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Dear Sir/Madam

Transmission Revenue: Draft Rule Proposal

The Australian Pipeline Industry Association (APIA) is pleased to provide a submission to the Australian Energy Market Commission (AEMC) on its Draft Rule Proposal for the regulation of transmission revenue.

While the Draft Rule is not directly applicable to the gas transmission industry, APIA is very interested in the current regulatory reform process and the directions taken in key areas. This is particularly important to APIA members given the move to a single energy regulator and the move towards common regulatory arrangements across the energy sector in Australia.

APIA is particularly concerned about the degree of prescriptiveness in the Draft Rule. While recognising the need to strike a balance between regulatory certainty and discretion, it appears the Draft Rule has taken a very inflexible approach on a range of issues, the impact of which is likely to be undue constraint on the proposal a regulated business can put forward. APIA considers that this reflects an unnecessarily 'heavy-handed' approach to regulation and would urge the AEMC to reconsider the prescriptiveness of its overall approach.

APIA looks forward to participating further in the AEMC's review process.

Yours sincerely



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Submission to AEMC on Transmission Revenue:

Rule Proposal

The Australian Pipeline Industry Association (APIA) welcomes the opportunity to provide a submission to the AEMC on its Draft Rule for the regulation of transmission revenue. APIA is the industry representative body for the gas transmission pipeline industry in Australia.

While recognising that the Draft Rule is not directly applicable to gas transmission pipelines, many of the matters addressed are also relevant to gas industry regulation and potentially set a regulatory precedent. This is of interest to APIA given the move to a single energy regulator and the Ministerial Council on Energy's (MCE's) objective of a common approach to energy regulation in Australia. In the context of the current MCE reform processes, APIA would like to make this further contribution to the debate.

The regulatory arrangements applying to the gas transmission industry have recently been subject to an extensive review by the Productivity Commission (PC).¹ The PC made a range of recommendations designed to improve the operation of the Gas Access Regime. APIA believes that the current Gas Access Regime, as modified by the PC's recommendations, provides a workable industry-specific access regime which operates in all States with minimal derogation. This contrasts with the large number of problems with the electricity access regime under the NEC and now NER. In the case of distribution, this has been characterised by derogation in a majority of states, and in the case of transmission, there has been widespread acknowledgement of the need for an overhaul that has resulted in the current rulemaking review by the AEMC for Chapter 6. While APIA did not support all of the recommendations of the PC, it supported the package as a whole as being an appropriate set of reforms and to avoid delays in implementation of necessary reforms.

Broadly, as part of the improvements to the Gas Access Regime, the PC review recognised the need for less intrusive regulation in a number of areas. For example, it recommended the inclusion of an option of a more 'light-handed' monitoring form of regulation. It also proposed that the regulator must approve a proposed rate of return for a regulated business if it is satisfied that it has been calculated on a plausible conceptual basis and the values lie within a range of plausible estimates. While the PC's recommendations were specific to the gas industry, APIA considers that the PC's overall approach is relevant to the issues being considered by the AEMC and represents a desirable approach. APIA therefore believes that the AEMC should have regard to the

¹ Productivity Commission, Review of the Gas Access Regime, August 2004

PC's approach and recommendations where there is commonality in the issues being considered.

APIA would like to make the following comments on certain aspects of the AEMC's Draft Rule. While not addressing each of the AEMC's recommendations, these comments seek to address the key issues and directions emerging from the Draft Rule from APIA's perspective.

Prescriptiveness

The AEMC has sought to address the question of the appropriate balance between certainty and regulatory discretion by codifying regulatory procedures in a number of key areas. The AEMC has proposed to retain the discretion of the regulator in other areas, but has provided guidance for the exercise of this discretion.

The Draft Rule provides direction to the AER in a number of key areas, such as: the form of regulation to apply; methodology for calculating the revenue cap; steps in the propose-respond process; and procedure for developing and amending AER Guidelines. For example, the Draft Rule specifies that a revenue cap based on the building block approach must apply to Prescribed Transmission Services. The Draft Rule also codifies elements of the building block approach, such as prescribing a post tax revenue model (PTRM), codifying the ACCC's current 'lock in' approach in regard to the asset base roll forward and prescribing the initial methodology/values of specified cost of capital parameters.

The Draft Rule provides guided discretion to the AER in the following areas: principles for the design of incentive schemes for standards of service and operating expenditure; information provision; cost allocation approach and the PTRM to be applied. The AER is to develop and publish guidelines for information to be submitted with a Network Service Provider's (NSP's) revenue cap proposal and cost allocation methodology.

APIA agrees that there needs to be an appropriate balance between providing certainty and flexibility. Where the regulator does have discretion, APIA is supportive of this discretion being guided to a degree (for example, by requiring the regulator to have regard to the objects clause in making its determination and the pricing principles to apply in setting reference tariffs). Nevertheless, even with this guidance to the regulator, a degree of regulatory discretion will necessarily remain.

Where there is a high level of prescription in the regulatory regime, the total level of discretion (to be exercised by either the regulator or the service provider) is reduced, APIA believes that the level of prescriptiveness in the Draft Rule will significantly constrain the remaining discretion that is able to be exercised by the service provider in making its proposal – i.e., it will significantly constrain the 'propose' part of the 'propose-respond' model.

APIA is concerned that the Draft Rule is too prescriptive in its specification of elements of the regulatory regime. Consistent with a true propose-respond model, APIA believes that the regulated business should have the discretion to propose an approach which is consistent with the Rules and which reflects its particular circumstances. The regulated business itself is best placed to make such decisions. For example, this flexibility should extend to the form of regulation to apply, the use of a building block or any other approach to determining revenue and preferred method of depreciation. The Gas Code currently provides this flexibility. APIA submits that this approach has worked effectively in the gas industry and should not be altered.

It would be more consistent with a true propose-respond model if the AER was able to reject a proposal only where it is inconsistent with the Rules or where parameter values in the building blocks are not within a reasonable range. APIA is concerned that, by unduly prescribing key elements of the regime, the regime becomes unnecessarily intrusive and inflexible and locks out worthwhile alternative approaches which could be put forward by regulated businesses.

In particular, APIA does not support the AEMC's decision not to follow a 'reasonable range' approach in determining the value of the WACC or the value of the revenue cap. Where an assessment by the regulator of 'reasonableness' is required, APIA submits that this can only be done by first identifying a reasonable range. Moreover, such an approach recognises the fact that there is no single correct method to determine a rate of return and that there is often a range of plausible estimates that could be used in applying a particular method. This was explicitly acknowledged by the PC in its recommendations in the review of the Gas Access Regime.² APIA believes that the AEMC should reconsider its approach on this issue.

APIA does not support the AEMC's proposal to require that the AER accept a NSP's proposed forecast capital and operating expenditure if the proposed expenditure is a 'reasonable estimate' of its requirements (having regard to a number of specified criteria). This is because the guidance provided to the AER in the Draft Rule regarding the information to be submitted with a NSP's proposal includes, among other things, a requirement for the business to provide independent certification of the reasonableness of its capital and operating expenditure forecasts and the underlying assumptions. Given that the AER will need to undertake its own assessment of the reasonableness of these forecasts, this duplication is unnecessary and unduly onerous. APIA proposes that the AER should be required to endorse all capex and opex forecasts submitted by a NSP with an independent certification that the forecasts are reasonable.

Propose-respond approach

The Draft Rule contains a 'propose-respond' process featuring a fixed 13-month timeframe and consultation process. Associated with this approach is a requirement for

² Recommendation 7.9

NSPs to prepare their proposals in a manner which complies with AER's information guidelines and models.

APIA strongly supports the propose-respond approach to regulatory assessments which currently applies in the Gas Code. Such an approach provides the regulated business with a degree of flexibility in making its proposal, while retaining the ability of the regulator to assess and accept/reject the proposals as it considers appropriate. This flexibility allows a business to tailor its proposal to suit its business and operations, provided that the requirements of the Rules are met. APIA believes that this approach should be carried forward into the new legislative framework applicable to both gas and electricity in the regulatory arrangements currently under consideration.

However, while APIA supports the move towards formally codifying a propose-respond approach in the AEMC's Draft Rule, the approach taken appears to fall considerably short of a true propose-respond model. There appears to be a significant degree of prescription in other aspects of the Draft Rule which would considerably constrain the proposal a business can put forward. For example, the Draft Rule prescribes the form of regulation as well as key parameters within the building blocks. This seems to have involved writing into the Rules the values proposed by the ACCC's Statement of Regulatory Principles.

APIA believes that a less constrained propose-respond approach, such as applies in the Gas Code, would be more appropriate, and urges the AEMC to reconsider the level of prescription in the Draft Rules.

Commercial negotiation

APIA considers that regulation should only apply where there is a clear economic justification for doing so. Where regulation is not justified, access arrangements should be subject to commercial negotiation. This is consistent with the findings of the PC review.

In light of this, APIA welcomes the approach taken in the Draft Rule whereby less intrusive forms of regulation may apply for services that are amenable to commercial negotiation of terms and conditions or which are supplied under more competitive conditions (ie. 'negotiated transmission services'). For similar reasons, the move to greater clarity in the definition of services subject to economic regulation is also a positive development.