisms, information gathering powers, merits review etc).

If the Commission is persuaded to move from its current decision making approach, it should move to one which removes the AER from making its own judgment of what is a reasonable estimate and focus more on whether the TNSP's forecasts were derived appropriately.

EnergyAustralia proposed in its submission on the Chapter 6 revenue draft determination that the Rules could be further enhanced if the AER was required to accept the TNSP's estimate if it believes the estimate was derived on a reasonable basis taking into account the criteria in 6A.6.7(b)(3). If it believes the estimate provided was not derived on a reasonable basis it may provide what it considers is a best estimate of forecast capex.

As noted in our submission this removes the onus on the AER to take on the role of network planner and instead focuses on the processes and methodologies the utility undertook in arriving at its best estimate using the criteria provided in the Rules.

Attachment 2: Case Study: Regulation under “consider-determine” model

Background

In 2005, the ACCC set a revenue cap for EnergyAustralia’s transmission network. This revenue cap decision was made under the “consider-determine” model. This framework requires the regulator to second guess the network’s planning decisions. This case study highlights the impact of this framework on EnergyAustralia’s capital replacement policy.

Revenue Cap Application

EnergyAustralia proposed a reasonable capital replacement program requiring expenditure of \$156m over the regulatory period (2004–2009). The application was based on EnergyAustralia’s capital replacement policy, which is designed to control the percentage of assets that have an age exceeding the standard regulatory life of that class of asset.

Under this policy condition monitoring for specific classes of assets is used wherever possible. A condition and risk assessment (CRA) methodology is used to assess the failure risk of all operating items, which are then given a rating prepared using the matrix shown in Table 1.

Table 1 – EnergyAustralia’s risk assessment matrix

Likelihood		Consequences				
		1	2	3	4	5
		Insignificant	Minor	Moderate	Major	Catastrophic
A	Almost certain	A1	A2	A3	A4	A5
B	Likely	B1	B2	B3	B4	B5
C	Possible	C1	C2	C3	C4	C5
D	Unlikely	D1	D2	D3	D4	D5
E	Rare	E1	E2	E3	E4	E5

Risk rating:

Extreme	Immediate action required
High	Senior management attention required
Moderate	Management responsibility must be specified
Low	Manage by routine procedures

Each asset is given a risk rating for

- less than five years;
- between five and ten years; and
- between 10 and 20 years.

As the network planner, builder and operator EnergyAustralia considered what these ratings could possibly mean for safety, network reliability and network security. EnergyAustralia’s replacement program was then developed based on this risk assessment. The revenue cap application included replacing assets with a risk rating of “C2”.

The ACCC decision

The ACCC, under the “consider-determine” model, was required to review EnergyAustralia’s proposed replacement program, which led it to review the replacement policy. The ACCC, while being an economic regulator, was forced to make a decision on a highly technical engineering matter, for which EnergyAustralia is held accountable.

Based on advice from engineering consultants, the ACCC decided that the assets classified as having a risk rating of “C2” should not be included in the revenue cap. The result was that EnergyAustralia did not receive funding to replace these assets.

Failure of consider-determine

On 20 July 2006, a circuit breaker failed, where the associated feeder is a critical link between the 132kV networks in the north and the south of Sydney. This circuit breaker had been included in the “C2” category of equipment at time of the regulatory submission. The “A” phase pole of the air-blast circuit breaker fractured, and subsequently collapsed, and caused the “B” phase pole to explode under high air pressure resulting in a large amount of porcelain being spread around the switchyard and damage to auxiliary equipment (see attached pictures).

This type of circuit breaker exists in two EnergyAustralia substations. In total, there are 31 circuit breakers, with some being installed in 1960 and some in 1968, which means they have almost reached their service life. The ACCC’s decision was to exclude the costs of replacing these assets from EnergyAustralia’s forecasts as the expenditure was not required prior to 2009.

Inspections of all these circuit breakers were undertaken to determine whether there was evidence to suggest a similar failure might occur in other circuit-breakers of this type. Inspections found cracks in the circuit breaker casting of varying degrees of severity, and each circuit breaker was placed in one of three categories:

1. significant cracks observed;
2. hairline cracks observed; and
3. no cracks observed.

Table 2 – Condition of circuit breakers

	Substation 1	Substation 2	Total
Category 1: Significant Cracks Observed	2	3	5
Category 2: Hairline Cracks Observed	7	2	9
Category 3: No Cracks Observed	10	7	17
Total number of CBs at site	19	12	31

EnergyAustralia immediately initiated an emergency replacement program of these circuit breakers. Costs associated with this replacement are outside the forecasts allowed by the regulator.



Figure 1 – Air-Blast Circuit Breaker



Figure 2 – Failed Circuit Breaker