

**AEMC REVIEW OF THE ELECTRICITY TRANSMISSION
REVENUE AND PRICING RULES:**

RULE PROPOSAL AND RULE PROPOSAL REPORT

Submission by the Electricity Transmission Network Owners Forum

March 2006

ElectraNet ♦ Powerlink ♦ SP AusNet ♦ Transend ♦ TransGrid

CONTENTS

| | |
|--|-----------|
| 1. Introduction and Overview | 3 |
| 1.1 Introduction | 3 |
| 1.2 TNOs Support many features of the Rule Proposal | 4 |
| 1.3 Changes to key elements of the Rule Proposal is required | 5 |
| 1.4 Savings and Transitional Arrangements | 9 |
| 1.5 Structure of Remainder of Submission | 9 |
| 2. Elements of the Rule Proposal that are Supported | 10 |
| 2.1 Importance of Regulatory Certainty for the Market Objective | 10 |
| 2.2 The Rule Proposal Advances Regulatory Certainty | 11 |
| 3. Elements of the Rule Proposal where Changes are Required | 12 |
| 3.1 Treatment of ‘Difficult to Forecast’ or ‘Unforeseen’ Capital Expenditure | 12 |
| 3.2 Ex Post Capital Expenditure Assessments | 15 |
| 3.3 Forecasts of Capital and Operating Expenditure | 17 |
| 3.4 Criteria for 5-yearly review of the WACC and other WACC Issues | 21 |
| 3.5 Service Performance Incentive Arrangements | 26 |
| 3.6 Negotiated Services and Negotiation Framework | 27 |
| 3.7 Assigning weight to expert evidence and due process | 29 |
| 3.8 Pass through arrangements and redetermination for ‘catastrophic’ events | 32 |
| 3.9 Commercial stranding risk | 33 |
| 3.10 Procedures for changing guidelines | 33 |
| 4. Drafting issues with the Rule Proposal | 35 |
| Attachment | 36 |

1. Introduction and Overview

1.1 Introduction

This submission is made by the Electricity Transmission Network Owners Forum, which comprises ElectraNet Pty Limited, Powerlink Queensland, SP AusNet, Transend Networks Pty Ltd and TransGrid (the “TNOs”). Collectively, this group own and operate over 40,000 km of high voltage transmission lines and have assets in service with a current regulatory value in excess of \$9.1 billion. The TNOs welcome the opportunity to respond to the Australian Energy Market Commission’s (the “AEMC”) Rule Proposal and accompanying Rule Proposal Report.¹

The TNO’s submission to the AEMC’s Issues Paper emphasised a number of important objectives for the review of the revenue setting Rules, which were to:

- establish meaningful high level objectives and criteria within the Rules to guide revenue cap decisions;
- ensure that the Australian Energy Regulator’s (“AER”) Statement of Regulatory Principles (“SRP”) framework is reflected in the Rules at an appropriate level of detail;
- ensure that businesses have appropriate incentives and sufficient certainty to undertake long term efficient investment decisions;
- improve the revenue setting process by establishing in the Rules clear rights and responsibilities for both regulated transmission entities and the AER;
- clarify within the Rules the scope of services to be regulated by the AER;
- establish in the Rules the extent of, and criteria for, the exercise of regulatory discretion by the AER; and
- provide certainty that commitments under existing revenue cap decisions are adhered to.

More specifically, in establishing the SRP regulatory framework in the Rules, it was argued that the review should provide greater certainty in relation to:

- the basic model for deriving revenue caps, namely by adopting formally the building block approach;
- asset base valuation;
- the incentive framework applying to capital and operating expenditure;

¹ AEMC, 2006, Review of the Electricity Transmission Pricing Rules Consultation Program – Revenue Requirements: Rule Proposal, February; AEMC, 2006, Review of the Electricity Transmission Pricing Rules Consultation Program – Revenue Requirements: Rule Proposal Report, February.

- service incentive mechanisms;
- achieving long term stability in WACC parameters; and
- pass through arrangements and provisions governing the re-opening of a revenue cap.

To facilitate the AEMC's consideration of these issues – and, in particular, to provide a more tangible statement of the TNOs' views – the TNO submission was accompanied by a set of 'Model Rules'. These Model Rules provided a practical translation of the TNOs' views on the extent of prescription required in the Rules generally, and on the specific matters where prescription is justifiable. They also illustrated the TNOs' views as to the appropriate procedural and decision-making criteria that should be included in the Rules.

1.2 TNOs Support many features of the Rule Proposal

The TNOs support many of the features of the AEMC's Rule Proposal, noting that the Rule Proposal has adopted a number of the features that were advanced in the TNO submission and Model Rules. In particular, the TNOs welcome the following:

- *Increased certainty* – the Rule Proposal adopts many of the key features of the SRP regime, and by promoting those features to the Rules provides investors with more certainty that the framework can be relied upon;
- *Form of regulation* – adopting the building block approach (and hence, a focus on firm-specific expenditure requirements) for deriving revenue requirements, and a revenue cap form of control, and setting out both of these methodologies in the Rules;
- *Regulatory prescription / discretion* – adopting an appropriate balance between regulatory discretion and prescription by promoting into the Rules the key methodological approaches for setting revenue caps and preserving discretion for the AER in relation to the more technical matters (e.g. the form of the financial model) and firm-specific matters (e.g. expenditure forecasts) with a requirement for the AER to issue binding 'guidelines' to provide greater certainty as to how it will exercise its discretion in these important matters;
- *Regulatory asset base* – adopting a 'roll-forward' approach to updating the value of the regulatory asset base over time and hence removing the threat of periodic revaluations of the regulatory asset base;
- *WACC* – largely adopting the SRP position of specifying key input parameters and thereby providing greater certainty in relation to regulated rates of return;
- *Capital expenditure* – continuing with a low-powered incentive regime for capital expenditure (consistent with the position in the SRP) and setting out criteria governing ex ante and any ex post assessment of expenditure (the TNOs views on the actual criteria that are set out in the Rule Proposal are discussed further below where the need for any ex-post assessment is questioned);

- *Depreciation* – recognising that there are net benefits to the market as a whole from providing the Transmission Network Service Providers (“TNSPs”) with flexibility over the selection of the profile of depreciation of their assets;
- *Information requirements* – recognition that the current requirements in the Rules (clause 6.2.5) provide an appropriate balance between the AER’s legitimate information gathering needs and the real cost that these requirements impose on industry (and ultimately customers); and
- *Regulatory procedures* – setting out in the Rules clear requirements for the procedures required for the assessment of a revenue cap (including the contents of the revenue cap application), including mandatory timelines for the assessment and decision making process.

The TNOs consider that promoting these positions into the Rules will materially advance regulatory certainty for investors and increased confidence about the future treatment of their investments. Investments in transmission assets may go through in excess of eight revenue cap reviews throughout their life, implying that stability and predictability in the regulatory framework is essential to ensure that TNSPs continue to have the incentive and means to provide the services that are sought by customers.

1.3 Changes to key elements of the Rule Proposal is required

There are a number of aspects of the Rule Proposal where reconsideration or refinement is necessary in order to meet the market objective. The particular areas of concern to the TNOs are:

- *Revenue cap re-openers for unforeseen capex* – while the Rule Proposal permits a re-opener for unforeseen capital expenditure, it also sets an extremely high threshold and requires a claw-back of efficiency gains achieved on other capital projects. The TNOs consider that a ‘contingent projects’ regime – a modified form of the model set out in the SRP operating in tandem with the re-opener mechanism – would be a superior means of addressing uncertain projects by providing better incentives for TNSPs to undertake uncertain projects, preserve incentives on projects within the ex ante allowance, and be administratively simpler.
- *Ex post capital expenditure assessments* – the Rule Proposal applies the SRP ex ante capital expenditure assessment regime, but provides scope for the AER to additionally undertake ex post review of expenditure. The TNOs consider this to be inconsistent with the incentives inherent in the ex ante assessment regime and to introduce an element of over-regulation. Moreover, we note that the AER ruled out the option of undertaking ex post assessments of ‘prudence or efficiency’ of capital expenditure under the ex ante regime. Therefore, it is appropriate for ex post assessments of capital expenditure to be precluded. However, if the AEMC determines that an ex post assessment is to be available to the AER, then the application of such a test should be restricted to circumstances where the ex ante capital expenditure allowance has been exceeded, and should concern only the ‘prudence’ of investments, with this standard clearly defined.

- *Forecasts of capital and operating expenditure* – the TNOs support the requirement in the Rule Proposal for the AER to accept the forecasts of expenditure if those forecasts are considered reasonable, which should lead to a reduction in the overall cost of regulation, accord weight to the forecasts of expert TNSP planners and ensure greater recognition of the unique circumstances of each TNSP. However, as presently drafted, the matters to which the AER is required to have regard are overlapping, interrelated and contain matters of little or no relevance, and do not provide guidance regarding the weight to be applied to each factor. Requiring the AER to have regard to such a list is not best practice regulation and is likely to misdirect the AER about its role, which is to undertake an analytical exercise and make findings of fact and not to make a public policy judgement, by trading-off disparate factors. Accordingly, the interrelated list of factors should be removed. Alternatively, if the AEMC considers it necessary to retain a list of factors to guide the AER, then these should direct the AER to consider only the key drivers of expenditure, along the lines of those set out in the TNO Model Rules.
- *WACC and Taxation Criteria* – TNOs welcome the AEMC adopting (for the most part) the input parameters and methodologies as set out in the SRP for the initial 5-year period, noting that the SRP was a product of extensive consultation. We also welcome the AEMC’s acknowledgement that the WACC should be neutral with respect to ownership and that the ACCC/AER’s use of an A-rating for the debt margin was unduly influenced by the public ownership of some TNSPs. However, the Rule Proposal contains little guidance for the AER’s review of those parameters after 5 years, whereas clear guidance on this matter is essential to create appropriate predictability and stability in the WACC (which, in turn, is of central importance to investors). The TNOs also consider that the Rules need to provide guidance for the forecast of inflation (but not to mandate the use of inflation-linked bonds) and require the ACCC/AER’s existing practice of using a benchmark assumption for the taxation allowance to be continued.
- *Service performance incentive arrangements* – The TNOs generally support the service performance incentive arrangements set out in the Rule Proposal and understand these to be aimed at improving the availability of transmission services, taking into account when these services are most valued by customers and by the market. Some refinement to the Rule Proposal is needed to make clear this intent. We note in this context that market participants emphasised at the AEMC Public Hearing the importance of notice and predictability with respect to the availability of transmission assets. In addition, while the TNOs welcome the protection in the Rule Proposal to limit revenue risk to TNSPs, it would be appropriate for individual TNSPs to be able to propose a higher risk exposure if they desire. We look forward to constructively addressing how the service performance incentive arrangements could be appropriately refined to best meet the needs of market participants and the market objective.
- *Negotiation regime* – the TNOs have concerns about three aspects of the proposed negotiation regime are as follows:
 - **Connection services to distributors:** the TNOs support the AEMC’s desire for ‘less intrusive’ forms of regulation, including increasing the scope for

commercial negotiation. However, we question the merits of removing connection services to distributors from the definition of prescribed services. Commercial negotiation in relation to distribution connection services may not be feasible given that transmission costs are generally a cost pass through for distributors. Removing these services from the revenue cap may also create price uncertainty for distribution customers. In addition, these assets, in general, form part of shared network services provided by transmission and distribution networks. As such there appears to be no measurable benefit to consumers in having them treated differently from other prescribed services. On the other hand there is scope for additional administrative costs to arise that would ultimately be carried by consumers.

- **Contestable services:** the definition of Negotiable Services in the Rule Proposal includes connection services that are contestable, which are currently non-regulated and for which there is no justification for extending the scope of regulation. While the TNOs welcome the AEMC’s confirmation that this was not its intent,² we consider it important for the Rules to clearly exclude contestable transmission services from the definition of the services that are subject to the negotiate/arbitrate regime (i.e. ‘negotiated services’).

- **Generator access:** while the TNOs welcome the AEMC’s confirmation that it is not its intention at this stage to introduce the notion of generator rights to ‘firm access’,³ we note that the Rule Proposal does materially increase the risk that the TNSPs will be required to provide ‘firm access’ to generators (and so bear the financial risk of constraints even though TNSPs cannot control the occurrence of constraints as these are affected by many factors, including the investment and operating decisions of other market participants). In particular, ‘firm access’ could be an outcome of ‘generator access’ as the Rule Proposal applies the existing ‘generator access’ provisions to TNSPs and also permits disputes about the terms of ‘generator access’ to be arbitrated through the proposed Chapter 6 arbitration arrangements.⁴ We discussed at some length the difficulties and risks associated with ‘generator access’ – and the related issue of firm access – in our submission to the AEMC Issues Paper. As a minimum, the AEMC should not change the existing Rules that deal with ‘generator access’ (currently clause 5.5) and not apply the Chapter 6 arbitration provisions to this service. Alternatively, if the AEMC considers it important for the negotiation framework to apply to generator-requested augmentations on the shared network, but does not intend generators to receive any form of capacity right in return for funding an augmentation, then the Rules could define a new service with these characteristics. The terms of this new service could then be subject to the new negotiation framework.

² Commissioner Carver, Transcript of the Public Hearing on the Rule Proposal, 8 March 2006, p.50.

³ Commissioner Carver, Transcript of the Public Hearing on the Rule Proposal, 8 March 2006, p.50.

⁴ This fact has been acknowledged by the AEMC in another context: AEMC, 2006, Congestion Management Review: Issues Paper, March, p.13. We note, however, that TNSPs are only required to negotiate generator access to the extent that those arrangements are consistent with ‘good electricity industry practice’ (clause 5.5(e)).

- *Pass through arrangements and re-opener for ‘catastrophic’ events* –the TNOs welcome the inclusion of ‘pass through’ arrangements for a set of defined events. However, we consider the proposed materiality threshold of 1 per cent of revenue to be excessive,⁵ given that the rationale for a threshold is to dissuade pass-through applications where the cost of administering a pass-through application exceeds the benefits.⁶ If the AEMC decides that a threshold for pass through applications is necessary, it would be more appropriate for the threshold to require an assessment of ‘materiality’ in the context of an individual pass-through application. We consider it would also be appropriate for the Rules to permit additional pass through events to be defined during a review of the revenue cap, guided by clear criteria. In addition, the TNOs consider that the Rules should permit the revenue cap to be revoked and redetermined if a TNSP suffers a catastrophic event (commonly referred to as a ‘shipwreck’ clause). The clause should permit the allowances for both operating and capital expenditure to be redetermined, and permit costs already incurred as well as costs forecast to be incurred, to be factored into the new revenue cap.
- *Commercial stranding risk* – the TNOs welcome the general proposition in the Rule Proposal that ‘regulatory stranding’ of assets is to be precluded in respect of the bulk of transmission assets. However, the threat of having shared assets that are dedicated to one or a few customers ‘stranded’ if the TNSP has not sought to enter into contracts with those customers to manage stranded asset risk, or to offer a discount to those customers, to require further consideration in the context of the broader service obligations of TNSPs. In particular, these provisions can only apply to the shared network (at least for future assets), but shared assets seldom if ever could be defined as dedicated to an individual customer. Moreover, even if dedicated but shared assets existed, the TNSPs have no leverage to require connecting customers to sign take-or-pay contracts to underpin an augmentation. The TNSPs’ reliability obligations require them to augment the shared network where required, and hence any threat to not augment the network unless a contract is signed would leave the TNSPs open to penalties for failure to meet these obligations. Accordingly, if it is intended for the Rules to require such a risk reallocation for new projects, the precise arrangements contemplated need to be spelled out in the Rules (and hence that behaviour authorised by the Rules), and for such arrangements to take account of the TNSPs existing reliability obligations.
- *Expert evidence and due process* – while the TNOs support the requirement in the Rule Proposal for TNSPs to provide certification of the reasonableness of expenditure forecasts by an independent and appropriately qualified expert, this requirement will achieve very little unless the Rules also direct the AER to accord the certification provided with commensurate weight in its analysis. More generally, the quality of decision making would be improved by directing the AER to ensure that all of the evidence of a technical nature that it considers when assessing a revenue cap application meets basic tests for quality, including that any experts retained by the AER are similarly appropriately qualified. The Rules

⁵ The TNOs note that any materiality threshold would not apply to grid support.

⁶ For the larger TNSPs, the threshold would be more than \$4 million per annum.

should include requirements for due process in relation to the use of expert material, in particular, to ensure that reasonable opportunity is provided to respond to that material before a draft or final decision has been made.

- *Procedures for changing guidelines* – the TNOs support the requirement for the AER to issue binding guidelines on a number of matters (which was a central component of the TNO Model Rules). However, the effect of this regime is that many important decisions are made in the setting of those guidelines rather than in reviews of revenue caps. Accordingly, it is important that the procedural and other requirements in the Rules that apply to changes to guidelines are as robust as the procedural and other requirements that apply to revenue cap reviews. Moreover, given the significance of the decisions that will be made outside of revenue cap decisions, the TNOs consider it essential for merit review (which we understand is currently being considered for application to defined AER decisions) to apply equally to AER decisions to change guidelines.

In addition, the Rule Proposal is very dense and is not drafted in a manner or sequence that makes it easy for even an experienced analyst to readily follow or understand. We urge the AEMC to improve the clarity and simplicity of the Rules to the maximum extent possible, noting that Rules that are unclear and difficult to interpret will add to the cost of regulation. We offer the attached comments on drafting by legal advisers Gilbert+Tobin to assist in this endeavour, noting that at this stage we have not undertaken a thorough due diligence of the drafting.

1.4 Savings and Transitional Arrangements

The TNOs consider that appropriate savings and transitional arrangements are an essential component of any change to the Rules, and without which the AEMC's objectives to increase the certainty of regulatory outcomes for investors may not be achieved.

We noted in our response to the AEMC Issues Paper that the savings and transitional arrangements should meet certain principles, which included that existing revenue caps should not be reopened, previous commitments that have been relied upon by the TNSPs (for example, about incentive arrangements) are upheld and there is clarity about the Rules well in advance of a revenue cap review.⁷ However, the precise nature of the required savings and transitional arrangements that are required depend upon the circumstances of the individual businesses. Accordingly, the individual businesses will respond to the detail of savings and transitional arrangements the AEMC has proposed, and this matter is not addressed further in this joint submission.

1.5 Structure of Remainder of Submission

The remainder of the submission is structured as follows:

⁷ Transmission Network Owners, 2005, Response to AEMC Issues Paper on Revenue Requirements, November, pp.47-48.

- Section 2 discusses in more detail the elements of the Rule proposal that are supported drawing upon our more comprehensive submission to the AEMC Issues Paper;
- Section 3 discusses the elements of the Rule Proposal where changes are required; and
- Section 4 discusses drafting issues with the Rule Proposal.

2. Elements of the Rule Proposal that are Supported

2.1 Importance of Regulatory Certainty for the Market Objective

Substantial investment in transmission assets is required to maintain transmission services at the level of reliability sought by users and mandated in regulatory instruments. Therefore, it is important to create an environment that provides TNSPs with the incentive and capacity to continue to attract and devote the funds required to invest. This will deliver substantial benefits to all industry participants and customers more generally – and hence, promote the market objective. The design of the regulatory arrangements for transmission assets has a central effect on the TNSPs’ incentives and capacities to make such investments.

As we pointed out in our submission to the AEMC Issues Paper, transmission assets tend to be specific to the task and hence have no viable alternative uses. Therefore, once investments are made, the investment is effectively ‘sunk’.⁸ Transmission assets also tend to have physical and economic lives that are upward of 40 years, and regulators typically set prices so as to return the investment over a long time frame. These two observations imply that investments in transmission assets are at the risk of regulatory outcomes (i.e. because they are sunk) and at risk for an extended period of time (i.e. because the assets are long lived). As a result, regulated assets will go through numerous price reviews over their lives – possibly upward of eight reviews, and so the expected payoffs from new investments will depend upon both the level of return offered in a given regulatory period, as well as expected returns in future regulatory periods.

Clearly, an essential part of an environment that is conducive to investment in such long-lived assets is the opportunity to earn a reasonable return on funds invested and to recover capital over time. This includes that ‘sunk’ investments are not expropriated after the capital has been sunk, and that appropriate regulatory returns are granted not just in the next price review, but in the following eight or more reviews. Accordingly, an essential component of an environment that is conducive to investment is that investors have confidence in the regulatory regime – and, in particular, that regulatory outcomes over time will be stable and predictable.

⁸ That is, if the investor is not happy with the regulated prices, it cannot use the asset for a different activity or sell it to another party to undertake an alternative activity. Selling an asset to another transmission provider would not assist in the recoupment of the investment given that the new provider presumably would also be covered by the same set of regulated prices.

A second essential component of an environment that is conducive to the substantial levels of investment required is to ensure that the overall degree of risk assigned to TNSPs is such that the businesses continue to have access to deep and liquid sources of investment funds, most notably debt finance. Accordingly, measures that limit the risk imposed on TNSPs to tolerable levels are also likely to provide substantial benefits.

We noted in our submission in response to the Issues Paper that it is important to understand that, while the TNSPs are subject to substantial reliability obligations, these obligations can only ensure the appropriate levels of investment (and service performance) in the short term. While TNSPs will always comply with their reliability obligations to the extent they are able, capacity to do so over the long term will depend upon the TNSPs' abilities to attract the necessary investment funds. Therefore, even with strong reliability obligations, certainty and stability in the regulatory regime remains central to meeting the market objective.

2.2 The Rule Proposal Advances Regulatory Certainty

In our submission to the AEMC Issues Paper, we argued that well-designed Rules had the potential to substantially improve the environment for investment in transmission assets and so promote the market objective, as noted above. In particular, by prescribing certain 'more settled' aspects of the regulatory regime in the Rules, setting out clear criteria where regulatory discretion remains and increasing overall regulatory transparency and accountability, the Rules have the potential to increase the stability and predictability of regulatory decisions over multiple regulatory periods, as well as increasing the quality of regulatory decision making generally.

The TNOs therefore welcome many of the elements of the Rule Proposal. We consider that the overall effect of the Rule Proposal will be to enhance the environment for investment, and in turn promote the market objective as noted above. TNOs support the following elements of the Rule Proposal:

- *Form of regulation* – adopting the building block approach (and hence, a focus on firm-specific expenditure requirements) for deriving revenue requirements, and a revenue cap form of control, and setting out both of these methodologies in the Rules;
- *Regulatory prescription / discretion* – adopting an appropriate balance between regulatory discretion and prescription by promoting into the Rules the key methodological approaches for setting revenue caps and preserving discretion for the AER in relation to the more technical matters (e.g. the form of the financial model) and firm-specific matters (e.g. expenditure forecasts) with a requirement for the AER to issue binding 'guidelines' to provide greater certainty as to how it will exercise its discretion in these important matters;
- *Regulatory asset base* – adopting a 'roll-forward' approach to updating the value of the regulatory asset base over time and hence removing the threat of periodic revaluations of the regulatory asset base;
- *WACC* – largely adopting the SRP position of specifying key input parameters and thereby providing greater certainty in relation to regulated rates of return;

- *Capital expenditure* – continuing with a low-powered incentive regime for capital expenditure (consistent with the position in the SRP) and setting out criteria governing ex ante and any ex post assessment of expenditure (the TNOs views on the actual criteria that are set out in the Rule Proposal are discussed further below where the need for any ex-post assessment is questioned);
- *Depreciation* – recognising that there are net benefits to the market as a whole from providing the Transmission Network Service Providers (“TNSPs”) with flexibility over the selection of the profile of depreciation of their assets;
- *Information requirements* – recognition that the current requirements in the Rules (clause 6.2.5) provide an appropriate balance between the AER’s legitimate information gathering needs and the real cost that these requirements impose on industry (and ultimately customers); and
- *Regulatory procedures* – setting out in the Rules clear requirements for the procedures required for the assessment of a revenue cap (including the contents of the revenue cap application), including mandatory timelines for the assessment and decision making process.

We also note the AEMC’s recognition that the current requirements in the Rules (clause 6.2.5) provide an appropriate balance between the AER’s legitimate information gathering needs and the real cost that these requirements impose on industry (and ultimately customers). However, we reiterate the view expressed in our submission to the AEMC Issues Paper that the AER’s information gathering powers are not considered to be within the scope of the current review.

There are a number of elements of the Rule Proposal that we consider do not promote the market objective, as well as elements where refinement of the Rule Proposal is required. These matters are discussed in the remainder of this submission.

3. Elements of the Rule Proposal where Changes are Required

3.1 Treatment of ‘Difficult to Forecast’ or ‘Unforeseen’ Capital Expenditure

The TNOs consider it important for the Rules to create the capacity to address ‘difficult to forecast’ or ‘unforeseen’ capital projects that emerge during the regulatory period. In particular, the TNOs note that the capacity to earn a return immediately on such projects will reduce substantially the risk to both the TNSPs and customers arising from the difficulty of accurately forecasting capital expenditure over a five year period and also reduce considerably the financial disincentive for TNSPs to respond to discretionary opportunities that would deliver net market benefits. We note that there are a number of types of projects that may fit into this category, which include:

- reliability augmentations that may have been contemplated at the time of a revenue reset but whose trigger is dependent upon a new customer (or major increase to the load of an existing customer) that has not been included in the demand forecast;

- potential economic ('market benefit') projects that may have been contemplated at the time of a revenue reset but whose precise scope and timing cannot be confirmed until after the conduct of the 'regulatory test'; and
- projects for which the AEMC requires a regulatory test to be conducted under its 'last resort planning power', which (presumably) would not have been included in the TNSP's capital expenditure forecasts.

In our response to the Issues Paper, we supported a modified version of the AER's SRP 'contingent projects' concept, which provided the scope to separate out large projects whose timing is uncertain and add them to the revenue cap when they arise. Such a mechanism was included in the TNO Model Rules.⁹

The TNOs note that the Rule Proposal attempts to address these 'difficult to forecast' or 'unforeseen' capital projects by providing for reopening of the revenue cap during the regulatory period. However, the scope of this arrangement is subject to two constraints that severely constrain both its operation and the scheme's ability to provide the appropriate incentives to undertake efficient unforeseen projects, which are:¹⁰

- First, revenue cap reopening is only permitted where the project has a cost of at least 5 per cent of the regulatory asset base at the beginning of the regulatory period.
- Secondly, the cost of the new project must first be met from any underspend that has occurred against the ex ante allowance for capital expenditure.

The first of these constraints will limit the arrangement to only extremely large projects – for the TNSP with the largest regulatory asset base (TransGrid), the project would need to have a cost that is in excess of \$200 million (based on the forecast opening RAB for TransGrid's next regulatory control period), and even for the smallest (Transend) will set a threshold of about \$30 million per project. The TNOs note that even the smaller of these thresholds is high, and narrows the scope of the scheme to a degree that is not effective in addressing the problems associated with 'unforeseen' or 'difficult to forecast' capital projects.

The second of the constraints implies that, prior to additional revenue being granted, the benefits from any efficiency gains made to date during the regulatory period must first be clawed back. This claw back will substantially reduce (or even eliminate) the incentives that are provided by the regime for efficient capital expenditure. In addition, the key motivation for the re-opener – namely that 'legitimate, but unforeseen, capital expenditure requirements relating to regulatory obligations or emergencies can be addressed under the form of regulation'¹¹ – would not be achieved, as the claw-back of the TNSP's benefits from efficiency gains already made during the regulatory period would be a disincentive.

⁹ TNO Model Rules, clauses 44.3, 64-68.

¹⁰ Rule Proposal, clause 6.2.12.

¹¹ AEMC, 2006, Rule Proposal Report, February, p.77.

The TNOs reiterate the view expressed above that an appropriate regime for dealing with ‘unforeseen’ or ‘difficult to forecast’ projects within the regulatory period is very important to ensuring that these projects proceed when it is efficient to do so, and hence to promote the achievement of the market objective. The AEMC noted ‘that the current contingent (excluded) project provision in the SRP does not adequately address this risk, since contingent (excluded) projects need to be identified at the beginning of the regulatory period.’¹² We consider that the most appropriate mechanism for dealing with such projects is through a two-tiered regime, namely:

- *Contingent project regime* – under which projects would be identified in the revenue cap determination, with a trigger for the projects also listed. As these projects would be identified at the time of the revenue cap review, the AEMC (and AER) could have substantial confidence that the project had been specifically excluded from the ex ante capital expenditure allowance, hence addressing the concern the AEMC recognised of the need to avoid the potential for the TNSPs to ‘double dip’ in respect of such projects.¹³ Once the trigger had been met (for example, the ‘regulatory test’ had been conducted and passed) the revenue cap allowance would be adjusted to include the new project. Actual capital expenditure would then be included in the regulatory asset base at the end of the regulatory period (i.e. the TNOs do not consider it necessary to include a separate incentive arrangement for these projects).
- *Re-opening for unforeseen projects* – under which the costs for projects that had not been contemplated during the review of the revenue cap but subsequently emerge could be included in the revenue cap during the regulatory period (i.e. using the mechanism described in the Rule Proposal). A realistic threshold would need to be determined for such projects. The TNOs consider that a more appropriate threshold is 2 per cent of the regulatory asset base, provided that there is a parallel ‘contingent project’ regime as proposed above. Furthermore, the claw-back of efficiency gains on the ex ante capital expenditure would need to be removed to avoid penalising the TNSP for undertaking the efficient new investment in a timely fashion. However, the TNOs accept that it would need to be a more thorough review of the unforeseen project to satisfy the AER that the new project had not been included in the ex ante capital expenditure allowance, nor was a substitute for projects that were included in that allowance. It is noted that if the project emerged through the operation of the AEMC’s last resort planning power, then this onus should be easily satisfied.

The TNOs consider that the combination of these measures would provide the necessary incentives to deliver efficient projects in a timely manner, and to reduce the risk to both TNSPs and end-users from the difficulties associated with forecasting transmission capital expenditure. Of the measures, the TNOs consider the ability to specify contingent projects to be a particularly useful means of dealing with capital expenditure uncertainty, although both measures would be required to deal effectively

¹² AEMC, 2006, Rule Proposal Report, February, p.77.

¹³ Commissioner Woodward, Transcript of the Public Hearing on the Rule Proposal, 8 March 2006, p.12.

with the full range of potential projects (such as the ‘last resort planning power’ projects).

If the AEMC decides not to implement a ‘contingent projects’ regime as described above, we note that the threshold for the ‘re-opener’ regime would need to be reduced substantially in order to address the forecast risk and incentive problems discussed above for a material proportion of the ‘difficult to forecast’ or ‘unforeseen’ projects. While judgement is required when setting such a threshold, we consider that a \$10 million threshold would be appropriate, noting that this would align with threshold over which public consultation is required under the Rules for ‘regulatory test’ assessments of new investments.

3.2 Ex Post Capital Expenditure Assessments

3.2.1. Tests of prudence or efficiency are unnecessary

The Rule Proposal allows scope for the AER to undertake an ex post assessment of the ‘prudence or efficiency’ of the actual capital expenditure that was undertaken by the TNSP over the previous regulatory period.¹⁴

The TNOs note that, in developing the SRP incentive arrangements for capital expenditure, the AER concluded that the financial incentives created under the ex ante regime would be sufficient to obviate the need to undertake an administrative test of the prudence or efficiency of that expenditure. That is, the AER concluded that it was feasible – and preferable – to rely upon the incentive properties of the framework it had created, rather than to undertake an intrusive examination of, or to second guess, the historical investment decisions of the TNSPs.

The AEMC’s Rule Proposal largely adopts the AER’s ex ante regime for capital expenditure, and so the AER’s conclusion that it is unnecessary for administrative tests of prudence or efficiency to be undertaken continues to hold. Indeed, the TNOs note that an AER spokesperson confirmed at the AEMC public hearing on the Rule Proposal that it was never intended to undertake assessments of prudence or efficiency under the SRP regime, and there would be no intention for such a test to be undertaken under the regime set out in the Rule Proposal.¹⁵ Providing the option of a test of prudence or efficiency creates risk for the TNSPs as the AER’s commitments not to undertake such examinations are not binding, and it could reach a different view in the future (for example, if there is a change in Commissioners or key staff) to the detriment of TNSPs.

For these reasons the most appropriate course of action – and the one most consistent with the market objective – would be to remove the option of ex-post assessment from the Rule Proposal. If it is subsequently demonstrated that administrative tests of prudence or efficiency are required, then the Rules can be changed. Indeed, the TNOs note that a key intention behind the creation of the new institutional arrangements for the economic regulation of electricity was to provide a means for regulatory

¹⁴ Rule Proposal, clause 6.2.3(3)(4).

¹⁵ Sebastian Roberts, Transcript of the Public Hearing on the Rule Proposal, 8 March 2006, p.54.

commitments to be made binding, but subject to review through a transparent, industry wide process by an entity that is independent of the regulator.

3.2.2. Prudence test should be bounded if it remains

If the option of some form of administrative test of prudence or efficiency is to remain in the Rules, then the TNOs consider that three refinements to the provisions are necessary:

- First, the TNOs consider that the prudence test should only be applied where capital expenditure has exceeded the ex ante allowance that is factored into the revenue cap. In particular, it is noted that the ex ante allowance would have been subject to detailed review when the revenue cap was set, and hence would provide an appropriate threshold to be met before such an intrusive analysis would be undertaken.
- Secondly, the test should be limited to a test of the ‘prudence’ of expenditure, rather than a test of the ‘prudence or efficiency’ or ‘prudence and efficiency’ of that expenditure, and this test should be clearly defined in the Rules. A test of prudence, as commonly understood, implies an examination of whether the procedures that were followed by the TNSP when assessing a particular project were consistent with the standard of ‘good electricity industry practice’ and hence recognises the important practical aspects of planning and decision making and focuses most of its attention on the procedures followed (including risk management), and the fact that hindsight is never available at the time a decision is made. A test of efficiency, in contrast, focuses squarely on whether the optimal decision was made to invest. By its nature, a prudence test imposes a test that a TNSP can have some confidence that it can demonstrate it has met, especially if greater certainty about the conduct of the test is provided (see below). In contrast, a test of efficiency inevitably will come down to a judgement by the experts retained by the TNSP against the experts employed by the AER – with an inevitably uncertain outcome and risk to the TNSPs as a result. In addition, notwithstanding the (appropriate) requirement in the Rule Proposal to take account only of information available at the time the decision was made, it will be difficult for the AER not to take into account hindsight when testing the efficiency of a project. In contrast, hindsight is uninformative when testing the prudence of a project.
- Thirdly, greater guidance should be provided about how the prudence test would be conducted so that TNSPs can respond effectively to the incentive that is intended to be created, and in so doing, also minimise the risk that is created. The TNOs note that the factors in the Rule Proposal that the AER would be required to have regard to when undertaking an assessment of prudence provide guidance about the design of the prudence test (for example, to minimise investment uncertainty); however, there is no further guidance on the form of test. The TNOs consider that requiring the AER to issue a binding guideline about how it would undertake a prudence assessment would best provide this further guidance. The

ACCC/AER previously set out its approach to prudence testing under the ex post regime,¹⁶ which would be an appropriate model for such a test.

Turning to the specifics of the clauses in the Rule Proposal, the TNOs consider that clause 6.2.3(d) requires substantial amendment. In particular, the requirement for the AER to have regard to a ‘laundry list’ of factors is inappropriate and should be deleted. The task of the AER is to form a view, based upon a proper assessment of the facts and other evidence,¹⁷ about whether a decision was prudent. Hence, specifying a list of factors, which suggest that some form of trade off between competing objectives is required, is likely to misdirect the AER about the intended nature of its task. Rather, if the option of an ex-post assessment is to be retained, then we suggest that clause 6.2.3 contain a clear definition of ‘prudence’ and require the AER to publish a binding guideline that provides more detail about how it will administer this test. The most appropriate definition of ‘prudence’ is as follows:

Prudence (or prudent) means acting in a manner that is consistent with *good electricity industry practice* taking into account only the information and analysis that the *TNSP* can reasonably be expected to have considered at the time.

3.3 Forecasts of Capital and Operating Expenditure

3.3.1. ‘Propose-respond’ model is supported

The TNOs support the requirement in the Rule Proposal for the AER to accept the forecasts of expenditure if those forecasts are considered ‘reasonable’, which the AEMC has described as a form of ‘propose-respond’ model. As explained at length in our submission to the AEMC Issues Paper, the TNOs consider that the propose-respond model would promote the market objective for a number of reasons.

First and foremost, it would ensure that regulatory interventions occur only where justified, and so reduce the overall cost of regulation. Limiting the scope for the AER to intervene only to where it is warranted is also appropriate given the TNSP’s greater expertise in this area and potential liabilities where service obligations are not fulfilled. In addition, the requirement to accept the TNSPs’ forecasts if they are reasonable should lead to a greater recognition of the unique circumstances of the different TNSPs, which again is appropriate.

3.3.2. Clarity of the ‘factors’ guiding the AER’s assessment of ‘reasonable’

A central feature of the assessment process that the Rule Proposal would create for assessing capital and operating expenditure is a prescribed set of factors that the AER is required to consider when forming its view about whether the proposed capital and operating expenditure is reasonable. However, the TNOs do not consider that providing a ‘laundry list’ of factors for this purpose is likely to improve the quality of

¹⁶ AER, 2005, Statement of Regulatory Principles for the Regulation of Electricity Transmission Revenues, August, Appendix B, clause B.4.

¹⁷ The TNOs’ views about the provisions that should be included in the Rules regarding findings of facts and evidence are discussed in section 1.3.7.

the AER’s decisions, but consider that the factors are likely to misdirect the AER as to the true nature of the task that it is required to perform.

In particular, the TNOs note that the normal purpose of ‘factors’ in legislative instruments is to guide the decision maker towards the trade-offs between key objectives that he or she may need to make. In contrast, however, the task the AER is required to perform under clauses 6.2.6 and 6.2.7 is to make an assessment of whether a forecast of expenditure is reasonable, which requires a proper assessment of the facts and other evidence,¹⁸ and not discretions about how different objectives should be weighted. Moreover, the TNOs have serious concerns about either the relevance or clarity of most of the factors that have been proposed, which are set out in the table below.

TNOS’ CONCERNS ABOUT THE ‘EXPENDITURE FACTORS’

| No. | AEMC Rule Proposal | TNO Comment |
|-------|---|--|
| (i) | the information included in or accompanying the submission of the <i>Revenue Proposal</i> | The AER should be under a general requirement to consider information presented by all parties (but also under requirements with respect to what should be treated as ‘evidence’), and hence this factor is irrelevant. Moreover, its inclusion suggests that a trade-off may be required between the views in the proposal and other submissions or factors, which is inappropriate – all that is required is a proper finding of fact. |
| (iii) | submissions received in the course of consulting on the <i>Revenue Proposal</i> | As for Factor (i), this factor is unnecessary as the AER is already required to take account of submissions received. Moreover, to the extent that a submission is from a non-expert who is unqualified to advise on capital and operating expenditure requirements, such a submission should not be treated as evidence and hence should not be taken into account. |
| (iv) | such analysis as is undertaken by or for the AER and is <i>published</i> prior to or as part of the draft decision of the AER on the <i>Revenue Proposal</i> under clause 6.15.1(a) or the final decision of the AER on the <i>Revenue Proposal</i> under clause 6.16.1(a) (as the case may be) | This factor suggests the AER is permitted to rely on material analyses or evidence <u>that it had not disclosed to the TNSPs prior to making a final decision</u> , which is inconsistent with any concept of due process. |
| (vi) | reasonable estimates of the benchmark capital expenditure that would be incurred by an efficient <i>Transmission Network Service Provider</i> over the <i>regulatory control period</i> | It is highly inappropriate for the AER to be directed to consider the results of benchmarking analyses without also directing the AER to only take account of that analysis where it meets reasonable standards of robustness and reliability. |

¹⁸ The TNOs’ views about the provisions that should be included in the Rules regarding findings of facts and evidence are discussed in section 1.3.7.

| | | |
|--------|---|---|
| (viii) | the relative prices of operating and capital inputs | The reference to the ‘relative prices of capital and operating inputs’ is only relevant to the extent that substitution is available (and hence duplicates Factor (ix)), with this latter factor also considered inappropriate (see below). |
| (ix) | efficient substitution possibilities between operating and capital expenditure | This factor is unlikely ever to be of primary importance where the task is merely to forecast expenditure over the following five-year period, and hence including this matter as a ‘factor’ is likely to require substitution possibilities to be considered to a level that vastly exceeds its relevance. |
| (x) | whether the total labour costs included in the capital and operating expenditure forecasts for the <i>regulatory control period</i> are consistent with the incentives provided by the <i>service target performance incentive scheme</i> that is to apply to the <i>Transmission Network Service Provider</i> in respect of the <i>regulatory control period</i> | It is not at all clear what this factor is seeking to achieve and, in any event, including such a matter as a ‘factor’ is likely to require it to be given significance in the analysis that vastly exceeds its relevance. |

The TNOs also consider that three other elements of clause 6.2.6 are inappropriate and should be removed (the second of which also applies to the equivalent provision in clause 6.2.7). First, clause 6.2.6(b)(2) is confusing as to its intent and is technically redundant given the drafting in clause 6.2.6(b)(2). Secondly, the ability for the AER to reject a proposal on the basis that the information provided does not meet the relevant requirements (clause 6.2.6(b)(4)) is inappropriate given that AER would already have assessed the completeness of the information as part of an earlier process (clause 6.13). More generally, such a clause would permit the AER to reject a proposal where there were minor or technical breaches in the information provided, but no problem with the substance of the proposal. This is inappropriate. Thirdly, clause 6.2.6(c) is purely descriptive, and should also be removed to improve the clarity of the Rules.

The TNOs do not consider that further guidance is required for the AER in how it assesses the reasonableness of the proposed expenditure. As noted above, this exercise is one of making a finding of fact on the basis of evidence. The TNOs consider that guidance upon findings of fact and the taking of evidence is essential – but should have general operation (discussed in section 3.7 below). In light of the matters set out above, the TNOs’ consider that an appropriate re-draft of clause 6.2.6 is as follows:

| | |
|---|---|
| 6.2.6 Forecast capital expenditure | |
| (a) | The <i>TNSP</i> is entitled as part of the <i>AER</i> ’s draft decision pursuant to clause X.X [draft decision] or clause X.X [final decision] to receive sufficient allowance for forecast capital expenditure to: |
| (1) | comply with all applicable <i>regulatory obligations</i> associated with the provision of |

- prescribed services;
- (2) maintain the quality, reliability and security of supply of *prescribed transmission services*;
 - (3) maintain the quality, reliability and security of the transmission system through the supply of *prescribed transmission services*; and
 - (4) meet the expected demand for *prescribed transmission services* over that period.
- (b) The *TNSP* must as part of the *Revenue Proposal* it submits pursuant to clause X.X [initial proposal] or clause X.X [revised proposal], include a forecast of the capital expenditure for each *regulatory year* of the *relevant regulatory control period* which the *TNSP* considers is a reasonable estimate of the *prudent* expenditure required to meet items (1) to (4) in clause 6.2.6(a). The forecast capital expenditure must accord with the *Cost Allocation Methodology*.
 - (c) The *AER* must in its draft decision pursuant to clause X.X [draft decision] or clause X.X [final decision] accept the forecast capital expenditure referred to in clause 6.2.6(b) except to the extent that the *AER* is satisfied that the forecast supplied by the *TNSP* pursuant to clause 6.2.6(a) is not a reasonable estimate of the *prudent* capital expenditure required to meet items (1) to (4) in clause 6.2.6(a).
 - (d) If the *AER* is required to substitute its own decision pursuant to clause X.X, then in doing so it must:
 - (1) only depart from the *Revenue Proposal* to the extent that clause 6.2.6(c) applies; and
 - (2) substitute values that the *AER* considers are reasonable estimates of the values concerned.
- Prudence** (or prudent) means acting in a manner that is consistent with *good electricity industry practice* taking into account only the information and analysis that the *TNSP* can reasonably be expected to have considered at the time.

Alternatively, if the AEMC considers it essential for the AER to be provided with a set of factors to guide its assessment of capital and operating expenditure forecasts, the TNOs consider that these factors should relate only to the key drivers of expenditure and be expressed as being factors that are additive and hence where trade-offs are not required. The most appropriate factors for this purpose are those the TNOs included in our Model Rules, which, for capital expenditure, were:

- 41.1 the current and projected condition of the relevant transmission network;
- 41.2 the current and projected utilisation of the relevant transmission network and growth in demand;
- 41.3 the capital intensive nature of transmission investments and the economies of scale available in undertaking such investments;
- 41.4 any service standards or regulatory obligations that apply or are reasonably expected to apply to the relevant *TNSP* over the new regulatory period; and
- 41.5 projects over the *regulatory period* that are reasonably expected to pass the *regulatory test*.

For operating expenditure, the drivers identified in the TNO Model Rules were:

- | | |
|------|--|
| 47.1 | the level of <i>operating expenditure</i> incurred during the previous regulatory period and trends in expenditure reasonably expected over the <i>new regulatory period</i> ; |
| 47.2 | the current and projected condition of the relevant transmission network; |
| 47.3 | the current and projected utilisation of the relevant transmission network; |
| 47.4 | any <i>service standards</i> or <i>regulatory obligations</i> that apply or are reasonably expected to apply to the relevant TNSP over the <i>new regulatory period</i> ; and |
| 47.5 | the expected cost associated with the operation of the <i>incentive arrangements</i> for <i>service performance</i> for the new regulatory period. |

3.4 Criteria for 5-yearly review of the WACC and other WACC Issues

3.4.1. 5-year industry WACC and use of SRP parameters

The TNOs support the proposal for the relevant WACC input parameters and methodologies to be redetermined through a single process for all TNSPs on a five-yearly cycle. It is noted that the use of a single process will reduce the costs borne by both the industry and the AER in this matter, as well as permitting a more considered and informed assessment of cost of capital related matters and better decisions as a result.

The TNOs also support the adoption (for the most part) of the WACC input parameters and methodologies that are set out in the AER's SRP for the initial 5-year period. As argued in our submission in response to the AEMC Issues Paper, the SRP was the product of substantial consultation over a number of years, and we saw little merit in reopening the question of the appropriateness of all of the WACC parameters so soon after that exercise had concluded.

That said, we welcome the AEMC recognising that the ACCC/AER's acknowledgement that the WACC should be neutral with respect to ownership and that the ACCC/AER's use of an A-rating for the debt margin was unduly influenced by the public ownership of some TNSPs.¹⁹ The AEMC's recognition of the arguments that a number of the TNSPs have made in previous revenue cap reviews will enhance further the environment for investment in the industry.

3.4.2. Criteria for re-determining the WACC

The TNOs note that there is little guidance provided in the Rule Proposal for the AER when undertaking its periodic review of WACC parameters and methodologies (the first review of which is scheduled to commence from 2011). Indeed, the only guidance provided is that the values 'be based upon a benchmark efficient Transmission Network Service Provider'.

¹⁹ AEMC, 2006, Rule Proposal Report, February, p.64.

Our submission in response to the AEMC Issues Paper noted that it is now well understood that the precision of estimates of the cost of capital is very poor. Hence it is possible for an independent expert's estimate of the cost of capital to vary substantially from review to review, even if the 'true' (but unobservable) cost of capital has not changed. Therefore, there is the potential for large changes in 'best estimates' of the WACC associated with the provision of regulated transmission services across regulatory periods.

We also noted that the Productivity Commission's review of the Gas Access Regime, and more recently the report from the Prime Minister's Task Force on infrastructure bottlenecks, identified the need for regulators' decisions on allowed returns to be made in a way that is likely to provide incentives for more, rather than less investment in infrastructure. In reaching this conclusion, the Productivity Commission noted the scope for regulatory error, asymmetric risks, and the high potential cost to society as a whole associated with setting the regulatory return below the actual cost of capital. Specifically, the Productivity Commission found that the cost of under-investment in national infrastructure far outweighs the detriment of (possibly) higher access prices.

Our submission in response to the AEMC Issues Paper discussed in some detail the nature of the criteria that we considered should guide the AER when reviewing the relevant WACC inputs, which were set out further in the TNO Model Rules. The specific objectives that we proposed were to:

- ensure that the AER takes account of the key lessons from the Productivity Commission's review of Australia's infrastructure access regimes (i.e. to ensure that the *level* of the WACC is consistent with the importance of the provision of sufficient infrastructure over the long term);
- put in place measures that will provide a discipline for regulatory returns to remain stable from review to review except where there is reliable evidence to support a change (that is, except for inputs that reflect easily observable movements in market variables, like interest rates); and
- otherwise, the important existing methodologies for deriving the regulatory return should be prescribed in the Rules.

The TNO's specific proposals in this regard are that, when calculating the regulatory return:

- the outcome provides an appropriate, risk-adjusted return;
- the return be calculated as a weighted average of the costs of equity and debt;
- the CAPM be used to estimate the cost of equity;
- the cost of debt reflect the current cost of borrowings for comparable debt;
- all parameters should be benchmarks (as opposed to reflecting actual decisions or costs); and
- for the parameters where there is uncertainty, the AER should be required to:

- consider the market objective when considering the likelihood that the regulatory return is understated; and
- satisfy itself explicitly that current evidence on the input is sufficient to justify a change from the value adopted in the last review.

The TNOs consider that these objectives and criteria for the AER’s review of WACC parameters remain valid. We also consider that our translation of these criteria into draft Rules in the TNO Model Rules remains appropriate, which is as follows.

| <i>Regulatory Return and Company Taxation</i> | |
|--|--|
| 35. | The <i>regulatory return</i> must provide a return that is commensurate with the prevailing conditions in the market for funds and the risk involved in delivering the <i>revenue capped services</i> , which must be estimated by applying the following criteria: <ul style="list-style-type: none"> 35.1 the estimate must reflect a weighted average of the estimates of the returns required by providers of equity and debt for the activity of providing <i>revenue capped services</i>, with the weights reflecting a <i>benchmark assumption</i> for the gearing level; 35.2 the estimate of the required return to equity providers in clause 35.1 must reflect a <i>benchmark assumption</i> about the required return on equity investments in the activity of providing <i>revenue capped services</i> and which must be estimated using the capital asset pricing model; and 35.3 the required return to debt providers in clause 35.1 must reflect a <i>benchmark assumption</i> about the return required for the provision of debt finance for the activity of providing <i>revenue capped services</i> that is sourced in Australian capital markets. |
| 36. | The allowance for company taxation pursuant to clause 27.4 must be calculated using <i>benchmark assumptions</i> about the relevant inputs to the calculation, including: <ul style="list-style-type: none"> 36.1 the available interest deductions; 36.2 revenue and expenses; and 36.3 tax depreciation allowances. |
| 37. | For the purpose of clauses 35 and 36, a <i>benchmark assumption</i> must: <ul style="list-style-type: none"> 37.1 reflect a notional value or decision rather than the actual value or decision attributable to or made by the TNSP; 37.2 where the derivation of a <i>benchmark assumption</i> requires an assumption about a decision that a TNSP would make, reflect the decision that would be expected of an efficient firm that is providing the same revenue capped services, and subject to the same obligations, as the TNSP; 37.3 where the derivation of a <i>benchmark assumption</i> requires an assumption about a particular cost or like matter, reflect an estimate of the cost payable by an efficient firm that is providing the same revenue capped services, and subject to the same obligations, as the TNSP; and 37.4 be consistent with all other <i>benchmark assumptions</i> that are used in the calculation of the <i>revenue cap</i>. |
| 38. | Where uncertainty exists with respect to an input that is used to estimate the return referred to in |

clause 35, that input must be derived such that:

- 38.1 the likelihood that the *regulatory return* will understate the return referred to in clause 35 is low, having regard to the *market objective*; and
 - 38.2 the value for the comparable input that was adopted at the time the previous *revenue cap* was determined must continue to be applied except where the evidence for changing the value is highly persuasive, having regard to the *market objective*.
39. The AER must maintain a Guideline that defines standard input assumptions or methodologies for deriving the regulatory return referred to in clause 35, which must meet the criteria that apply to the derivation of that return. The *regulatory return* included in the *revenue cap package* for the *new regulatory period* must use the standard input assumptions or methodologies set out in the Guideline in force six months prior to the time that the TNSP was required to submit a *new revenue cap package* pursuant to clause 2, unless agreed otherwise between the AER and TNSP.

3.4.3. Inflation forecast and benchmark assumption for taxation depreciation

There are two matters upon which the TNOs consider that refinements are warranted for the guidance that is provided to the AER in relation to the calculation of the regulatory return and calculation of company taxation over the initial five year period.

INFLATION FORECAST

While the Rules Proposal prescribes values or methods for most of the key financial inputs, it is silent on the forecast of inflation. Where a nominal version of the regulatory return is used (as the Rule Proposal would require) and revenues and regulatory asset values are adjusted for inflation, the forecast of inflation is a key input. An error in the inflation forecast is equivalent to a one-for-one error in the regulatory return.

The TNOs consider that the Rules should direct the inflation forecast that is adopted to reflect a ‘best’ forecast, which in turn would imply that it uses the latest information available, adopts the best techniques and considers reliable evidence. A more technical specification would be to require the forecast to be a ‘statistically unbiased’ forecast.

The TNOs note that the dominant method that is used by Australian regulators to forecast inflation is to use the difference between the yield on the nominal government bond rate and the yield on the inflation-linked bonds of the same term to maturity. While the TNOs do not consider that this method necessarily should be precluded, it would be highly inappropriate for the Rules to prescribe the use of inflation-linked bonds (unadjusted) to obtain the forecast of inflation.

It is well recognised that the market for inflation linked bonds is very small and is expected to decline in volume over time.²⁰ This means that the observed yields may

²⁰ The Commonwealth Government has stated that it does not intend to issue additional inflation linked bonds. Of the four series that were in circulation year ago (maturities of 2005, 2010, 2015 and 2020), the 2005 series matured and hence disappeared in August last year and the 2010 series

not provide an accurate reflection of the real risk free rate if unusual events occur. Indeed, the Victorian Essential Services Commission has adjusted the observed yield on inflation linked bonds for expected biases in both of its reviews of the price controls for the Victorian electricity distributors. Moreover, it has been noted in a number of submissions that part of the difference between nominal and real bonds will reflect an inflation risk premium, which means that the difference between these bond yields will overstate expected future inflation. Even if this inflation risk premium (and hence the upward bias in inflation forecasts) has been low in recent years, it would become material if inflation began to rise. Accordingly, the TNOs consider that the method that is used to forecast inflation should be a matter that is left to be resolved in the context of reviews of revenue caps, having regard to the best evidence available at that time.

TAX DEPRECIATION CALCULATION

While the Rule Proposal makes it clear that the interest deduction that is used in the estimation of corporate income tax must reflect a benchmark, the Rule Proposal would appear to require a firm's *actual* tax depreciation allowance to be used in this calculation. While the TNOs would expect the rates of depreciation that are available for tax purposes to be used in taxation calculations (as the AER does at present), the issue of concern is what is adopted as the tax asset value (i.e. the value that is assumed to be depreciated for tax purposes) and, in particular, how acquisitions are to be treated.

In Australia, depending on how transactions are structured, a purchaser of an asset may be able to reset the taxation asset value to the purchase price of the asset. Accordingly, if the TNSP's actual tax depreciation deductions are to be used when calculating the allowance for company tax in regulated revenues, a number of unwanted or perverse results may follow. First, regulated revenues will no longer be independent of ownership decisions, but will be influenced by the purchase prices that are paid for assets – inconsistent with the AEMC's view that 'a core principle of good regulation is that it is neutral with respect to ownership'.²¹ Secondly, the taxation asset value may turn out to be above the regulatory asset value – which would amount to the use of an inconsistent (and unreasonable) choice of benchmarks.²²

The more appropriate method for accounting for the taxation asset value (and hence calculating tax depreciation) is to set an initial taxation asset value for the regulated assets (which has been done for all of the existing TNSPs) and to then roll that value forward, mirroring the approach used for the regulatory asset value, ignoring the effects of sales/acquisitions. This method – which is the standard approach of the

will mature and disappear prior to the proposed review of the WACC parameters by the AER in 2011.

²¹ AEMC, 2006, Rule Proposal Report, February, p.51.

²² The implicit assumption behind the value that is determined for regulated assets is that an efficient investor could have constructed or purchased an asset for that amount (after accounting for depreciation) – this is the reason that a return is only required on the regulatory asset value. Accordingly, choosing a taxation asset value that is higher than the regulatory asset value implies assuming that the tax authorities would permit more than the cost of the asset to be depreciated for tax purposes – which is not permitted by tax law.

ACCC/AER and Victorian ESC (where a number of subsequent sales/acquisitions have occurred) – implies that the tax depreciation calculation is a benchmark, which should in turn be reflected in the Rules. Clauses 36-37 of the TNO Model Rules, quoted above, addressed this matter adequately.

3.5 Service Performance Incentive Arrangements

In our submission in response to the AEMC Issues Paper, we noted a number of objectives and design criteria for the service performance incentive arrangements. A key concern was that the appropriate role of service incentive arrangements be to focus on encouraging efficiency in TNSPs' *operating decisions*, rather than to seek to influence *investment decisions*, which, in broad terms, implies setting incentives to encourage a TNSP to optimise the availability of its assets and resulting capacity to meet the needs of market participants. The reasons why it is appropriate for the service incentive arrangements to focus on operating decisions only are a function of the following constraints:

- reliability and other non-discretionary projects account for nearly all of TNO capital expenditures, leaving little scope for financial incentives on investment to play a useful role; and
- adequate incentives and other measures exist already to encourage the TNSPs to undertake efficient discretionary investments – which are discussed further below.

A second key concern was to ensure that the risk imposed on TNSPs by the service incentive regime is kept to a reasonable level, for the reasons discussed above (section 2.1). A third element of the TNO position was that the AER should remain as the designer of the detailed arrangements, but should be required to publish a guideline setting out the details of the arrangements.

The TNOs generally support the service performance incentive arrangements set out in the Rule Proposal and understand these to be aimed at improving the availability of transmission services, taking into account when these services are most valued by the market. Some refinement to the Rule Proposal is needed to make clear this intent. We note in this context that market participants emphasised at the AEMC Public Hearing the importance of notice and predictability with respect to the availability of transmission assets, for example with the representative of the National Retailers Association of Australia commenting as follows:²³

The issue was not so much the absolute level of transmission investment. It's the unpredictability of the operations of the transmission system that causes us problems.

In addition, while we welcome the need for the risk positions of TNSPs to be protected, we consider that it would be appropriate to permit a TNSP to propose a higher revenue threshold than 1 per cent if it considers it appropriate. We note here that SP AusNet already is subject to a (jurisdictional) scheme that exposes it to greater risk. However, the departure from the 1 per cent threshold must be at the discretion of the TNSP to ensure that the intended protection remains.

²³ Mr Cruickshank, Transcript of the Public Hearing on the Rule Proposal, 8 March 2006, p.38.

More broadly, while the TNSPs consider that the requirements of the new Rule could be met with only incremental changes to the current service performance incentive arrangements (for example, by changing the existing performance measures to differentiate the importance of outages by network element or time), we welcome the opportunity to respond to the needs of market participants and the market more generally in this area. Accordingly, we will participate actively in the refinement of the existing service performance incentive arrangements as encouraged by the AEMC.

3.6 Negotiated Services and Negotiation Framework

3.6.1. Negotiation arrangements and distribution connections

While the TNOs welcome the AEMC's intention to pursue 'less intrusive' forms of regulation and 'commercial negotiation', we note that the pricing and other principles contained in the Rule Proposal imply that negotiated pricing will inevitably be constrained to cost. Hence, the TNOs do not consider that their financial outcomes will differ materially to the situation where the relevant services or projects are part of the revenue cap.

In addition, we question the merits of removing connection services to distributors from the definition of prescribed services. Commercial negotiation in relation to distribution connection services may not be feasible given that transmission costs are generally a cost pass through for distributors. Removing these services from the revenue cap may also create price uncertainty for distribution customers. In addition, these assets, in general, form part of shared network services provided by transmission and distribution networks. As such there appears to be no measurable benefit to consumers in having them treated differently from other prescribed services. On the other hand there is scope for additional administrative costs to arise that would ultimately be carried by consumers.

3.6.2. Recognition of contestable services

The AEMC's definition of Negotiable Services includes connection services that are contestable, which are currently non-regulated and for which there is no justification for extending the scope of regulation.

While the TNOs welcome the AEMC's confirmation that it did not intend to extend regulation to contestable services,²⁴ changes to the Rule Proposal are required in order to give effect to the AEMC's intention. We consider it important for the Rules to clearly exclude contestable transmission services from the definition of the services that are subject to the negotiate/arbitrate regime (i.e. 'negotiated services'). We welcome the opportunity to work with the AEMC and other stakeholders through the working group the AEMC has established to develop definitions for 'prescribed' and 'negotiable' services that exclude contestable services, and with the definitions so produced to be clear in their operation.

²⁴ Commissioner Carver, Transcript of the Public Hearing on the Rule Proposal, 8 March 2006, p.50.

3.6.3. *Negotiation for generation access arrangements*

Our submission in response to the AEMC Issues Paper discussed at length the substantial practical difficulties associated with the provision of ‘generator access’ services as currently defined in the Rules,²⁵ and the potential for unacceptable risk to be imposed on the TNSPs as a result.²⁶ We noted that one plausible outcome for such a service is the provision of ‘firm access’ to the generator, which indeed has been the service sought in applications to the TNSPs.²⁷ We noted in our response to the AEMC Issues Paper that, before the AEMC sought to promote the greater use of ‘generator access’, it should first clarify the intended scope of ‘generator access’ and, in particular, the intended role (if any) and design of capacity rights to generators. We also noted that this is a matter that would need to be considered on a market-wide basis, but was outside of the scope of the current review.

The TNOs, therefore, welcome the AEMC’s confirmation of its intention that it does not intend to require capacity rights to be granted to generators in return for funded augmentations:²⁸

There is equally no intention at this stage of the process, given of course we are still going through the exercise of looking at pricing questions ... to introduce the notion of a generator right to firm or firmer access. What we are seeking to achieve in the negotiated services regime is an environment in which, if a generator wishes to achieve firmer access – ... the term ‘firm access’ is generally associated with ideas of property rights, and we are not at this stage going anywhere near those sorts of propositions. But if there is a desire by a generator to achieve firmer access by contributing to the funding of augmentations, then we want a commercial negotiation regime in which that can - where the two parties can come together and resolve matters that might be in dispute. Again if the draft rules actually don’t really deliver that proposition, we need to re-look at the drafting.

Notwithstanding the AEMC’s intentions, however, the effect of the AEMC’s Rule Proposal would be to substantially increase the risk that the TNSPs could be required to provide ‘firm access’ and be potentially exposed to substantial market risk as a result. In particular, the AEMC has proposed to:

- include a new clause 5.4A that is intended to clarify that the ‘generator access’ provisions apply to the TNSPs; and

²⁵ ‘Generator access’ is defined in the Rules as ‘[t]he power transfer capability of the transmission network and/or distribution network in respect of the Generator’s generating units or group of generating units at a connection point which has been negotiated between the Generator and the relevant Network Service Provider in accordance with clause 5.5.’ Clause 5.5(f)(5) envisages that the TNSP would pay compensation to the generator where it is constrained off as a result of insufficient transfer capability at its connection point.

²⁶ Transmission Network Owners, 2005, Response to AEMC Issues Paper on Revenue Requirements, November, p.37.

²⁷ This potential arises because clause 5.5 envisages that compensation would be paid by the TNSP to the generator if it is constrained off or constrained on during a trading interval. If these compensation arrangements are structured around market outcomes, then the generator’s right would be equivalent to ‘firm access’. We note, however, that TNSPs are only required to negotiate generator access to the extent that those arrangements are consistent with ‘good electricity industry practice’ (clause 5.5(e)).

²⁸ Commissioner Carver, Transcript of the Public Hearing on the Rule Proposal, 8 March 2006, p.50

- to permit disputes about terms for ‘generator access’ to be resolved through the proposed new (and highly abbreviated) dispute resolution process.

The effect of these provisions is that the risk that the TNSPs will be required to provide ‘firm access’ to generators as part of a generator access arrangement has increased substantially.

As a minimum, the TNOs consider that the AEMC should not change the existing Rules that deal with ‘generator access’ (currently clause 5.5) and not apply the Chapter 6 arbitration provisions to this service, until it has considered properly the intended operation of the ‘generator access’ provisions and created more certainty for all market participants in this regard. This is a matter that needs to be resolved at an industry level, which is outside of the scope of the current review. The TNOs also consider it highly inappropriate for the details of ‘generator access’ – and the matter of whether firm access should be provided and how – to be considered in an arbitration process between a single generator and TNSP.

Alternatively, if the AEMC considers it important for the negotiation framework to apply to generator-requested augmentations on the shared network but without any form of capacity right (or financial arrangement that has the same effect as a capacity right) being provided in return, then a new service that has these characteristics should be defined.

3.7 Assigning weight to expert evidence and due process

The Rule Proposal includes a new requirement for TNSPs to submit the following in relation to capital expenditure forecasts that are contained in their revenue proposals:²⁹

- (e) a certification of the reasonableness of the key assumptions by an independent and appropriately qualified expert
- (f) a certification of the reasonableness of the capital expenditure forecasts by an independent and appropriately qualified expert

Identical provisions apply with respect to operating expenditure.³⁰

The TNOs support the requirement in the Rule Proposal for TNSPs to submit a report from an independent and appropriately qualified expert that effectively gives assurance of their expenditure forecasts, noting that this will provide additional discipline on the TNSPs regarding the rigour of their forecasting methods. This discipline, in turn, should increase the likelihood that the AER will accept those forecasts (and hence reduce the cost and controversy of revenue cap reviews). However, the TNOs consider that a requirement for them to obtain independent and expert assurance of their forecasts will achieve little in the way of improvements in the efficiency of the regulatory process unless the Rules also direct the AER to accord the certification with a commensurate weight in its analysis.

²⁹ Rule Proposal, Schedule 6.9.1(e)-(f).

³⁰ Rule Proposal, Schedule 6.9.2(f)-(g).

More generally, in our submission in response to the Issues Paper, we noted our concern that the accountability requirements that existed in the previous Code had not been sufficient to ensure that the ACCC properly considered the matters tabled before it and reached well-founded, predictable conclusions. One of the concerns that we expressed in particular was the ACCC weighting of certain information placed before it. Our concerns in this regard include placing insufficient weight on material that the TNSPs have submitted from independent and appropriately qualified experts, as well as the ACCC placing excessive weight on reports that it has commissioned from parties who were not qualified to advise on the relevant matter or who expressed incomplete or insufficiently justified conclusions.

Accordingly, the TNOs consider that the quality of decision making would be improved by the Rules including a provision with general application that directs the AER as to the weight that it should assign to the evidence that it receives. Such a provision would aim to ensure that all of the evidence of a technical nature that it takes into consideration when assessing a revenue cap application meets basic tests for quality, including that:

- the evidence is obtained only from individuals who have appropriate expertise in the matter;
- is supported appropriately by evidence that can be replicated by third parties, and
- makes clear conclusions, taking account of the full context within which the evidence will be used.

The TNOs consider that the following provisions would provide appropriate guidance about how the AER should weigh evidence and reach its findings.

X.X.X Preparation and use of expert material under this Chapter

- (a) In making decisions under this Chapter, the AER must base its decisions only on the factual material available to it and suitable expert opinion.
- (b) For an expert opinion to be taken into account by the AER, the TNSP, interested party or AER procuring the opinion (as the case may be) must brief the expert in writing setting out:
 - (1) the questions which the opinion is to address;
 - (2) which provisions of the Rules is the opinion to be an input to; and
 - (3) any facts or assumptions upon which the expert is requested to rely.
- (c) For an expert opinion to be taken into account by the AER, the expert must:
 - (1) express the opinion in signed, written form;
 - (2) set out the breadth of the expert's relevant expertise and experience; and
 - (3) set out in the opinion the facts, assumptions, matters and circumstances of the report, the expert's conclusions and the process of reasoning used to reach those conclusions.
- (d) In respect of each expert opinion which the AER procures, the AER may only take the opinion

into account:

- (1) if the opinion is prepared prior to the draft decision published pursuant to clause X.X; or
 - (2) to the extent that the matters addressed in the opinion were first raised by the TNSP after the draft decision.
- (e) If the AER procures an expert opinion, before publishing the report it must provide a copy of the opinion to the TNSP a reasonable time prior to publication to enable the TNSP to:
- (1) identify any confidential inputs; and
 - (2) to enable the TNSP to undertake or prepare for any necessary or appropriate internal and external disclosure.

In addition, in past revenue cap reviews, there have been a number of instances where the TNSPs have not been shown, and had an opportunity to make submissions on, key reports commissioned prior to decisions being made (including final decisions). Similarly, there have been instances where substantial changes in key approaches or methodologies have been adopted in decisions (including final decisions), again in circumstances where the opportunity to make submissions was not provided.

These practices are not conducive to regulatory decisions being fully informed, and also create an environment where the discipline to make high-quality decisions is not optimised. The TNOs consider that the inclusion of Rules that impose explicit obligations on the AER to comply with best-practice transparency and due process requirements would substantially improve the quality of regulation, and hence promote the market objective.

The relevant clauses in the TNO Model Rules – which the TNOs consider to be appropriate – are as follows.

Process in Relation to Expert Advice or Analysis

13. Where the AER proposes to take into account expert advice or analysis when making a draft or final determination not provided by the TNSP, the AER must:
 - 13.1 make a copy of that advice available to the TNSP prior to making the draft or final determination (whichever is relevant);
 - 13.2 if requested by the TNSP, secure the attendance of the author of the advice or analysis at a meeting with the TNSP to explain further the advice; and
 - 13.3 specify a reasonable time within which the TNSP may respond to the advice or analysis (which time must not be less than 15 business days).

New Material Matters Prior to the Final Determination

14. Where the AER is considering adopting a finding, conclusion or methodology on a material issue in a final determination that differs in a material way to the finding, conclusion or methodology adopted in a draft determination, and the different finding, conclusion or methodology had not been foreshadowed as an option in the draft determination or advocated in a submission to the draft determination, the AER must:

- | | |
|------|--|
| 14.1 | inform interested parties of the finding, conclusion or methodology that it is considering and any material matters under consideration that are relevant thereto; and |
| 14.2 | specify a reasonable time within which the interested party may make a submission on the matter (which time must not be less than 15 business days). |

3.8 Pass through arrangements and redetermination for ‘catastrophic’ events

The TNOs welcome the inclusion of ‘pass through’ arrangements for a set of defined events (namely, for defined changes to insurance, service standards, taxes, a terrorism event and a defined change to grid support payments). However, we consider that two changes to the arrangements are appropriate.

First, the proposed materiality threshold of 1 per cent of revenue amounts to more than \$4 million per annum for the largest of the TNSPs.³¹ As the rationale for having a threshold for pass through applications is to dissuade such applications where the administrative costs exceeds the benefits, we consider this threshold to be excessive. If the AEMC considers that a threshold for pass through applications is warranted, we consider that the Rules should simply require the pass through to be a ‘material’ amount, and to permit this to be determined having regard to the circumstances of an individual pass through application. Amongst other things, this would provide the flexibility to deal with multiple separate (but connected) events, events that may span two or more regulatory years, and other like matters that a prescriptive threshold may not adequately address.

Secondly, additional pass through events may also be appropriate for the unique circumstances of individual TNSPs, and hence the TNOs consider that the flexibility for additional pass through events to be defined during a review of the revenue cap should be allowed for, subject to clear criteria about when they would be appropriate. Such a mechanism was proposed in the TNO Model Rules, the relevant clause from which was as follows:

Supplementary Pass Through Events

- | | |
|------|---|
| 56. | Any <i>supplementary pass through events</i> as contemplated by clause 70 must meet the following criteria: |
| 56.1 | relate to an event whose occurrence and consequences is substantially outside of the control of the TNSP; and |
| 56.2 | where the transfer in risk from the TNSP in respect of that event would promote the <i>market objective</i> . |

In addition, the TNOs also consider it appropriate for the Rules to permit the revenue cap to be revoked and redetermined if a TNSP suffers a catastrophic event. In this case, a materiality test would not be inappropriate; however, the clause should permit the allowances for both operating and capital expenditure to be redetermined, and also

³¹ The TNOs note that any materiality threshold would not apply to grid support.

to permit expenditures (including operating expenditures) that may have occurred prior to the revenue cap being redetermined.

3.9 Commercial stranding risk

The TNOs welcome the general proposition in the Rule Proposal that ‘regulatory stranding’ of assets is to be precluded in respect of the bulk of transmission assets. However, the Rule Proposal includes the threat of having shared assets that are dedicated to one or a few customers ‘stranded’ if the TNSP has not adequately sought to manage the risk of assets no longer contributing to the provision of the service, either by negotiating for those customers to enter into arrangements that provide a reasonable allocation of the risk to that customer, or to negotiate a lower price with that customer.

The TNOs consider the requirements of these provisions to be excessively vague and to expose the TNSPs potentially to considerable risk.

First, the stranding arrangements can only apply to assets that are part of the ‘shared’ network (at least in the future), given that connection services will either be negotiated services (for distribution connections) or contestable services, and excluded from the regulatory asset base. However, while specific assets may well be caused by individual (large) increases in load, the physics of electricity transmission means that it is seldom the case that parts of the shared network are solely for the benefit of individual customers.

Secondly, even for augmentations to the shared network that are caused by individual customers, TNSPs have little scope to require customers to enter into take-or-pay agreements to underwrite the investment. In particular, most TNSPs are subject to obligations with respect to the reliability of the shared network, and are required to augment the shared network if required to meet those obligations. The TNSPs also face more general competition law obligations not to frustrate or hinder access to the network.

Accordingly, if it is intended for the Rules to require such a risk reallocation for new projects, the precise arrangements contemplated need to be spelled out in the Rules (and hence that behaviour authorised by the Rules), and for such arrangements to take account of the TNSPs existing reliability obligations.

3.10 Procedures for changing guidelines

The TNOs support the requirement for the AER to issue (binding) guidelines on a number of matters, noting that this was a central component of the TNO Model Rules. However, the effect of this regime is that many important decisions are made in the setting of those guidelines rather than in reviews of revenue caps. Accordingly, it is important that the procedural and other requirements in the Rules that apply to changes to guidelines are as robust as the procedural and other requirements that apply to revenue cap reviews. The TNO Model Rules addressed this matter as follows.

Process for Issuing or Changing a Guideline

88. As part of its consideration of issuing a Guideline or changing an existing Guideline, the AER must:
- 88.1 release a consultation paper that identifies any material issues under consideration in relation to the Guideline or changes to an existing Guideline and specify a reasonable time within which interested parties may make a submission on the consultation paper (which time must not be less than 30 business days);
 - 88.2 release a draft Guideline or draft changes to an existing Guideline and specify a reasonable time within which interested parties may make a submission on the draft Guideline or draft changes to an existing Guideline (which time must not be less than 30 business days);
 - 88.3 if requested by any interested party on or before the date on which submissions on the draft Guideline or draft changes to an existing Guideline are due in accordance with clause 88.2, convene a public forum after the receipt of those submissions and provide all interested parties with a reasonable opportunity to:
 - 88.4 elaborate on matters raised in their submissions on the draft Guideline or draft changes to an existing Guideline;
 - 88.5 respond to the arguments or material advanced or relied upon in the draft Guideline or draft changes to an existing Guideline; and
 - 88.6 respond to the arguments or material advanced in other any submissions; and
 - 88.7 after the public forum, provide a further reasonable time within which any interested party may make a submission on any matter arising from the public forum (which time must not be less than 15 business days); and
 - 88.8 issue a final Guideline or final changes to an existing Guideline.
89. The AER must publish reasons for any draft Guideline or draft changes to an existing Guideline and reasons for any final Guideline or final changes to an existing Guideline. Those published reasons must set out:
- 89.1 sufficient detail of analysis underlying the determination of the elements of the Guideline or changes to an existing Guideline to enable that analysis to be replicated, including (where relevant) disclosure of methodologies adopted, disclosure of options considered, reasons for assumptions or judgements made in material qualitative and quantitative analyses and values adopted in material calculations;
 - 89.2 a response to all submissions received, including the manner and extent to which the AER has taken account of that submission; and
 - 89.3 for all matters where the AER has had to consider and apply weight to contradictory pieces of evidence, an analysis of whether, and the extent to which, the AER has given weight to the evidence and how that evidence was adopted in the AER's determination as required by clause 17.
90. The AER must comply with the criteria set out in clauses 13 to 17 as modified below when considering whether to issue a Guideline or to change an existing Guideline:
- 90.1 all references in clauses 13 to 17 to a draft determination shall be taken as references to draft Guideline or draft changes to an existing Guideline;
 - 90.2 all references in clauses 13 to 17 to a final determination shall be taken as references to

final Guideline or final changes to an existing Guideline; and

- 90.3 all references in clauses 13 to 17 to an assessment of a *revenue cap package* shall be taken as references to considering whether to issue a Guideline or to change an existing Guideline.

In addition, given the significance of the decisions that will be made outside of revenue cap decisions, the TNOs consider it essential for merit review (which we understand is to apply to defined AER decisions) to apply equally to AER decisions to change guidelines. While the TNOs note that the AEMC is not the decision maker with respect to the scope of merit review, the TNOs request that it bring to the attention of Government Officials the implications for the Rule Proposal for the appropriate scope of merit review.

4. Drafting issues with the Rule Proposal

The TNOs note that the Rule Proposal is very dense and is not drafted in a manner or sequence that makes it easy for even an experienced analyst to readily follow or understand. While the TNOs support the proposition that the Rules should codify regulatory practice in a number of areas – which necessarily requires a degree of prescription in the Rules – we note that over-prescribing matters brings with it its own risks, such as the potential to inadvertently omit important matters or a mismatch between intent and application. The TNOs also need to communicate the nature of their regulatory arrangements to parties outside of the small number of experienced Australian regulatory analysts (for example, international debt providers), which is not assisted by complexity in the regulatory arrangements.

The TNOs note that much of the methodology that is codified into the Rule Proposal reflects standard practice that is generally understood amongst regulatory experts and AER, which means that the intended degree of certainty should be able to be provided in a more economical and accessible manner.

Therefore, we urge the AEMC to improve the clarity and simplicity of the Rules to the maximum extent possible, noting that Rules that are unclear and difficult to interpret will add to the cost of regulation. We offer the attached comments on drafting by legal advisers Gilbert+Tobin to assist in this endeavour, noting that at this stage we have not undertaken a thorough due diligence of the drafting.

ATTACHMENT

MEMORANDUM FROM GILBERT+TOBIN

17 March 2006

To ElectraNet Pty Limited; Powerlink Queensland; SP AusNet;
Transend Networks Pty Ltd; TransGrid

From Nick Taylor / Catherine Dermody

Matter No 252089

Subject Concerns relating to the drafting style adopted in the Draft
National Electricity Amendment (Economic Regulation of
Transmission Services) Rule 2006

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We refer to the *Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 (draft rule)*, published by the Australian Energy Market Commission (the **AEMC**) on 16 February 2006.

In this memo we have identified certain aspects of the drafting of the draft rule that are likely to cause difficulty in interpretation and application.

As an aside, we note that since their respective commencement, the Gas Code has had a considerably more accessible drafting style than has the Electricity Code which tends to have a lengthy, complex and dense style. The draft rule continues and perhaps accentuates that difference.

To some extent, differences are necessary because the electricity industry is more complicated and the rules must cover additional ground. However, to a significant extent we consider the drafting style adopted poses a risk that the intention and the effect of the rules could significantly diverge.

In particular, we make the following comments:

1. the structure of the draft rule could be significantly improved such that it follows a more logical sequence;
2. the draft rule is repetitive;
3. the definitions used lack clarity, and in a number of cases terms would benefit from being defined;
4. the draft rule uses the passive voice;
5. redundant words and provisions are often included; and
6. drafting may give rise to AER discretions and TNSP obligations which are unstated but may be implied.

Each of the comments noted above is discussed at a conceptual level in the following section. Attachment 1 examines rule 6.2 for the purpose of providing specific instances of the style of drafting that gives rise to the concerns identified above.

1. The structure of the draft rule could be significantly improved

The overall structure of the draft rule could be significantly improved if a more logical sequence was followed, both in terms of the order of the individual rules and also in terms of the subparagraphs within the various rules. For example, rule 6.2.3 lasts for 7 ½ pages of text and covers the following detailed provisions interspersed amongst each other:

- (i) provisions for the initial establishment of the regulatory asset base – an assessment that is ordinarily made only once ever for each transmission system;
- (ii) provisions for the re-set of all the elements of a regulatory cap including the regulatory asset base – an activity that occurs once every five years;
- (iii) provisions for the annual movement in certain elements of the regulatory cap including the regulatory asset base; and
- (iv) provisions for the reopening of the revenue cap.

Rule 6.2.3 itself sits within a series of other provisions of rule 6.2 which cover primarily (ii) and (iv). Other key elements of (ii) appear primarily in rules 6.11-6.17 and other elements of (iv) appear in rule 6.2.12 and 6.2.13.

Further, the draft rule frequently mixes together general provisions with exceptions to those provisions. At times general provisions are also mixed with transitional provisions.

2. The draft rule is repetitive, often with different formulations of the same proposition

In a number of areas, the draft rule repeats the same substantive obligation and several times often in different terms which leads to confusion and uncertainty.

One example concerns the term “Maximum Allowed Revenue,” which at least two provisions purport to give meaning (rules 6.2.1(b)(1) and (3)).

3. The definitions used lack clarity

The draft rule uses:

- many terms which are undefined;
- regulatory “jargon” rather than plain English drafting; and
- multiple different terms for what are apparently intended to refer to the one concept,

with the potential for unintended meanings to be given to the relevant terms.

4. Use of the passive voice

Often the rule describes what is to be done without explicitly stating who is to undertake the task. For instance, the rule frequently states that a figure “must be calculated” or an amount “must be included” without saying who must calculate the figure or who must include the amount.

There are two risks associated with this approach:

- TNSPs may be required to undertake a task that the AER was in fact intended to undertake; or
- the AER may claim as its role a function or choice that was intended to be for the TNSP.

5. The inclusion of redundant words and provisions

There is a presumption of legal interpretation that if a word is, or words are, used in the rules that they be given the same meaning.

Therefore, where a provision includes redundant words or provisions perverse interpretations can arise as the courts struggle to give the words meaning.

Much of rule 6.1, rule 6.2.1, rule 6.2.3(a) and the first half of rule 6.2.4(b) are redundant introductory provisions that have the potential to conflict with the substantive provisions.

Also throughout the text of the substantive provisions there are redundant words that give rise to concerns. Some of the most significant are:

- the draft rule frequently uses the term “but only to the extent that they are used to provide such services”, which leaves open the suggestion that where assets are used for providing a number of services, even where a proportion of their value has been allocated to such services, they may not meet the “but only” criteria; and
- the rules frequently refer to the requirement that the AER provide an adequate allowance for the costs arising from the “need” for TNSPs to meet their regulatory obligations, implying that a situation may exist where a TNSP may not “need” to comply with any particular requirement.

6. Hidden or implied AER discretions or TNSP obligations

Implicit in the drafting are instances in which the AER is apparently allowed a significant decision making discretion that is not explicit and may well not be intended.

Similarly, the drafting often implies the TNSPs have certain obligations, where that is not apparently intended.

7. Other matters

- In some cases provisions which are of general application are in fact drafted (from a grammatical viewpoint) as exceptions. The above approach tends to obscure meaning and risks confusing businesses, regulators and courts as to which elements of provisions prevail and/or which provisions are to be permanent as opposed to temporary.
- The means by which dollar figures are indexed is cumbersome and detracts from an accessible drafting style. The AEMC has recognised that dollar figures in the rules should, over time, be adjusted for inflation. The method to achieve that indexation is to index the amount as at the current date. Over time, as the rules are progressively amended, and different dates for nominal figures are chosen, that approach will become increasingly complex. A simpler approach would be to define a value unit for the purposes of the rules (say \$1 as at the commencement of the rules) and to use that to denominate figures for the purposes of the rules.

Attachment 1: Preliminary review of rule 6.2

Regulatory asset base (rl 6.2.3)

1. Structure

- The following are mixed together:
 - Opening RAB (TNSP and AER);
 - Reset of RAB (TNSP and AER);
 - Intra-period year-on-year RAB changes which is “automatic”; and
 - Reopening.
- Rule 6.2.3(c)(2) is the general provision with both transitional and exception provisions mixed in – for example:
 - Rule 6.2.3(c)(1) is, in fact, a transitional provision for all existing regulated networks; and
 - Rule 6.2.3(c)(3) is an exception to the general concerning services newly becoming prescribed services.
- Rule 6.2.3(f)(ii), first phrase, is a transitional provision.
- Rule 6.2.3(f) final sentence is a transitional provision.

2. Repetitive and often inconsistent repetition

- The sentences in rules 6.2.3(c)(2) and (3) commencing “The value of the regulated asset base for...” are repetitive of the rule 6.2.3(4) which is the provision in which the re-set of the RAB is undertaken.
 - Rule 6.2.3(c)(3) appears to duplicate 6.2.3(c)(4)(ix).
 - Rule 6.2.3(f)(3) duplicates rule 6.2.3(f)(1).

3. Definitions lack clarity

- Outturn inflation is not defined (rule 6.2.3(c)(4)).
- Market benefit is not defined (rule 6.2.3(c)(3)(ii)(B)).
- “Benefit” or “penalty” associated with the return on capital arising from any difference between such estimated and actual capital expenditure is not defined (rule 6.2.3(c)).
- “Inflation” or the oxymoron “value of inflation” in rule 6.2.3(g)(4) are both used and neither is defined. Is it actual or forecast and how does it differ from CPI?
- “Annualised” in rule 6.2.3(d) is not defined.
- Rule 6.2.3(a) appears solely to be a definition and inconsistent with the provisions of 6.2.3 with respect to the use of the term “value”.

- “Transmission Network Service Provider’s Revenue Proposal” and “Revenue Proposal” are both used.
- “Inter-regulatory” should be “Intra-regulatory” in clause 6.2.3(g).

4. Passive drafting

- Passive drafting is used in:
 - Rule 6.2.3(c)(4) – the reset of the RAB; and
 - Rule 6.2.3(h) – “must not be increased”, “must not be adjusted to remove”.

5. Redundant wording

- “Value” (throughout rule 6.2.3).
- “Increase” (rule 6.2.3(c)(4), rule 6.2.3(g), rule 6.2.3(h)(1)).
- “Reduced” and “adjusted to remove” (rule 6.2.3(c)(4), rule 6.2.3(g), rule 6.2.3(h)(2)).
- “Adjust” (rule 6.2.3(c)(4), rule 6.2.3(g)).
- The “need to provide a reasonable opportunity for the relevant TNSP to recover efficient costs...” (rule 6.2.3(d)). Compare this with the drafting in rule 6.2.10(a)(4) which is more appropriate.
- The “desirability of minimising investment uncertainty...” (rule 6.2.3(d)).
- The word “current” in rule 6.2.3(e).
- The word “all” in rule 6.2.3(f)(2).
- The introductory words in rule 6.2.3(g).

6. Hidden or inadequately specified discretion/ hidden obligations on TNSPs

- Rule 6.2.3(c)(4) through the use of the term “adjust” and “increase” suggests that such a process is to be undertaken when in fact the provisions provide for the reset RAB to equal the old RAB plus certain quantities less certain other quantities.
- Rule 6.2.3(c)(4) uses the phrase “estimated capital expenditure approved by the AER”:
 - Who undertakes the estimate? It should be the TNSP.
 - What happens if it is not approved by the AER? It should only be rejected if AER satisfied incorrect based on fact and suitably qualified opinion.
- Rule 6.2.3(c)(4)(v) provides that the additional capital to be included in the RAB at a reset corresponding to capital expenditure should only be included if it is “properly allocated to the provision of prescribed transmission services...”. This assumes that there is a decision to be made by the AER as to whether it does or does not comply with the Cost Allocation Methodology:
 - By whom and using what inputs?
 - What if a contrary decision is made?

- Rule 6.2.3(d) appears to permit tradeoffs to be made by the AER between the objectives in (1) to (6). However, certain of them (eg (1)) should not be traded off but rather be minimum requirements of an AER decision.
- Decisions concerning “need” and “desirability”:
 - The “need to provide a reasonable opportunity for the relevant TNSP to recover efficient costs...” (rule 6.2.3(d)). Compare this with the drafting in rule 6.2.10(a)(4) which is more appropriate.
 - The “desirability of minimising investment uncertainty...” (rule 6.2.3(d)).
- The last sentence of rule 6.2.3(g) suggests that perhaps working capital can be excluded from the RAB and provides no guidance as to how or when.

Return on capital and rate of return (rl 6.2.4)

1. Structure

- The deeming in Rule 6.2.4(b) of 1.0 and 6.0% is transitional as is the last sentence in rule 6.2.4(e).
- Rule 6.2.4(c), final phrase is an exception provision.

2. Repetitive and often inconsistent repetition

- Rule 6.2.4(a) and (b) with (a) redundant.

3. Use of definitions

- Rule 6.2.4(b), first phrase appears solely to be a definition.
- Rule 6.2.4(e) “values and methodologies”.
- Rules 6.2.4(c) and 6.2.4(d) use “Commonwealth Government bonds with a maturity of 10 years” and “Commonwealth annualised bond rate”.
- “CPI” and “Inflation” are both used.

4. Passive drafting

- Rule 6.2.4(a) and (b), rule 6.2.5(a) and (b) – “must be calculated”.
- Rule 6.2.4(d) – “observed”.

5. Hidden or inadequately specified discretion

- Rule 6.2.4(d) who is to establish the “benchmark”?

Depreciation (rl 6.2.5)

1. Use of definitions

- “Life” in rule 6.2.5(c) – is this actual life or estimated and, if so, whose estimate?

2. Redundant wording

- Rule 6.2.5(c) “for that *transmission system*” is redundant.

3. Hidden or inadequately specified discretion

- Rule 6.2.5(a)(1) – “assets included in the regulatory asset base” – does this mean there will be some assets that may not be included? Who makes that decision?
 - That the TNSP establish a life for an asset – rule 6.2.5, last phrase.
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Forecast capex (rl 6.2.6)

1. Structure

- Rule 6.2.6(c) is a reopener provision and is redundant given 6.2.12.

2. Repetitive and often inconsistent repetition

- Rules 6.2.6(b)(viii) is redundant given 6.2.6(b)(ix).

3. Redundant wording

- Rule 6.2.6(a)(4) “through the supply of...” is redundant.
- Rule 6.2.6(b)(i) – “accompanying the submission of the”.
- The “need to provide a reasonable opportunity for the relevant TNSP to recover efficient costs...” (rule 6.2.6(b)(2)(ii)). Compare this with the drafting in rule 6.2.10(a)(4) which is more appropriate.

4. Hidden or inadequately specified discretion

- Rule 6.2.6(a)(1) – “expected demand” – whose expectation? If this is the AER, when can it make this decision?
 - Rule 6.2.6(b)(1) refers to the “Cost Allocation Methodology for the TNSP”. Does this imply there would be a different CAM for each TNSP?
 - Rule 6.2.6(b)(vi) “reasonable estimates” of the “benchmark” capital expenditure.
 - “TNSP considers” (rule 6.2.6(a)), “identified” (rule 6.2.6(b)(2)) – is it not clear if these provisions are self regulatory.
 - Implied obligation to provide services – rule 6.2.6(a).
 - Implied obligation to provide a “submission” in addition to the “Proposal” – rule 6.2.6(b)(i).
-

Forecast opex (rl 6.2.7)

1. Repetitive and often inconsistent repetition

- Rule 6.2.7(b)(viii) is redundant given 6.2.7(b)(ix).
- Criteria in 6.2.6(b) and 6.2.7(b) are identical and can be collapsed using the drafting technique in rule 6.2.8(c).

2. Redundant wording

- Rule 6.2.7(b)(i) – “accompanying the submission of the”.
- The “need to provide a reasonable opportunity for the relevant TNSP to recover efficient costs...” (rule 6.2.7(b)(2)(ii)). Compare this with the drafting in rule 6.2.10(a)(4) which is more appropriate.

3. Hidden or inadequately specified discretion

- Rule 6.2.7(a)(1) – “expected demand” – whose expectation? If this is the AER, when can it make this decision?
- Rule 6.2.7(b)(1) refers to the “Cost Allocation Methodology for the TNSP”. Does this imply there would be a different Cost Allocation Methodology for each TNSP?
- Rule 6.2.7(b)(vi) “reasonable estimates” of the “benchmark” capital expenditure.
- “TNSP considers” (rule 6.2.7(a)), “identified” (rule 6.2.7(b)(2)) – is it not clear if these provisions are self regulatory.
- Implied requirement to provide services – rule 6.2.7(a).
- Implied requirement to provide a “submission” in addition to the “Proposal” – rule 6.2.7(b)(i).

Efficiency benefit sharing scheme (rl 6.2.8)

1. Structure

- The following are transitional words:
 - “at a time that is no less than 2 months after the *publication* of the *efficiency benefit sharing scheme*” in rule 6.2.8(b);
 - the whole of rule 6.2.8(d).

2. Repetitive and often inconsistent repetition

- Rule 6.2.8(a)(3) is redundant given (4). Indeed, if (3) is to stay, it should be “optimise” not “reduce”.

3. Use of definitions

- “Fair” in rule 6.2.8(a). Should this be efficient?
- “Inappropriately capitalise” in rule 6.2.8(a)(5).

4. Hidden or inadequately specified discretion

- How will it be determined what is “inappropriately capitalise” in rule 6.2.8(a)(5)?
- Rule 6.2.8(e) implies that the AER can determine a start time for the new guidelines.

Estimated cost of corporate income tax (rl 6.2.9)

1. Use of definitions

- Rule 6.2.9(a):
 - “Statutory income tax rate” – should be a defined term; and
 - “taxable income” also requires a definition.
- Rule 6.2.9(b) – “utilisation of imputation credits”.

3. Redundant wording

- “assumed” in rule 6.2.9(b).

Service target performance incentive scheme (rl 6.2.10)

1. Structure

- Rule 6.2.10(e) is the general provision.
- In rules 6.2.10(b) the following are transitional provisions:
 - “At the same time as it *publishes a service target performance incentive scheme* under this rule 6.2.10...”; and
 - “no less than 2 months after the *publication*”.
- The whole of rule 6.2.10(d) is a transitional provision.

2. Redundant wording

- The word “greater” in rule 6.2.10.
- The word “minimise” should be “optimise” in rule 6.2.10(a)(5).

3. Implied obligations on TNSPs

- An obligation to improve reliability in the use of “greater” in rule 6.2.10(a)(1)(i) and “improve” in rule 6.2.10(a)(1)(ii).

X factor (rl 6.2.11)

1. Implied obligation on TNSP

- An implied obligation to continuously improve.

Reopening of revenue cap for capital expenditure, general reopening and pass-throughs (rl 6.2.12)

1. Repetitive and often inconsistent repetition

- Rules 6.2.12, 6.2.13 and 6.2.14 could be consolidated and much of the detail in 6.2.12 could be replaced by drafting in the style of 6.2.13(c).

2. Redundant wording

- The provision uses the term “may...apply” in rule 6.2.12(a) instead of “may trigger”.
- rule 6.2.12(f) could mean that a new project is unnecessarily delayed by 90 days + 60 days + 12 months.

3. Hidden or inadequately specified discretion

- The provision uses the term “may...apply” suggesting that the AER may decline to do so (see rule 6.2.12(a)).
- The use of “should” in rules 6.2.14(d)(2) and 6.2.14(g)(2) and “any other factors the AER considers relevant” in rule 6.2.14(j) suggest a broad discretion for the AER increasing uncertainty.