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22 March 2006

The Chairman  
Australian Energy Market Commission  
PO Box H166  
AUSTRALIA SQUARE NSW 1215

Dear Sir

## **Transmission Revenue and Pricing Rules MEU Inc Response to AEMC Proposed Draft Revenue Rules**

Attached is the Major Energy Users Inc response to the above referenced AEMC Proposed Draft Revenue Rules

Major Energy Users Inc is the umbrella body for expressing the views of the Energy Markets Forum (NSW), Energy Consumers Coalition of SA, Energy Users Coalition of Victoria and Major Employers Group Tasmania when addressing national issues which would impact on each of these regional groups of energy consumers.

Yours sincerely

Mark Gell  
Chair, Major Energy Users Inc

# MAJOR ENERGY USERS INC

THE VOICE OF ENERGY CONSUMERS

## Australian Energy Markets Commission

### Review of the Electricity Transmission

### Revenue and Pricing Rules

## Comments on the Revenue Requirements

## Proposed Draft Rules

by

The Major Energy Users Inc

And

Major Employers Group Tasmania

March 2006

Assistance in preparing this submission by the Major Energy Users Inc was provided by  
Headberry Partners Pty Ltd and Bob Lim & Co Pty Ltd.

The content and conclusions reached in this submission are entirely the work of the Major  
Energy Users Inc., MEG Tasmania and its consultants.

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## Executive Summary

The Major Energy Users Inc (MEU) and the Major Employers Group, Tasmania (MEG) consider that some of the proposed changes to the Rules by the AEMC are sound, some are neutral, but overall, many are inimical to end users' interests.

The MEU and MEG consider that the AEMC's regulatory framework for Chapter 6 issues must be informed by the following concerns:-

1. The recent ownership changes in some transmission (and distribution) network businesses and the adoption of complex financial engineering models, which have vast implications for the robustness and effectiveness of the proposed changes to the Rules; the efficacy of the AER to undertake effective and efficient regulatory reviews under those changes to the Rules; and exposing consumers to a systematic upward bias in the returns provided to transmission network businesses as a result of the changes to the Rules;
2. Clear evidence that network businesses are substantially more profitable than other businesses on the ASX 200 and increasingly so; and
3. Absence of evidence (let alone analysis provided by the AEMC) that there has been investment deterrence and network businesses require additional incentives to make investments.

The presumption that a lighter handed regulatory approach will incentivise network investments is not contested. The real issue is, is that necessary? But the impact on consumers is higher network costs, which will have detrimental effects on downstream and upstream investments.

Details of the concerns with, and comments on, the proposed changes to the Rules are covered in this submission.

## Introduction

### The MEU and MEG

The Major Energy Users (MEU) and the Major Employers Group Tasmania (MEG) comprising some 30 major energy using companies in NSW, Victoria, SA, Tasmania and Queensland welcome the opportunity to provide comments on the Review of the Electricity Transmission Revenue. In particular, the submission represents the views of the Energy Markets Reform Forum (NSW), Energy Consumers Coalition of South Australia Energy Users Coalition of Victoria and Major Employers Group Tasmania.

Analysis of the electricity usage by the members of MEU and MEG shows that between them they consume about 7% of the electricity generated in the NEM. Many of the members are located in regional parts of Australia, some distance from the regional centres. As such they are highly dependent on the transmission network to deliver the electricity essential to their operations. Being regionally located, the members have an obligation to represent the views of their local suppliers and of the regionally based workforce on which the companies are dependent. With this in mind, the members require their views to not only represent the views of large energy users but also those of smaller power consumers located near to their regional operations.

The companies represented by the MEU and MEG (and their suppliers) have identified that they have an interest in the **cost** of the energy network services as this comprise a large cost element in their electricity and gas bills.

Although electricity is an essential source of energy required by each member company in order to maintain operations, a failure in the supply of electricity or gas effectively will cause every business affected to cease production, and members' experiences are no different. Thus the **reliable supply** of electricity and gas is an essential element of each member's business operations.

With the introduction of highly sensitive equipment required to maintain operations at the highest level of productivity, the **quality** of energy supplies has become increasingly important with the focus on the performance of the distribution businesses because they control the quality of electricity and gas delivered. Variation of electricity voltage (especially voltage sags, momentary interruptions, and transients) and gas pressure by even small amounts now has the ability to shut down critical elements of many production processes. Thus

member companies have become increasingly more dependent on the quality of electricity and gas services supplied.

Each of the businesses represented here has invested considerable capital in establishing their operations and in order that they can recover the capital costs invested, long-term **sustainability** of energy supplies is required. If sustainable supplies of energy are not available into the future these investments will have little value.

Accordingly, MEU and MEG are keen to address the issues that impact on the **cost, reliability, quality** and the long term **sustainability** of their gas and electricity supplies.

The members of MEU have been involved in nearly every major economic regulatory review (both gas and electricity) since deregulation of the energy markets commenced in 1996, as well as participating in the drafting of the electricity and the gas access regulatory regimes. As a result, they have accumulated a wealth of knowledge of the relevant regulatory and legislative processes, and in particular observed and experienced a number of perverse outcomes resulting from the application of the rules and regulations over the past decade.

### **A Brief Statement of the Current National Electricity Market and Consumers' Perspectives**

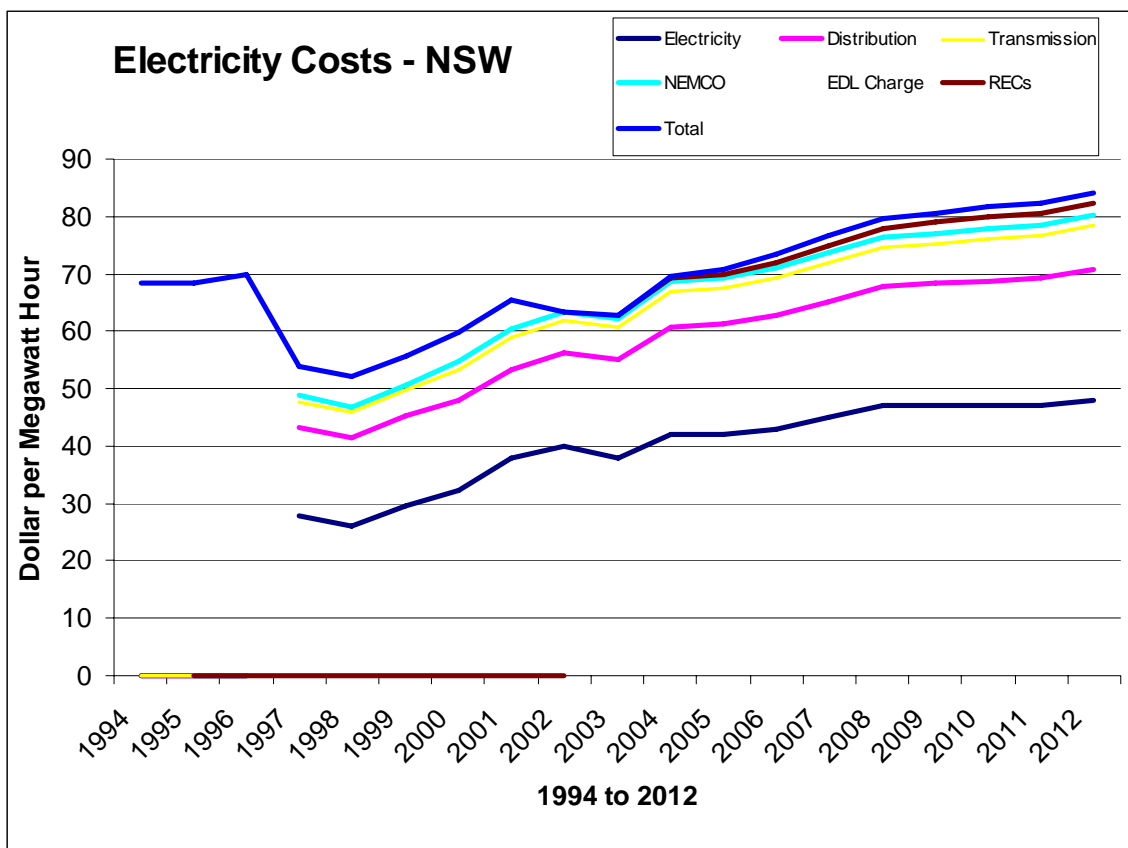
In the MEU's previous submission to the AEMC regarding transmission revenue, a statement was provided which summarised the history of the progression of the de-regulation process to date. The statement also provided a summary of the views of the current electricity market as held by consumers. It is essential that the AEMC take heed of consumer views as it was to provide consumers with a better (from the cost, reliability, longevity and quality perspectives) electricity supply that underpinned the entire deregulation process.

It is appropriate to state that in the early stages after deregulation that large consumers did enjoy a better electricity supply service at a lower cost. However, as the following graph shows, these early gains (considered by many as unsustainable in the early years) have evaporated.

The graph shows the estimates into the future for the various inputs into the make up of the delivered cost of electricity in NSW. What is regularly overlooked by many when examining electricity prices is the various additions imposed on

electricity users such as the MRET scheme, regional schemes like the NSW NGA, and levies in their various guises (NSW EDL and Victoria’s smelter levy)

The forward estimates of electricity prices show that the current price of electricity is now close to that of electricity before deregulation, and that the price of delivered electricity will exceed pre-deregulation prices in the near future.



Source: Energy Markets Reform Forum

With regard to domestic consumers, a study by the Consumer Law Centre Victoria (CLCV) just recently released<sup>1</sup> supports that this trend of nearing pre-deregulation prices is widespread amongst all consumers.

The report comments on:-

**“Price**

<sup>1</sup> Electricity Reform in Victoria: Outcomes for Consumers by Consumer Law Consumer Law Centre Victoria and Centre for the Study of Privatisation & Public Accountability, February 2006, pages (i) and (ii)

The price benefits associated with the reforms to the Victorian electricity industry, including the introduction of full retail competition ...domestic consumers [have experienced] only a slight decrease in real electricity prices ...

### **Access**

In terms of the physical access to electricity networks across Victoria, the project found that not much has changed. In particular, the perceived potential for a negative outcome ... – that network expansion would not continue, in the absence of commercial viability – has not been realised. Primarily, this is the result of a robust regulatory framework that has ensured the continued expansion of networks throughout Victoria.

### **Quality**

The analysis of quality outcomes found that on most quality of electricity supply measures, reform has resulted in improvements for consumers. However, this was not the case with all quality measures, for example, in the area of momentary interruptions, quality has declined. It was also found that benefits were not uniform across all consumer groups, and some consumer groups, particularly those consumers in rural and regional areas, had not received the same degree of quality improvements as their metropolitan counterparts.

### **Accountability**

Overall, Victorian consumers have benefited from enhanced public accountability mechanisms, as a consequence of market reform.

### **Summary**

Notwithstanding these improvements, the report recommends that further work is necessary to enhance the role of stakeholder consultation within regulatory decision making. In addition, the accountability arrangements of the ESC are an issue which needs to be examined in greater detail to ensure that reform continues to bring positive benefits for consumers.”

The report directly provides support for the contentions of larger electricity consumers that:-

- it is a robust regulatory environment that has permitted gains to be made in some areas.
- investment in electricity supply elements has not been constrained by the current regulatory environment (and even that the current arrangements could well have ensured that investment has occurred)
- it is essential that further consumer involvement in regulatory decision making must be encouraged.



The MEU appreciates the opportunity to review and comment on the proposed changes of Chapter 6 of the National Electricity Rules. Its underlying theme in the approach to any changes is that they must assist in achieving a **sustainable and competitive national electricity market**.

## 2. Encouragement for Investment

### 2.1 Introduction

In its report attached to the proposed draft Rules, The AEMC offers the following two key themes which it has used as the basis for its review.

- “Aligning incentives for TNSPs to invest in, and operate, transmission networks in a way that delivers efficient outcomes for the electricity market, market participants and consumers; and
- Increasing clarity, certainty and transparency of economic regulation so as to provide a more certain regulatory environment for efficient long-term investment.” (Page 9)

Whilst the two key themes are admirable and supported, consumers would point to the experiences in the NEM in order to put some perspective in the approach to these key themes.

The clear implication of the AEMC approach is that the current arrangements are seen as insufficient to achieve the results implied as needed by these two key themes – that more is needed than what is currently in place. The AEMC has no basis at all to assume that there is a greater need for more incentives to encourage investment nor has it provided any evidence for that proposition. In fact a review of the market would confirm that there are already sufficient incentives now.

### 2.2 Profitability of the sector

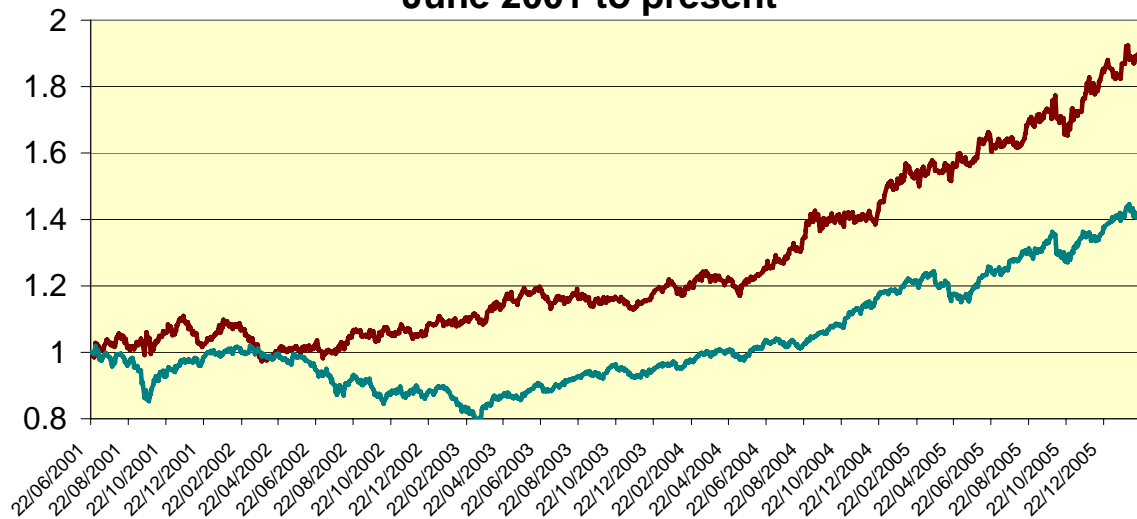
It should be recognised that a business will not grow if it does not invest. Each of the regulated businesses has been reported (and at regulatory reviews) to have sought to grow their businesses.

The fundamental reason why an enterprise invests is to make a profit out of the process. Unless forced to by a public licence provision (government pressure) or a need to invest to retain market share (this does not apply to the regulated transmission monopolies) then the key driver of investment is profits that will come from the investment.

The MEU has examined the outcomes of the regulatory reviews to date, in order to identify if there is a commercial reason why the regulated

businesses might not be investing. The review shows that (profit maximising) regulated businesses have every reason to invest as their profitability is greater than the market average. The following graph shows the Utilities sector share performance compared to the share average as defined by the ASX 200.

### Movement of Utilities index (red) relative to ASX 200 (blue), June 2001 to present



Source: Commonwealth Securities

The ASX 200 is recognised to be particularly buoyant in the past 2-3 years as a direct result of the “China resources” boom. This should not have impacted on the Utilities index yet despite the China boom, the Utilities index has significantly outperformed the market average overall, but particularly even during the China boom period. This shows that the companies within the Utilities index are seen as extremely profitable businesses, relative to risk.

A review of the companies comprising the index shows that DUET, Hastings, Alinta, AGL, APT, Envestra, GasNet, SPI AusNet, Spark Infrastructure are all in the index and between them, they comprise over 90% of the index capitalization – supporting the following assessment.

Analyzing the figures provided by Commonwealth Securities (CommSec) shows that the ASX 200 demonstrates that the market risk premium (MRP) for the sector for the past five years is at about the long term average of

6.05%, rising from an MRP of between 3-4% observed for the past 30 years<sup>2</sup>. CommSec has calculated an equity beta for this sector<sup>3</sup> at 1.08, again about the mean for the long term market average.

In comparison, analyzing the figures provided by CommSec shows that the Utilities index demonstrates an MRP of 11% for the sector for the past five years. This is despite the fact that regulators have been setting an MRP of 6% in all regulatory decisions made during the same period, as well as for the five years before. CommSec has calculated an equity beta for this sector at 0.31, less than one third of the value used in all regulatory decisions up to late 2004.

It is the outcome of actions by the regulators of providing an MRP and equity beta well in excess of appropriate amounts which has produced the massive out performance of the Utilities sector. In other words, regulators have been incentivising businesses to invest.

Based on the relatively high rewards provided by the regulators to companies within the sector, there is little doubt that with such rewards being available, the Utilities sector has had every profit incentive to invest.

### **2.3 Where is the lack of transmission network investment which is supposedly needed to be encouraged?**

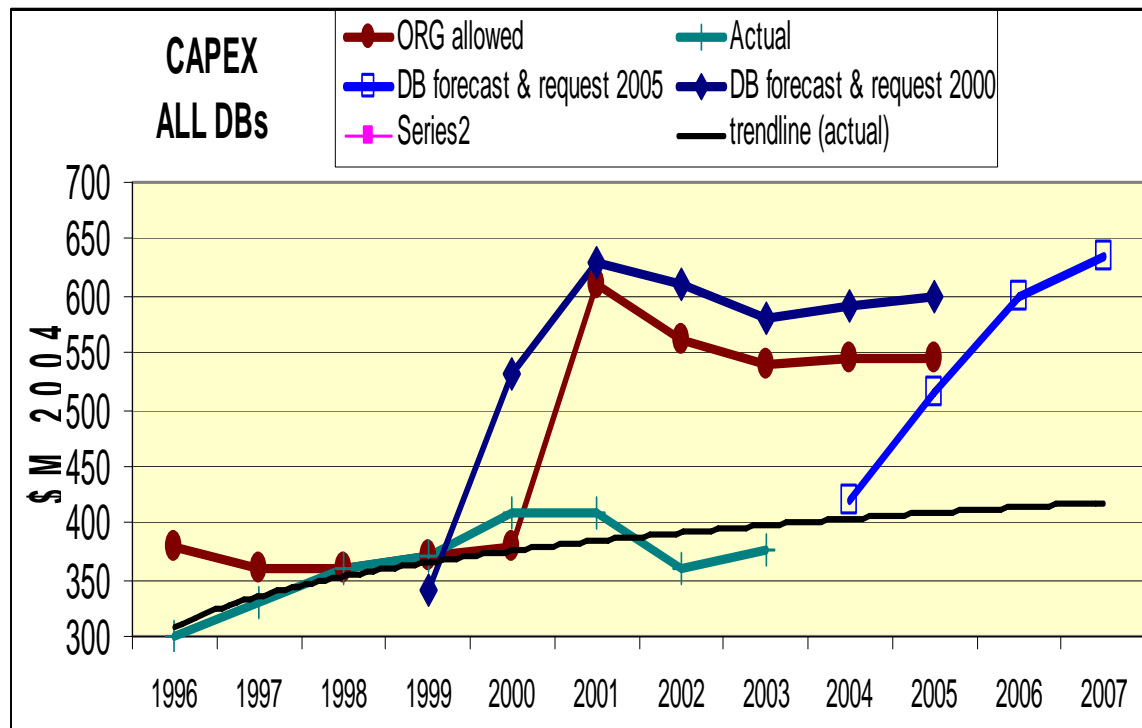
MEU has attempted to identify where investment in transmission businesses is needed that has not resulted due to the regulatory environment or due to the provisions of the NEL and NER. Regulators have provided so much entitlement to capex for investment that in many cases the businesses have not been able to spend all of the capex permitted. This in turn has created a windfall profit for the regulated businesses as they are permitted to retain the return on the capex included in the regulatory decision, even if the capital is not expended. **Thus under the current incentive arrangements there is a driver for the regulated businesses to maximise the capex allowances, and to underspend during the period.**

A classic example of this was the capex allowed the Victorian businesses in the periods up to 2005. The following graph shows the capex requested by the businesses, the amount approved and included in the regulatory decision, and the actual amounts spent.

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<sup>2</sup> See assessments by Prof R R Officer

<sup>3</sup> See appendix 1 which provides a listing of equity betas and sector and subsector dividend yields for each market sector. This data was sourced from Commonwealth Securities.



Source: ESCoV

At the same time as the regulated businesses were claiming the massive injections of capex to ensure that the performance standards would not slip (that the lights would go out) they underspent massively compared to their claims and still achieved marginal performance improvements.

This example shows very clearly that regulated businesses do overstate their capex needs to meet current standards yet are well able to manage on much less than they forecast.

In the transmission networks, there has not been a failure of supply of significance that can be attributed to a lack of capex, based on the current standards of contingency events. Most transmission networks can withstand a single contingency event (N-1) and even some double contingency events (N-2).

Where problems have occurred they have been caused more by **other** issues such as:-

- Bushfires which are a very common cause of outages

- Constraints in transfer between regions which are caused by the failure of the Regulatory Test to recognise the importance of transmission augmentation in minimising inter-regional pool price differentials
- Constraints in transfer between NSW and Victoria which are caused by Snowy bids at Tumut and Murray, utilizing the NEMMCO CSC/CSP arrangements.
- Insufficient incentive on the TNSP to maximise uptime of the network when it is most needed and take elements out of service when there is a lesser need for the network
- Legal battles (such as with the SA-NSW interconnector) which arose out of an MNSP or generator seeking to protect its interests by limiting competition.

The following table shows the claims of the TNSPs in relation to their RAB and the capex allowances granted by the regulator.

<b>TNSP</b>	<b>Year of review</b>	<b>Opening RAB \$m</b>	<b>Capex claimed \$m</b>	<b>Capex granted \$m</b>
<b>Powelink</b>	2001	2,276.9	1040.5	1040.5
<b>TransGrid</b>	2004	3,012.8	2147	1910
<b>EnergyAustralia</b>	2004	635.6	290.4	242.9
<b>PowewrNet</b>	2002	1,835.6	330.7	378.6
<b>ElectraNet</b>	2002	824	436	358
<b>Transend</b>	2003	603.6	391	307

Source: ACCC decisions

Unfortunately, reviews of TNSP performance do not yet provide sufficient evidence of actual capital spend by all TNSPs in relation to the allowances included in the allowed revenue. In the case of TransGrid the actual capital spend was some \$289m higher than the amount included in the 1999 ACCC decision. However, it should be noted that the actual capital spend was greater than the forecast provided by TransGrid by some \$251m.<sup>4</sup> Further, not all the actual capex used by Transgrid was deemed prudent, and the allowed roll forward of capex into the RAB was discounted by some \$127m<sup>5</sup>. Thus at most the ACCC decision had a marginal impact (perhaps less than \$6m in a total capex of \$1750m or less than 0.4%) on the revenue required by TransGrid for its own assessment of capex appropriate to be included in the allowed revenue.

<sup>4</sup> See ACCC final decision on TransGrid 2005, page 72

<sup>5</sup> Ibid page 75

Analysis of the ACCC decisions on capex shows that the regulator has attempted to apply logic to the allowance for capex to be used in the revenue calculation. In general the capex awarded is equal to or less than the starting RAB (the recent decision of TransGrid is an exception). This principle addresses the essential logic that each TNSP is not only unlikely to be physically capable of increasing the value of the network by more than 50% in a five year period<sup>6</sup>, but there will be severe constraints on its ability to raise such funds and properly control its capital management and expenditure programs.

It must be noted that even where a lesser amount of capex was permitted than claimed by the TNSP, the ACCC notes that a greater amount of capex can be rolled into the RAB at the next period if the additional capex passes the Regulatory Test requirements. Thus the TNSP is at very little risk of not receiving a reasonable return for investment where a return on capex spent but not covered in the allowed revenue might have occurred. As the capex program runs for five years, the only amount of return on capex where a prudent over-run occurs would be at most outstanding for a period of perhaps two years, whereas the asset has a life of 40-60 years, and over this long period the TNSP will in reality receive a substantial return despite not receiving a return over these first two years. An offset that applies is that the TNSP is permitted to retain the return on capex not spent within the regulatory period, creating a degree of symmetry of risk between consumer and TNSP. This is evidenced by the actual outworkings from the TransGrid assessment above.

Thus there is little evidence, if any, that the usually relatively small reductions in capex allowed in the allowed revenue by the regulator, has had any negative impact on any of the TNSPs or their capital investment programs.

#### **2.4 Business structures are providing for trailing fees which in the long term must eventually come from consumers.**

The Major Energy Users Inc is very concerned to ensure that the AEMC is alive to the major ownership structural changes that have been underway in many Australian electricity network businesses (both transmission and distribution) and the financial engineering models used to under-pin such changes.

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<sup>6</sup> It should be noted that most businesses (regardless of whether it is a regulated or operates in a competitive environment) would have a challenge in carrying out a 10% increase in capital every year, let alone raise the funds for such an ambitious program

These changes can involve an investment bank or asset owner creating a special investment vehicle to purchase and own several utility assets – including transmission networks – and then stapling and listing the securities which are then offered to/held by superannuation and managed funds. The listed investment vehicle is highly leveraged with very high levels of debt. High prices are paid for the utility assets. Relatively high returns are offered on the stapled securities. High management fees, advisory fees, performance fees and trailing commissions are contracted with the proponents of these types of securities.

A few questions arise (from the standpoint of energy users):

- Will a large proportion of earnings of say, a network business, need to be directed to service debt or the range of fees?
- Will assets need to be continually revalued to book profits?
- Will the network business have sufficient funds to maintain its operations, let alone invest in capital augmentations and additions?
- Will incentives need to be extremely high in order to incentivise the network business to make capex investments?
- Will new capex investments become the new battleground for regulatory “gaming” to raise regulated revenues to service debts, fees and dividends?

Perhaps the most critical question concerns how and whether regulators will be able to assess adequately (let alone understand) the complex financial engineering models used and gain legitimate access (i.e. pierce the corporate walls and confidentiality agreements) in order to obtain information to attest that all claimed regulated costs are robust, at arms-length, and are fair and reasonable.

Unless regulators are empowered to undertake such investigations (i.e. they are also armed with legislative authority under the NEL and NER), the frightening prospect is that major energy users are likely to be faced with alarming levels of network prices in order for the network business to service its debt, various fees, and dividends (on top of its network operating costs).



The issues for the AEMC are as follows:-

- It must be clearly established that the current NEL and NER have the relevant provisions to empower the AER to pierce corporate veils, confidentiality agreements, etc, in order that network costs can be established to be robust, undertaken at arms-length, efficient, fair and reasonable, and are legitimate network costs net of financial engineering costs.
- Consider the need to specify principles for regulatory costs allocations by the AER, and in particular, address the issue of the treatment of fees and costs generated by such financial engineering models.
- Consider carefully how the AEMC proposes to 'lock-in' the regulatory asset base (the MEU prefers that the 'lock-in' value could be the value established/used by the ACCC at the first regulatory review); and how financial engineering costs, including purchase price of the network business, are treated in the regulatory asset base (and in regulatory accounts).
- The difficulties likely to be faced by the AER at regulatory reset time with a highly leveraged, risky network business (see separate box on Fitch Ratings of certain utilities) requiring high levels of earnings (regulated revenues) to service its debt and other obligations, (or even to book profits) before it conducts capex augmentations and additions.
- The separate box article below by Alan Kohler (which appeared in the Sydney Morning Herald of 8 March, 2006) on Babcock & Brown Wind Partners shows, inter alia, a performance fee is paid to Babcock & Brown of \$33 million for the six months to December, whilst cash flows for that period amounted to \$15.8 million. More interesting from a financial engineering viewpoint is the example cited, concerning Alinta Infrastructure Holding.

## **Babcock is pipped at the post for fee record**

By Alan Kohler  
March 8, 2006

LAST week Babcock & Brown Wind Partners (BBW) reported cash flow for the six months to December of \$15.8 million, but a net loss of \$18.3 million after paying a performance fee to Babcock & Brown of \$33 million.

After putting their eyes back in their sockets, some shareholders of BBW have since remarked upon this to me, in the context of recent columns about Macquarie Bank's fees. Those can sometimes make one feel a bit groggy, and to briefly lose consciousness when they are paid with debt, along with dividends, but a performance fee of double the cash flow? That's a good one.

Is the BBW fee the high watermark of Australia's infrastructure bubble? After all, long-bond yields are rising — if they keep going and a genuine global bear market in bonds develops, the police will soon arrive at the infrastructure party, the lights turned on and the folk in blue overalls brought in to clean up.

I turned to the fees section of the BBW Product Disclosure Statement and studied it for two days and two nights, blacking out frequently. The base fee is 1.4 per cent of market capitalisation plus debt plus any "firm commitments" to spend money minus cash.

Right ... got that, although I do wonder about a fee calculated on debt plus intentions to spend money, and whether that might somehow encourage debt and intention rather than cash and action.

Anyway, at least it could be comprehended. The incentive fee, however, is virtually impossible for an earthling to understand, so I asked one of the friendly aliens at B&B to explain.

It's simple really — the fund pays 20 per cent of any outperformance against the S&P/ASX 200 Accumulation Index. The reason it takes two pages of Sanskrit to explain this is because BBW's performance is expressed as an index so that losses are carried forward into future years.

In other words if BBW's price falls, that has to be made up before any further fees can be paid.

No argument with that. So how come B&B made off with \$2 for every \$1 of cash earned by BBW in the latest half? Because after it was listed on October 27 in an initial public offering priced at \$1.40 a share, BBW's price immediately jumped to \$1.68 and closed on December 31 at \$1.75 — a gain of 26 per cent versus 8 per cent for the S&P/ASX 200 Accumulation Index for the half-year.

If the starting point is taken as just one day later — October 28 — BBW's performance to December 31 is 5 per cent, versus 9.6 per cent for the index — no incentive fee at all.

The reason for the outperformance is that BBW was underpriced in the float. The vendor was Babcock & Brown and friendly investors, which means that part, but not all, of what B&B missed out on in the float has now been made up in fees, although what the co-vendors in the IPO who didn't get any fees think about this is not known.

Anyway, while the BBW fee of \$33 million might look like burglary, it is much the same as everyone else's in the infrastructure playground, including Macquarie's.

We can perhaps argue about whether these fees, in general, are excessive, and whether it's a good idea to pay them on capital rather than income, but they are not out of line with Macquarie's and Macquarie's are not out of line with B&B's.

The one that is out of line is Alinta Infrastructure Holdings (AIH). Alinta charges its infrastructure fund as follows: a base fee rising to 1 per cent of market capitalisation, plus 20 per cent of any outperformance against the S&P/ASX 200 Accumulation Index, plus 3 per cent of gross revenue, paid monthly. Plus, Alinta actually has the nerve to charge AIH for services rendered (at cost).

I think we can confidently say that *this* is the high watermark of the infrastructure bubble. Alinta's particular entry in the Guinness Book of Fee Records is the 3 per cent of revenue, in addition to charging for services provided. No one else does that.

This, presumably, is why Alinta can afford to overpay for AGL — just stick the assets into AIH and almost any level of debt can be serviced by the fees.

Meanwhile bond yields are beginning to rise, and the bond bears are rousing themselves again and mournfully ringing the bells for the Beginning of the End.

Ten years of falling bond yields have supported all asset values, with the infrastructure boom perhaps the most extreme manifestation.

If it's true, as some are saying, that we are in for a longish period of rising bond yields, then infrastructure fund promoters such as Macquarie and Babcock & Brown will struggle to get another dollar of performance fees for years, since these are tied to share price. The funds themselves will be fine, because most debt has fixed interest rates and income tends to be on long-term, inflation-linked contracts, but the value of fund equity will tend to decline as discount rates increase with bond yields.

Alinta, of course, will keep getting its 3 per cent of revenue no matter what happens to the price of AIH; even better if it's 3 per cent of AGL's infrastructure revenue as well.

## 2.5 The impact of gearing on networks operation

The issue of gearing of the transmission businesses is two fold. The first reflects the basis on which the regulator assesses the notional corporate structure, and the second is the degree to which the owners' actually structure their businesses.

Whilst the funding permitted by the regulator assumes a notional but sound corporate structure giving a high credit rating, the owners of the business are permitted to structure the business to suit their own needs. This creates a significant concern amongst consumers. Consumers are paying for a soundly based relatively risk averse corporate structure, but the owners can and do structure the businesses in such a way that puts them at a higher risk of financial failure. If there is a failure (such as unpaid interest on the debt) the outcome will be the financiers taking over the business and attempting to minimize their exposure, as happened in the case of Loy Yang Power Station. Such financial failure could lead to the financiers stepping in as operators (even though they might not have the requisite skills) or drastically cutting back opex and capex in order to pay interest bills. Either form of financial failure will adversely impact consumers.

Of concern is that many regulated businesses are gearing well above the notional level assumed by the regulator when establishing the WACC. In this regard we draw your attention to the recent Fitch report, Corporate Finance, 3 February 2006 from which excerpts are reproduced in the box below

**Australian Utilities: What's the Mix for 2006?**

The ratings outlook for Australian utilities is negative, reflecting a move towards more aggressive corporate and financial strategies.

M&A event risk is likely to continue, driven by increased vertical integration and the emergence of infrastructure investment funds.

Based on Fitch's estimates of cash flow from operations (less dividends) for 2006, most Australian transmission and distribution utilities will need to draw upon additional debt to meet their very high capex commitments.

While the regulated infrastructure assets themselves are viewed as having strong business risk profiles with relatively consistent and predictable cash flows, event risk arising from M&A and capital structure changes is a major factor at the infrastructure fund/holding company level. Managers are typically adopting more aggressive capital structures to improve the overall weighted average cost of capital and therefore increasing shareholder returns to the potential detriment of credit profiles. In addition, the infrastructure vehicles such as SP AusNet, Spark, AGL Infrastructure and Alinta have aggressive acquisitive strategies. Purchase prices for new infrastructure assets are expected to rise as competition increases for a limited list of targets.

**The MEU considers that the new Rules should have a requirement that if the owners of the transmission businesses seek to implement higher gearing than the notionally low risk gearing assumed by the regulator, then there must be a means of protecting consumer interests in the event of financial failure.**

## **2.6 The erroneous view that there is competition in electricity transmission**

The function of electricity transmission is to deliver as much power as required from as many generation facilities to a central location for ultimate use by consumers, as possible. The economics of such transfers of energy demand are such that it is uneconomic to even attempt duplication.

The physical requirements of electricity transport require that large amounts of power is required to be transported as this is most economically carried out at higher voltages. The higher the voltage used the lower the cost per unit of transport and the lower the losses that are incurred (and which have to be paid for by consumers). Lower voltages are used for

smaller amounts of electricity transfer and where the delivery distance is shorter.

Thus bulk supply of electricity is best carried at high voltages (usually 66kV to 500kV) and lower voltages (3300 kV to 415V) used for reticulation to many small demand customers.

The technical requirements for managing high voltage transfers are much more onerous than for managing lower voltages. This results in fewer but extremely competent companies operating with higher voltage transport. In Australia almost entirely the technical skills for managing higher voltage transport reside within the regional transmission businesses. The costs of entry to the electricity transmission business are extremely high, as evidenced by the challenges faced by Quebec Hydro when it entered the Australian market to build Directlink and Murraylink. Since the electricity deregulation process began, there has been no new entrant of significance<sup>7</sup> into electricity transmission in Australia.

In addition to the technical skill barrier to entry of this market, there is a more pervasive barrier – that of location and the size of augmentations. Because the essential element of transmission is transport of large amounts of power over large distances, the networks themselves cover large areas of Australia, and because of the origins of the main transmission companies, are very closely aligned with state boundaries. It is not surprising that except for a very few inset networks located near to state boundaries there has been no large scale movement by transmission companies across state boundaries. The reason for this is at the centre of how a business develops, owns and operates a transmission network.

The formatting factors are:-

- The marginal costs involved with extending a network (loosely referred to as “brownfield” development) are lower than the costs of relocating to what is a “greenfield” development if carried out by a new entrant
- The logistics of distance prevent a competing transmission asset owner to control a relatively small inset in another’s region. For example, the costs for TransGrid to own and operate a small inset network in South Australia are too great in relation to the costs for ElectraNet to do so, as

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<sup>7</sup> National Grid which owns the Basslink could be considered as such, but as its revenue is effectively underwritten by the Tasmanian Government (through its ownership of Tas Hydro which guarantees Basslink), it is not really independent. Further, the technical requirements for Basslink preclude the Australian transmission companies from owning and operating such a facility.

ElectraNet is able to marginally cost the additional attendance, whereas TransGrid needs to fully cost the activity.

- The local transmission company has more powers in relation to securing easements, or even uses its own easements which are not available to a competitor.
- For a single user owning a small element of a transmission system, the Public Liability risks are so high as to eliminate a user from sensibly taking such a risk or insuring against it (due to the low probability with extraordinarily high potential cost outcome). The incumbent TNSP is able to amortise the risk over a much larger asset base, and to marginally cost the increased risk due to the augmentation.
- A pragmatic business view is that by commencing such work in another TNSP region, would expose the TNSP itself to competition.

The above demonstrates that an incumbent TNSP has significant benefits when augmenting its own network when compared to a new entrant.

What is just as important is that there is effectively no competition available to an end user seeking a new or additional electricity supply. Electricity has become the only cost effective method of providing motive power and smelting and electrolysing minerals. It is these two uses that creates the demand for the bulk of electricity used in the NEM (for driving motors, for aluminium and steel smelters and for minerals refinement)<sup>8</sup>.

Thus, to assume that electricity delivery is anything but a monopoly denies the actuality of the matter.

- End users must have electricity; there are no competitors to it as an energy source for certain uses.
- The economics of production and delivery of electricity preclude the introduction of a multitude of small supply options, severely limiting competition.
- For the reasons given above, the existing transmission businesses do not “poach” in another’s territory.

Effectively end users are constrained to use the incumbent transmission businesses, whether for maintaining existing supply, or augmenting supplies.

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<sup>8</sup> Despite the large amounts of electricity used by end users, there are very, very few which can economically locate adjacent to electricity production facilities. This then requires transmission networks to deliver electricity to locations remote from electricity production, giving these networks extreme market power, as electricity is essential for the downstream industry.

When compared to other apparent monopoly suppliers (e.g. telecommunications where end users have a choice of service type - land line, wireless/mobile, computer, etc - and relative low entry costs for providers - witness the entry of Optus, Vodaphone and ISPs offering VoIP), the degree of monopoly held by the electricity transport businesses is absolute.



## 3. Scope and Form of Regulation

### 3.1 Type of Regulation

The MEU supports the continuation of the Revenue Cap CPI-X incentive program currently in use for regulation of transmission assets providing the prescribed services, and proposed to be retained by the AEMC.

There has been discussion that a price cap approach might provide greater incentive to TNSPs. The experience of MEU members with the price cap approach suggests that monopoly providers use the facility of price caps to optimize the revenue stream for the business. This issue was clearly demonstrated in the recent Electricity Distribution Price Review undertaken by the ESCoV. It was clear from the revenue streams earned by the DBs that they had been able to optimize the allocation of prices between the various tariffs to over recover revenue above the growth forecasts. By manipulating tariffs the DBs in Victoria were able to increase revenue well above the forecast revenue implied by the previous review, even allowing for the variation in forecast growth. Unless there is control of the allocation of costs between tariffs, then a price cap regime permits the monopoly business to achieve a greater return than implied by the regulatory approach.

### 3.2 Definition of Services

In its report the AEMC makes the observation that:

“The Commission believes that there has been a tendency for an over-inclusion of the services that are subject to a revenue cap. The consequences of this include more intrusive regulation than may be warranted and the crowding out of opportunities to increase the level of contestable service provision.” (page 28)

The report goes on to comment that there are effectively two separate categories of services provided by transmission businesses, which should be either included in regulation (shared assets) or open to commercial negotiation (dedicated assets which need to be provided by the TNSP for exclusive use by an end user). The AEMC has established an industry/end user working group (with the MEU as a participant) to rationalize a description of these two options. The AEMC states that services outside these two categories should be un-regulated and uses the example of consultancy services which typifies this category.

What the AEMC fails to recognize is that there are effectively **five** different services provided by TNSPs as part of their service provision, and which show high but varying degrees of monopoly power. These are:-

1. Shared services, where many users benefit from the service (e.g. assets between TNSP substations)
2. Augmentation of the shared services to increase the capacity or redundancy to deliver a greater amount of power or with more certainty than is currently feasible
3. Connection services within the boundary of the TNSP assets (e.g. within a substation) where the connection of a customer requires the TNSP to provide dedicated assets used only by that customer which then provides multiple end users (e.g. a DNSP)
4. Connection services within the boundary of the TNSP assets (e.g. within a substation) where the connection of a customer requires the TNSP to provide dedicated assets used only by one end user (e.g. a large end user or generator)
5. Connection assets outside the boundary of the TNSP assets where the connection of a customer requires the TNSP to provide dedicated assets used only by one end user (e.g. a large end user or generator)

The AEMC proposal implies that the shared services would be subject to regulation, and the connection of a customer for work within the boundaries of the substation would be subject to commercial negotiation. The implication is that services provided outside the boundaries of the substation would be unregulated.

The AEMC avers that recognizing these differences and using different approaches will result in less intrusive regulation. The reason for seeking this “less intrusive regulation” is not stated, except that it must be inferred that “less intrusive regulation” will result in greater clarity and incentive to TNSPs to greater investment, and finally consumers will benefit.

**This bland assumption (more an assertion) is not supported at any point covered in the report. The report makes no attempt to demonstrate or justify that greater incentives to TNSPs to invest are required, or that there are observed deficiencies..<sup>9</sup>**

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<sup>9</sup> This assumption smacks of economic rationalism which has not been tested and follows slavishly the approach in the Productivity Commission review of the Gas Access Regime where, in support of its finding 4.3, the PC on finding no evidence of a lack of investment in the gas transport industry to support its contention that the Gas Access Regime regulation had stifled investment, resorts to the basis of “conceptual

Examining each of the subgroups identified above provides a better understanding of what form of regulation might best apply. This is a reasonable approach which the AEMC should consider.

### **Service option 1 Shared services**

There would appear to be no reason not to include these services within the category of prescribed services. There are many users, and the use made by each varies over time, allowing little ability to identify the extent to which any user is benefiting from the service over time.

The service requires the assets to be augmented as required by the increase in demand for the service by end users. The overarching objective of the NEM, as espoused in the NEL, states that the cost for augmentation of these services is only to be that caused by an increase in demand by consumers, therefore implying an increase in capacity caused by a requirement from increased generation would not be included as a prescribed service.

Thus the augmentation of the shared services required as a result of increased generation must be funded by the generator seeking access. However, over time more demand for service will come from consumers, but this can be accommodated within the element funded by the generator, resulting in a “free ride” by new consumers.

### **Connection service option 1 Augmentation of shared services**

Throughout the draft new Rules is the assumption that there is permitted variations to the standard services (for a cost consideration). As discussed in section 3.3 below the only increased service level possible is that there maybe additional redundancy or additional capacity built into the shared network to meet a higher service level than the one imposed by the Rules or a jurisdictional direction.

This creates a potential conflict into the future where one party has sought and paid for a marginal increase in service standard in the shared network

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considerations”, to arrive at the conclusion that “The Gas Access Regime is likely to be distorting investment ... “.

expecting a higher performance, yet the actions of others connected can still prevent the service level outcome sought, being delivered in actuality as the TNSP has no control on what other customers do which might prevent the greater certainty paid for. It will be these other customers who will receive a “free rider” benefit.

## **Connection service option 2 Connection of a DB at a substation**

Almost all connections to the transmission network are to a distribution business. Under the proposal this would be on a commercial basis and the DB and the TNSP would negotiate an acceptable price. However, as the DB has the right to pass through all its costs to its customers, there is no incentive on the DB to do anything else than accept the price offered by the TNSP for the connection.

In this scenario, the TNSP can request and be granted whatever price it deems appropriate and there is no avenue for any verification of the price unless the DB seeks it. The only constraint that might occur would be if the regulator did not permit the pass through of the connection costs by the DB to its customers. This is would be an indirect path to ensure that connection costs demanded by the TNSP are in fact reasonable and can be established to be so.

However, there is no constraint on an embedded generator connecting to the assets comprising the connection service paid for by the DB. In most cases (but not all) the embedded generator will be smaller than the demand from the DB customers, resulting in few if any costs associated with connecting the embedded generator. This creates a “free ride” for the embedded generator, at the expense of consumers.

The DB, being in the business of transporting electricity itself, has no need for the TNSP to provide a service beyond the boundaries of the substation, and the DB can connect new users at will, dependent only on the capacity of the connection at the substation.

Almost by definition, the connections a DNSP makes are for the benefit of a number of end users. It would seem a pointless exercise to require a TNSP to negotiate the connection with a DNSP when the connection is for the benefit of many users. In fact by doing so there will inevitably be a different cost for each connection point which the DNSP has later to average anyway

to ensure that costs for the same service are the same for the same class of end users.

### **Connection service option 3**

#### **A dedicated connection to a single party at a substation**

Although almost all connections to a TNSP are to a DB, there are a number where a generator or a single end user connects to the TNSP assets.

In this instance it would appear that commercial negotiation might be feasible. However, to ensure that the TNSP (being the party with the market power) does not use its market power to extract monopoly rents, there is a need to require the avenue for arbitration in the event that the negotiation stalls (which is almost always likely when negotiating with a monopolist).

This arbitration must be timely. By delaying any access to arbitration it will provide the party with the monopoly power a benefit, as the party seeking connection is almost inevitably constrained by time pressures, and so delaying an outcome will severely impede the applicant.

In an AC electricity system it takes significant time to design and build an augmentation, and to identify the scope and need for augmentation within the shared network<sup>10</sup>. Because the TNSP is not exposed to any effective competition, a determined TNSP can use delays in the arbitration process to stifle the ability of a customer seeking redress for a perceived or real overstatement of connection costs. A proponent seeking access to the network is heavily constrained by delays in the process as the essential electrical connection is only one of many critical aspects a new development requires.

Thus whilst permitting an arbitration process might engender a modicum of a reduction in regulation (at the expense of delays and increased costs incurred in the arbitration process), it has the potential to significantly stifle downstream investment, or at best, cause unnecessary higher costs for downstream business, effectively reducing the benefit of a national wealth creation opportunity. By doing so the process proposed does not meet the single market objective of providing an efficient service for the long term interests of consumers.

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<sup>10</sup> An example of this was the need to augment TransGrid network as far south as Tumut, when examining the impact of a generator located within 8 km of Sydney central.==

Over time it may be commercially sensible that an additional connection be made to a dedicated connection. Such a connection might be to a single user or to a group of users through a DB. The question then arises whether the cost of the initial connection was efficient as it now would be used for additional users, and so might become part of the shared service. Unless the initial cost has been oversighted as efficient, then there is uncertainty as to the amount to be rolled into the RAB is appropriate.

#### **Connection service option 4 Connection outside the substation**

There is a general belief that there is no reason for a TNSP to provide a service outside of its substation. In theory this work can be constructed by any competent person, and be owned and operated by a competent person. This perception is different to reality.

In reality a higher voltage connection requires a competent operator. Due to economies of scale and geographic distance, there is unlikely to be a competitor to the incumbent TNSP. This is discussed in section 2 above. This results in an effective monopoly<sup>11</sup> for provision of the service for connection works outside the bounds of the substation, and the TNSP uses this to maximize its commercial return.

Currently there is no constraint on a TNSP charging what it wants, and probably it would price such works to the Ramsay price level rather than to price to the direct costs. Again such an approach does not meet the single market objective of the NEM for consumers.

As in connection option 3, there is the potential over time that the external connection is sensibly used to connect other consumers. This is typical of the growth of transmission networks historically, with the dedicated connection becoming (sensibly) part of the shared assets.

There are two negative outcomes resulting from this supposedly contestable augmentation of the transmission network:

1. The TNSP prices its external services to meet the next lowest cost option. This results in a reduction of profitability of the downstream consumer, perhaps preventing new national wealth creating opportunities.

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<sup>11</sup> Members of MEU have found this to be factual.

2. When over time the augmentation is to be incorporated into the shared assets, at what price does the regulator include the assets? – the DORC or the price charged by the TNSP at the time the augmentation was built? Either option has a negative impact on consumers, including the party initially funding the external connection works.

## **Negotiation vs. Prescription**

The principle of using negotiation rather than regulation is that there is a perception that negotiation leads to a better outcome, one that is acceptable to both parties to the negotiation.

In principle there is some support for such an approach, but for a successful negotiation there needs to be equal power available to the parties negotiating. If there is unequal power then there is no negotiation. The reason for imposing regulation on a party is that there is an expectation that the balance of power lies so heavily in one direction (i.e. that of the monopoly) that there can be no expectation of an equitable outcome, and that an equitable outcome will only occur if there is prescription of the outcome. Regulation is a method of providing this prescription.

The recent decision of the Australian Competition Tribunal supports this view in its decision regarding the Sydney Airport appeal by Virgin Airlines. The outcome was that the Sydney Airport Corporation (SAC) did have market power and that even a well resourced and competent party to a negotiation (Virgin) can be (and was) defeated by the monopoly power of SAC. The ACT decided that regulation was required to ensure equity for the users of the service.

The decision<sup>12</sup> states:

“17. We are satisfied that any commercial negotiations in the future between SACL and airlines using Sydney Airport as to the non-price terms and conditions on which the airlines utilise the facilities and related services at Sydney Airport are likely, as in the past, to continue to be protracted, inefficient, and ultimately resolved by SACL using its monopoly power to produce outcomes that would be unlikely to arise in a more competitive

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<sup>12</sup> File No 1 of 2004, Application for review of the decision by the Parliamentary Secretary to the Treasurer, dated 29 January 2004 in relation to the application for declaration of the airside service provided at Sydney Airport by: Virgin Blue Airlines P/L before Goldberg J (President), Mr G F Latta and Dr J S Marsden 9 December 2005, summary clauses 17 and 18.

environment. This situation is exacerbated by the lack of an appropriate dispute resolution procedure providing independent arbitration in any of the commercial agreements entered into or proposed between SACL and the airlines.

18. We are satisfied that the ability of SACL to exercise monopoly power in relation to the airlines' use of the Airside Service is not subject to any effective constraints. We do not consider that the airlines have any significant countervailing power, or that the threat of re-regulation by the Commonwealth Government is an effective constraint upon SACL, or that SACL's ability to derive non-aeronautical revenues operates as a sufficient constraint on SACL's monopoly power."

It is accepted that Sydney Airport does have a monopoly service, but the reasons why it does lie both at the uniqueness of the facility and the lack of a credible alternative. For instance other aeroplanes (including jets) can and do land at Bankstown Airport but this is an inconvenient location, demonstrably not a cost effective alternative for passenger services, and is therefore not a practical alternative to using Sydney Airport. The MEU points to the equivalent option for electricity transmission services – that the alternatives are not commercial, convenient or practicable.

The balance of a negotiation will only be maintained if there is a credible alternative on the part of the buyer (i.e. there is no monopoly), and a credible alternative on the part of the seller (i.e. there is no monopsony). In the case of electricity transmission services there is no monopsony, as electricity is an essential form of energy. There will always be many buyers. However as discussed above in section 2, there is a monopoly of service provision, effectively created by a number of unique features of electricity and the commercial realities of the provision of transmission.

To assume that there are credible alternatives to transmission services exposes consumers to a higher level of risk with less certainty, and as such creates tension with the single market objective. There is no discussion within the AEMC report as to why the AEMC seeks such an aggressive approach towards reducing regulation, other than it seeks to increase certainty for the TNSP and to increase the incentive for investment. The AEMC report provides **no** explanation as to why it considers the move of more services to "negotiation" status will achieve either of these goals. It has to do better to justify such a major and (to consumers) disconcerting move.



Thus on balance the AEMC should err on the side of caution when allocating regulatory activities between prescribed services and negotiated services – and even the allocation of services to competitive status.

Before the AEMC allocates services to “competitive” status it must examine the actuality of the service provision and satisfy itself that there is credible competition that can actually compete. If there is no credible competition, then such a service must be oversighted to ensure that monopoly rent taking is not in the least possible, and is prevented.

Before the AEMC allocates services to “negotiated” status, it must ensure that in practice the negotiation will ensure a balance of interests and power between the parties. If there is a bias (most commonly in favour of the party with greater time availability), then there must be a rapid and clear ability to ensure resolution of the reason for non-conclusion of the negotiation.

A number of regulators have advised other investigative bodies about their poor experiences with negotiate/arbitrate model options and even price monitoring. In the recent report on the Gas Access Regime by the Productivity Commission<sup>13</sup>, both the ESCoV and the ACCC offer a view that these other regulatory approaches have considerable detriments. On page 20 of the report, the ESCoV submission points to the difference in market power in gas distribution for a negotiate/arbitrate model to operate effectively, and the ACCC (see page 32) opines that price monitoring won’t be effective (as also confirmed by the ACT in the Sydney Airport case).

## **Recommendation**

### **Connection services**

**The MEU recommends that**

- **Where there is no credible alternative to the incumbent TNSP carrying out an augmentation, the TNSP must be required to carry out the work providing it meets the other criteria of safety and system ability to carry the power**
- **all augmentations carried out by a TNSP be oversighted by the regulator with a view to verifying the costs of an augmentation to**

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<sup>13</sup> Productivity Commission Inquiry Report No. 31, 11 June 2004, Review of the Gas Access Regime

**ensure that they are in keeping with the costs accepted and approved for the shared assets**

- **the regulator with its extensive experience in assessing network costs, be responsible for overseeing the rapid review of disputed augmentation costs, and supervising the performance of the arbitrator appointed.**

**The MEU approach allows for**

- **negotiation with a TNSP as a first step for connection works,**
- **permits rapid resolution of connection price disputes,**
- **uses its acquired knowledge of the networks and its costings, rather than follow a time consuming and expensive process of commercial arbitration,**
- **permits certainty that in the future the cost of a dedicated augmentation, if used later by multiple users, will be accepted for inclusion in the RAB.**

### **3.3 Scope of services outside the “standard service”**

The service standards sought by consumers relate to longevity (a function of the age of the shared assets and the degree of maintenance provided by the TNSP), reliability (a function of many more parameters than just transmission thereby putting this service level outside the exclusive jurisdiction of transmission), and quality (a function of NEMMCo for frequency stability and inputs from other consumers operating outside permitted ranges).

At best, voltage stability is a matter within the control of the transmission business, and whilst the design of the shared system contributes to the ability to manage voltage stability, there are many other exogenous influences (weather, other consumers, the wider public, etc) which impact on voltage stability. Thus for a TNSP to address voltage stability for a specific customer is virtually impossible.

There are some services which a TNSP can provide which are truly in the “contestable” arena, such as in consultancy services. However, these are a result of the requirement that it is to provide an electricity transmission service. It is obvious that the bulk of the TNSP revenue comes from the services it provides as a transmission service provider.

On examination of the other services that it can provide, it would appear that within the scope of transmission services, there are very few options where the TNSP can provide a lesser or greater service. For instance, an increased service (such as redundancy or capacity) might be able to be offered at connection point, but if the shared network only accommodates a lower degree of redundancy, there is no value in paying for an increased service at the connection point if the shared network is incapable of supporting the increased service level at the connection point.

In spite of the various controls that must be provided or coordinated by TNSPs as detailed in Rules schedule 5.1, the only variations that a TNSP can offer a customer to the “standard service” are:

- voltage variation at the connection point
- variation of capacity (the current flow at a given voltage) at the connection point but not necessarily within the shared network
- the degree of redundancy available at the connection point, but not necessarily within the shared network (e.g. N, N-1, and N-2).

These three service variations are all established at the connection point, and impact on the cost outcome incurred at the connection point. Rather than being identified as increased or decreased service options, they would be better described as options for connection.

**A TNSP is not able to offer any increased or decreased service level other than these. Thus to consider that there is a large range of contestable services which can be offered by a TNSP to a customer is fallacious, and we would contend does not warrant a separate service approach.**

## 4. Regulatory Procedures

The AEMC proposed draft new Rules is predicated on reducing regulatory uncertainty. Throughout the report and in the draft Rules themselves, there is an underlying assumption that regulatory certainty is to be the province of the regulated businesses. It is agreed that this is part but only part, of the regulatory uncertainty that needs to be addressed.

To consumers the concern for regulatory certainty is that the regulator will provide an outcome that meets the goals of consumers, and in particular the long term needs of consumers. The AEMC has concentrated on the need to further incentivise regulated businesses to invest. This is one but only one of the goals of consumers who also seek reliable supply of high quality and at a reasonable cost.

It is incumbent on the regulator to ensure that in providing a more certain environment that it does so for both business and consumer, and that the result does not provide unnecessary revenue and profits at the expense of consumers or without a concomitant increase in service performance such as reliability and quality.

In this regard the AEMC should have regard for the fact that industrial consumers (those that contribute to the national wealth) use some 70%<sup>14</sup> of all electricity generated. In comparison domestic consumers' use between 12-20%<sup>15</sup> of the total of all electricity generated. Any unjustifiable transfer of wealth from industrial end users to network providers reduces the profitability of the wealth creating industries on which the electricity system itself is heavily dependent.

It is essential that care be taken to ensure there is a real balance of interests assessed when making Rule changes.

### 4.1 Direction and Guided Discretion

The exercise of discretion reduces certainty – for the regulated business and for those paying the regulated charges. Equally, for example, when preparing the Gas Access Regime Code of Practice, there was so many items where there was dispute over what should be prescribed, that the only alternative was to provide discretion so that the various scenarios raised where there was dispute, could only be resolved where the regulator had the power to assess each scenario as it would apply to each unique business on a case by case basis.

Notwithstanding this, the principle of allowing the AER to have discretion is supported but that there should be clear guidelines as to how the

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<sup>14</sup> AIG estimate, supported by analysis of the energy market

<sup>15</sup> ABARE estimate, supported by calculations of household usage and the number of dwellings

discretion should be used. The SRP provides some of the bases for guidelines in the use of discretion provided to the AER.

We also note that the current Rules also allow the TNSP significant discretion as to how they prepare their applications and provide information. We believe that in the interests of transparent, equitable and timely regulation, there is a need to limit the extent of TNSP discretion as to what is required and how, and to ensure that information is prepared in an approved known format, so that records will be kept to provide the information required for a review will be provided and in the most appropriate format for use by the regulator.

The aspects which the new Rules would provide direction are:

- Form of regulation (to be CPI-X building block for PTS negotiation for NTS) ;
- Methodology for the calculation of the revenue cap for PTS;
- The process for dispute resolution in relation to charges for NTS;
- The steps in the Propose-respond process by which TNSPs make proposals and the AER assesses those proposals; and
- Procedures for developing and amending AER Guidelines.

**The MEU supports that these activities should be a direction to the AER, although there are comments elsewhere in the submission where we do not necessarily agree with the detail of what the direction might be.**

The aspects which the new Rules would provide guided discretion are:

- Principles for the design of incentive schemes for standards of service and operating expenditure; and
- Information and Cost Allocation Guidelines and PTRM Model to be prepared by the AER in line with the Rules.

**The MEU supports that these activities should provide guidance to the AER to apply their discretion. The AER should develop their own guidelines for the exercise of this discretion so that clarity and transparency apply. There are comments elsewhere in the submission where we do not necessarily agree with the detail of the scope of this guided discretion.**

## 4.2 Information Requirements

As noted in the AEMC report, the provision of information which is accurate, timely and in a format allowing easy dissemination of the information is essential to maintaining a strong transparent regulatory process.

Establishing a format for the provision of information (the regulatory accounts) required by the regulator allows the regulated business to set up its internal reporting structure to match the reporting required by the regulator; thus creating for the regulated business an ability to minimize the impact of securing the information required by the regulator. Such a process also reduces the time required by the regulator to complete the review as it should have all of the information it requires provided by the business at the commencement of the review.

Some jurisdictional regulators have implemented guidelines for the regulated businesses to provide not only the information required for reviews, but between reviews. Having this prior information not only allows for monitoring performance throughout the period, but also provides a continuous feed of information which is essential at the time of a review. It is suggested that the AER implement such continuous feed of needed information throughout a regulatory period.

**The MEU strongly supports the establishment of a guideline which defines the information required for a review and the format in which the information is to be provided. The MEU recommends that the collection of information be a continuous process throughout the regulatory period to minimize the amount of information delivered at the commencement of the review.**

The MEU suggests that having a continuous flow of information will also permit the regulator to identify any shortcomings in performance of the regulated business and if needed, implement action to correct performance.

## 4.3 Propose-Respond Procedures

As pointed out by the AEMC, a propose-respond procedure is in fact what the current regulatory review arrangements are. The key difference proposed by the AEMC is that the AER is now required to publish what information is required to be included in the TNSP proposal and for the

TNSP to provide the information in a standard format established by the AER to allow ready integration of the information into the review process.

It is essential that the two requirements be seen as joint requirements, because if the formalizing of the propose-respond approach is implemented without the requirement to provide information in a specific format, then the benefits of both changes loses impact.

The AEMC provides a flow chart of the process and this is supported. The only concern that the MEU has is that the derived 13 month review period might not be sufficient in practice. Jurisdictional regulators have allowed even longer for the review process and still have found that there has been insufficient time available because the provision of essential information has not been provided by the regulated business as detailed at the time it is required.

One of the key elements of the current regime is the ability of the business to release information to suit its goals. From a consumer viewpoint in seeking regulatory certainty, the timely provision of information is paramount. There needs to be an incentive created for the regulated business to provide all of the required information at the time required. Failure to do so must involve some penalty, as it is in the interests of the business not to provide timely information (particularly that which might lead to a reduction in revenue) in order to create a time pressure on the regulator. End user experience in a number of regulatory reviews shows that the regulator has been placed under time pressures by the businesses being reviewed and so an environment has been created where the regulatory outcome has been less that satisfactory.

**The MEU supports the formalizing of the propose-respond approach as detailed providing that there is a requirement for information provision to permit the AER to define the information required and the format in which it is provided.**

**The AEMC must add to the Rules a requirement that information be provided to meet the propose-respond timeframe and that if the business fails to comply with the timelines, then there is a penalty to be imposed on the business.**

However in its consideration of the Productivity Commission review of the Gas Code, the Expert Panel on Energy Access Pricing recently released Draft Report to the Ministerial Council on Energy in which it made

comments about the “propose-respond” approach to regulation. In its draft report it commented that the PC view (see proposed changes to Gas Code clauses 8.6 and 8.31) that the regulator should accept a proposal from an applicant if the:-

- (a) proposed method has a plausible conceptual basis; and
- (b) values used in applying the method lie within the range of plausible estimates.

The Expert Panel noted that the Export Infrastructure Taskforce adopted the PC’s recommendations, albeit with another variation of the same theme. On consideration the Expert Panel considered the PC and EIT to be in error on this issue. The Expert Panel comments:-

- “the ordinary meaning of ‘plausible’ is defined in the Oxford Concise English Dictionary to be ‘apparently reasonable or probable *without necessarily being so*’ (emphasis added);
- there is no established law and practice in relation to the application of a judgment of ‘plausibility’ in regulatory law;
- establishing a range with respect to variables about which there might be considerable uncertainty in relation to their statistical distribution is conceptually and practically difficult;
- there is no accepted statistical standard for determining a ‘range of plausible estimates’.

The Panel concludes by stating that such a formulation would:

- “provide little practical guidance to the Regulator;
- create great regulatory uncertainty;
- lead to litigation in an effort to clarify the limitations it places on the Regulator’s decisions;
- lead over time to a systematic upward bias in the returns provided for infrastructure providers;
- be an inferior policy response to concerns about the impact of regulatory error on the provision of infrastructure”

**In light of the Expert Panel’s concerns, which are strongly shared by the MEU, the MEU recommends that the AEMC ensures that the redrafting of**



**Rules does not lead to the outcomes identified by the Expert Panel resulting from the formalization of the propose-respond mechanism.**

This very concern was raised in the MEU response to the AEMC's Issues Paper on this matter where we pointed to our concern that transferring some of the control of the regulatory process to the regulated business will enable the business to exercise its power to maximize its revenue.

#### **4.4 Regulatory Decision Criteria**

The proposed draft Rules suggests that regulatory risk and uncertainty will be reduced if a number of elements of the building block are codified. The implicit assumption is that a better investment environment will apply if there is greater codification and less potential for variation of the elements to be varied during and after review by the regulator.

It suggests that the elements to be codified would be

- The form of Post-Tax Revenue Model ;
- The opening value of the RAB to be listed in the Rules with a model for rolling forward and indexation of the RAB to be developed by the AER (Rule 6.2.3);
- The value of the WACC (Rule 6.2.4);
- Cost of corporate income tax;
- Depreciation (Rule 6.2.5); and
- Revenue increment or decrement due to efficiency sharing benefits scheme and performance incentive scheme.

In addition to these codifications, it is proposed that the TNSPs will be permitted to set the capex and opex requirements and that the AER must accepted them if they are considered "reasonable".

The MEU sees no reason for regulators to not settle on a standard form of setting the revenue model. The current approach is that there is a basic assumption that a well conceived business structure for providing this essential service should reflect the a conservative ratio of debt to equity relative to the security of cash flow, and that the notional business would reflect the current mix of local and overseas investment which limits the ability of investors to secure all of the benefits of tax imputation.

**Thus the MEU supports that the PTRM approach and an assumption of 50% utilization of tax credits (i.e.  $\gamma = 0.5$ ).**

Similarly the revenue model has to reflect the benefit/detriment of historic performance achievement, whether this is related to service standards, opex savings or more efficient use of capex.

The three main concerns held by MEU and its members relates to the setting of the WACC parameters, the free ability of the business to select its depreciation rate for use in the notional financial business structure and the opening RAB. The concerns relating to rate of return, depreciation and opening asset base are addressed in section 6.

#### **4.5 Cost Allocation Method**

The MEU supports the requirement for there to be a clear and unequivocal methodology for allocating costs from the revenue cap into cost reflective tariffs. It is essential that tariffs represent as close as is possible the actual cost each customer (generator and end user) should be required to pay is reflective of the usage each makes of the network assets.

Further as pointed out in the Report, with the expectation of an increasing movement of assets from the Prescribed Services to the Negotiated Services, there is potential for there to be cross subsidization between the two classes of service. Greater transparency of methodology will reduce the potential of cross subsidization.

#### **4.6 Revocation of a Revenue Cap**

The proposed Draft Rules continue to permit the reopening of the revenue cap under certain circumstance – at a pragmatic level mostly it will apply to when the TNSP is seeking to increase its revenue. The new Rule sensibly excludes the requirement to reopen where ownership has changed.

Where the TNSP is seeking to increase its revenue cap it will be proactive in seeking the reopening. Unfortunately, as the TNSP has all of the financial data available and during a regulatory period this is not required to be provided to the regulator, it might not be apparent until the next reset that the TNSP has not advised there was an error in its favour. At the reset this information might then become apparent to others. Therefore, it is imperative that there be an incentive for the TNSP to reveal when there is a need for a reopening leading to a reduction of the revenue cap. Unless this

is implemented than the ability to revoke a revenue cap is one sided – with the TNSP being the beneficiary either way.

**In principle MEU agrees with this draft Rule, but it has concerns that it will only work in one direction. MEU suggests that if the regulator becomes aware that the TNSP has not alerted it to the fact that there was potential for a revenue cap reopening reduction, then the regulator must recover all of the over-recovered funds resulting from the error, and to apply a penalty premium to that amount.**

## 5. Regulated Revenue

### 5.1 Regulated Revenue for PTS

There have been suggestions that would allow revenues to be set in respect of depreciation and the cost of capital for the full life of those assets (or for longer than 5 years). This it is alleged would reduce regulatory uncertainty, perhaps lower the cost of capital, and strengthen companies' credit quality as assessed by ratings agencies.

This is considered inappropriate as it has the major downside that it would lock in the allowed cost of capital and preclude consumers from benefiting in the event that companies refinance their debt at a lower cost in the future as a result of the cost of debt reducing in the future. It also exposes the regulated businesses to the movement of the cost of debt upwards in the future, as there are few lenders who will provide debt for long periods on a fixed basis. For example debt provision for residential needs is usually only available for 25-30 years forward and this only on a variable interest rate. Examination of the debt profile of most businesses is that debt has an average life of about 7-8 years, with shorter periods when debt costs are falling and longer periods when debt costs are rising.

The MEU is of the view that the WACC elements of the revenue should be set only for the ensuing five year regulatory period to reflect the costs of debt and equity over the prescribed regulatory period for the business and that depreciation should be set on a linear basis over the economic life of the asset.

#### 5.1.1 Regulatory Asset Base and Capex

The RAB is derived from three key elements; initial capital base (ICB), past capex and future capex during the regulatory period. The proposed draft Rules provide a lock in of the ICB and past capex permitting no retrospective review for optimization or previous errors. The lock in approach provides greater regulatory certainty for the businesses but equally requires consumers to have to pay forever on stranded assets incorporated in the PTS. Under the DORC approach to setting regulatory values, the RAB is the initial cost less depreciation plus inflation. As depreciation is over the technical life of the assets (usually exceeding 40 years or 2.5% pa<sup>16</sup>), the impact of inflation (which averaged some 6.2% for the period 1949-

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<sup>16</sup> Source: Reserve Bank of Australia

1995) will effectively increase the value of the RAB regardless of any subsequent capital injection. Thus any asset included in the RAB now will always be in the RAB.

The proposed draft Rules include a table which sets the initial capital base for future regulatory reviews, and against which there can be no reopening.

Transmission Network Service Provider	Regulatory Asset Base (\$m)
EnergyAustralia	635.6 (as at 1 July 2004)
TransGrid	3,012.78 (as at 1 July 2004)
Powerlink	2,276.87 (as at 1 July 2001)
ElectraNet	823.75 (as at 1 January 2003)
Transend	603.6 (as at 31 December 2003)
SP AusNet	1,835.60 (as at 1 January 2003)
Murraylink Transmission Company	102.96 (as at 1 October 2003)
Directlink	[#] (as at 1 July 2005)

These ICB figures are those developed by the ACCC at the latest reviews of each of the businesses, rather than the derived figures generated by the ACCC in subsequent reviews. It is queried whether the ICB figures used by the ACCC should be the ICB figures used in the draft Rules, rather than the later derived figures decided by the ACCC at the latest review. The only concern that using different figures is that capex approved by the ACCC to be rolled into the RAB in its latest review may have been influenced by the potential for a future right to re-optimize this capex at a future time. The decision by the AEMC would be to prevent this ever occurring and so will place an impost on consumers in the future. MEU has no view on this issue.

What is of concern to the MEU is the way capex is to be rolled into the RAB in future. The AEMC proposes that once rolled into the RAB capex cannot be reviewed for prudence and efficiency. Whilst the MEU considers that the regulatory risk on future optimization is a deterrent to investment, if such an approach is to be implemented there has to be a high degree of certainty that the capex to be rolled in is demonstrably prudent and efficient.

The MEU has noted that TNSPs are not necessarily best able to forecast needs, to

estimate costs and to manage capex programs. For example the post capex review of the TransGrid Haymarket project found there was a major and unnecessary over-run in capex of over \$100 million. Under the proposed draft Rules this over-run would not have been identified and would have been locked into the RAB for ever. Another example is the building of QNI where Powerlink expenditure was identified as being very substantially more efficient than the TransGrid expenditure.

In light of these examples, the MEU retains considerable concern about the proposal for roll in, and these are more fully detailed in section 6.2 below.

**The MEU supports the principle of no future optimization, but this support is only provided if the three recommendations below are accepted.**

- 1. The capex must be demonstrably prudent and efficient, and either ex-post review is undertaken or an approach similar to instituting a quality program to demonstrate that the TNSP actual capex is prudent and efficient as required by the Regulatory Test.**
- 2. There should be no re-openers until all capex has been used, and then only for a specific and urgent project.**
- 3. The MEU is of the view that the proposed incentive on usage of capex will lead to regulatory gaming at the review, and that therefore there should be no incentive on the efficient use of capex as such, rather the incentive should be dedicated to service levels to which capex is a significant contributor. Such an incentive is achieved by the amount of MAR at risk being increased as suggested in section 6.1**

The Rules now contain a requirement (Rule 6.2.6) that the capex program proposed by the TNSP must be accepted if it is determined to be reasonable when assessed against ten criteria which are:-

- (i) the information included in or accompanying the submission of the *Revenue Proposal*;
- (ii) the need to comply with all applicable *regulatory obligations* associated with the provision of *prescribed transmission services*;
- (iii) submissions received in the course of consulting on the *Revenue Proposal*;

- (iv) such analysis as is undertaken by or for the *AER* and is *published* prior to or as part of the draft decision of the *AER* on the *Revenue Proposal* under clause 6.15.1(a) or the final decision of the *AER* on the *Revenue Proposal* under clause 6.16.1(a) (as the case may be);
- (v) the actual and expected capital expenditure of the *Transmission Network Service Provider* during any preceding *regulatory control periods*;
- (vi) reasonable estimates of the benchmark capital expenditure that would be incurred by an efficient *Transmission Network Service Provider* over the *regulatory control period*;
- (vii) the reasonableness of the demand forecasts on which the forecast capital expenditure is based;
- (viii) the relative prices of operating and capital inputs;
- (ix) efficient substitution possibilities between operating and capital expenditure; and
- (x) whether the total labour costs included in the capital and operating expenditure forecasts for the *regulatory control period* are consistent with the incentives provided by the *service target performance incentive scheme* that is to apply to the *Transmission Network Service Provider* in respect of the *regulatory control period*;

The first issue with this approach is that there is no direction to the regulator if the regulator (for any reason) deems the capex applied for is not deemed to be reasonable.

The second issue is the point raised by the Expert Panel when addressing the PC commentary on the Gas Code where it was concerned that the terms “plausible” and “reasonable” imply a range of outcomes. Where there is a range, the Expert Panel (see section 4.3 above) was of the view that permitting a range of outcomes (or even what is “reasonable”) creates even greater uncertainty and the opportunity for the TNSP to seek legal redress if it is unsatisfied with the regulator’s decision if it considers the capex to be unreasonable.

A TNSP would be incentivised to maximize its capex claim and be prepared to argue in a court that the amount they claimed was “reasonable”. The words used above by the Expert Panel would apply equally to this draft Rule in that it would :-

- “provide little practical guidance to the Regulator;
- create great regulatory uncertainty;
- lead to litigation in an effort to clarify the limitations it places on the Regulator’s decisions;
- lead over time to a systematic upward bias in the returns provided for infrastructure providers;
- be an inferior policy response to concerns about the impact of regulatory error on the provision of infrastructure”.

The MEU draws attention to the actions of the transmission pipeline regulation where every decision of the ACCC has been appealed by the gas transmission providers, despite the views of end users and gas suppliers that the ACCC decisions were indeed reasonable, even overly supportive of the transmission pipeline owners.

**The MEU does not consider that the proposed ten step approach is adequate in that it does not provide an alternative if the regulator considers the application to be unreasonable, and that the changes proposed will not lead to greater certainty but rather they have the potential to create more uncertainty rather than reduce it, and can lead to increased litigation.**

**What is supported by the MEU is for the regulator to be able to make a decision as to what is an appropriate capex program based on a realistic energy demand forecast, a demonstrable ability to manage and implement the size of capex program considered (bearing in mind the need to contain costs and meet time requirements), supported by the application and its reasons, independent reviews, the historic performance of the TNSP (trend analyses) and the use of exogenous benchmarks. In many ways this replicates the current approach used by all regulators in assessing an appropriate level of capex.**

### **5.1.2 Return on capital**

The return on capital is intended to be a forward looking estimate of the costs of funds required for the ensuing five years. This is to ensure that the WACC awarded to a regulated business is as truly reflective of the coming period as is possible, such that there is a reasonable expectation that the



business will be able to secure funding for its capital program and that consumers are not exposed to paying a higher return on capital than is necessary.

The proposed draft Rule will enshrine the WACC applicable for regulatory purposes to a minimum of five years for the first review and a maximum of nine (which would apply to the last regulatory review in any five year period). Fixing the CAPM elements for such long periods is not in keeping with the principle of setting a return on capital which will apply to the regulatory period under review

Without attempting to debate the value of the inputs to be used in the CAP approach, it is now accepted that many of the inputs vary extensively in the short term and in the long term and in particular the values for the risk free rate (the 10 year bond rate), the equity beta and the market risk premium.

The Draft Rule 6.2.4(e) stipulates that the AER must assess the input values for the CAPM by and publish these by December 2006. These input values are to be fixed until 1 July 2011 when another review must have been completed. The input values are to be assessed again each five years thereafter.

Bearing in mind the volatility of each of the inputs over the short and long term it is inappropriate to set the input values for five years – in fact the proposed wording of the Draft Rule would have the input values set for up to nine years in the case of the last regulatory review of any five year period.

What the AEMC is seeking is a degree of certainty as to the method of the setting of the return afforded each of the regulated businesses. To set the input values for such a long period creates uncertainty in itself, due to the volatility and movements of the inputs.

As the inputs vary both up and down, there is potential for the regulated businesses to be exposed to risk of these movements just as it is for end users. If low inputs are used for CAPM, it is quite feasible that towards the end period of the last regulatory review, the WACC accorded the regulated business will be insufficient for it to secure funding for needed investment. Already regulators admit to bias towards the regulated businesses<sup>17</sup> when

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<sup>17</sup> See for instance, the statements made by the ESCoV where it has commented that despite there being valid reasons to use lower inputs into the CAPM, it has used higher figures in order to be conservative towards the regulated businesses interests.

setting the WACC elements. To extend these durations of periods where the WACC elements are fixed will only exacerbate this bias.

Already the WACC elements are fixed for five year periods when each regulatory review is completed. Inherent in the Draft Rules is that there would be a minimum of five years between setting new CAPM inputs, with the period between being as high as nine years for some regulated businesses.

There is an alternative which provides a degree of certainty in that the CAPM inputs are fixed for five years, and that the new WACC calculated applies to all regulated businesses, including those already part way through a regulatory period. This however creates uncertainty for any fund raising that a regulated business has put in place for future investment but not yet implemented.

**On balance the MEU considers that the WACC elements should be set uniquely for each business for its coming five year regulatory period as is current practice. The proposed draft Rules only increases uncertainty and exposes the businesses to increased risk, and end users to increased costs. This approach permits there to be a series of smaller changes in the WACC rather than one large change every five years.**

What is excluded from the Draft Rules is that the regulator should be required to assess the impact of its decision on the regulated business. Currently this is carried out by the regulator developing financial indicators for the regulated business demonstrating that the regulatory decision has not exposed the business to a financial condition that might lead to financial difficulties during the regulatory period. The market objective is that the regulation be in the interests of consumers. It is not in the consumer interests for the regulated business to fail due to regulatory interference. If the business does fail it must be demonstrable that it was not the regulator which caused this and this can be achieved by the regulator estimating and publishing financial indicators which show financial viability.

This process also allows the regulator to verify that the WACC is not only sufficient to permit the regulated business to thrive, but also to show end users that the WACC is not excessive when compared to returns earned in the competitive arena.

Just as opex and capex elements are benchmarked for demonstrating efficiency, MEU also views the need to benchmark the returns granted to

regulated businesses must be benchmarked to ensure that the awarded amount reflects performance in a competitive environment. The single market objective seeks the regulatory environment recognizes the long term benefits for consumers. Regulation is intended to replicate (as far as possible) the outcomes of competition. Without comparing returns on regulated businesses to those earned in the competitive sector, the regulator is failing in achieving the market objective.

**The MEU considers that for ensuring greater certainty, the return awarded to the regulated business should be benchmarked to returns earned in a competitive environment, and this requirement included in the Rules.**

### 5.1.3 Depreciation

The proposed draft Rules permit the depreciation schedule to be nominated by the regulated business, and this schedule to be used in the roll forward of the RAB.

Depreciation is the method whereby the asset owner is able to recover the capital cost of providing an asset. Depreciation is seen as a cost to the business and is allowed by the tax office to regard it as such. The principle that is espoused throughout the current Rules and the proposed draft Rules, is that the regulator should not be permitted to impose a financial structure on a specific business but to asset the costs as would result from a notional business structure. The notional business structure needs to have a given financial structure and approach to operation and investment in order for the regulator to establish the most appropriate revenue.

The notional business is assumed to have 60% debt, 50% tax imputation benefit, employ a direct labour force and other such similar aspects. This allows the regulator to set a revenue for the business which allows the business to optimize its own structure within the revenue permitted.

Depreciation is only a financial tool for the recovery of capital invested. If the approach espoused in the draft Rule is followed then depreciation becomes that which gives the regulated business the best outcome from the regulatory review. To allow the business to select its own depreciation schedule creates three major concerns for MEU.

1. It creates an unnecessary precedent in the proven approach to the regulator building the cash flow required for a notional business.

2. Allowing freedom to set its own depreciation schedule, the business can introduce a greater risk profile for consumers in that it could permit faster recovery of capital and so increase risks in later years
3. Leads the regulator into agreeing to a financial structure which might expose the regulator to being complicit in approving what might later prove financially damaging to the business and consumers.

Requiring the regulator to follow a notional depreciation schedule insulates the regulator from later criticism.

**The MEU considers that the revenue must be set on the basis of a notional business and allow the businesses freedom to structure their business to suit their own needs. Depreciation is just another financial tool used by business to control its profitability and tax liabilities.**

The AEMC states that one of the benefits of allowing the business to set its own depreciation schedule is that it can be used for the smoothing the annual revenue. This is true, but smoothing of annual revenue can also be achieved in other ways (e.g. ensuring the smoothed cash flow has the same NLV as the “lumpy” cash flow coming for the calculated revenue stream). The use of depreciation is not essential to smoothing the revenue stream and should not therefore be used as an excuse for giving greater freedom to the regulated business in setting a depreciation schedule.

**The MEU considers that depreciation for the notional business should be set over the economic life of the assets involved and be assessed on a linear basis over this period.**

By depreciating over the economic life of the assets, this creates a positive incentive on the business to negotiate agreements for services as it allows the business to set its own depreciation schedule for the service, with the benefit of faster depreciation if the economic life is shorter than the technical life.

#### 5.1.4 Opex

As in the case for capex the proposed draft Rules propose that the regulator must accept the applicant’s assessment of opex if it considers it “reasonable” when assessed against ten criteria listed in Rules 6.2.7, which are:-

- (i) the information included in or accompanying the submission of the *Revenue Proposal*;

- (ii) the need to comply with all applicable *regulatory obligations* associated with the provision of *prescribed transmission services*;
- (iii) submissions received in the course of consulting on the *Revenue Proposal*;
- (iv) such analysis as is undertaken by or for the *AER* and is *published* prior to or as part of the draft decision of the *AER* on the *Revenue Proposal* under clause 6.15.1(a) or the final decision of the *AER* on the *Revenue Proposal* under clause 6.16.1(a) (as the case may be);
- (v) the actual and expected operating expenditure of the *Transmission Network Service Provider* during any preceding *regulatory control periods*;
- (vi) reasonable estimates of the benchmark operating expenditure that would be incurred by an efficient *Transmission Network Service Provider* over the *regulatory control period*;
- (vii) the reasonableness of the demand forecasts on which the forecast operating expenditure is based;
- (viii) the relative prices of operating and capital inputs;
- (ix) efficient substitution possibilities between operating and capital expenditure; and
- (x) whether the total labour costs included in the capital and operating expenditure forecasts for the *regulatory control period* are consistent with the incentives provided by the *service target performance incentive scheme* that is to apply to the *Transmission Network Service Provider* in respect of the *regulatory control period*

The first issue with this approach is that there is no direction to the regulator if the regulator (for any reason) deems the opex applied for is not deemed to be reasonable.

The second issue is the point raised by the Expert Panel when addressing the PC commentary on the Gas Code where it was concerned that the terms “plausible” and “reasonable” imply a range of outcomes. Where there is a range, the Expert Panel (see section 4.3 above) was of the view that permitting a range of outcomes (or even what is “reasonable”) creates even greater uncertainty and the opportunity for the TNSP to seek legal redress if it is unsatisfied with the regulator’s decision if it considers the opex to be unreasonable.

A TNSP would be incentivised to maximize its opex claim and be prepared to

argue in a court that the amount they claimed was “reasonable”. The words used above by the Expert Panel would apply equally to this draft Rule in that it would :-

- “provide little practical guidance to the Regulator;
- create great regulatory uncertainty;
- lead to litigation in an effort to clarify the limitations it places on the Regulator’s decisions;
- lead over time to a systematic upward bias in the returns provided for infrastructure providers;
- be an inferior policy response to concerns about the impact of regulatory error on the provision of infrastructure”.

The MEU draws the attention to the actions of the transmission pipeline regulation where every decision of the ACCC has been appealed by the gas transmission providers, despite the views of end users and gas suppliers that the ACCC decisions were indeed reasonable, even overly supportive of the transmission pipeline owners.

**The MEU does not consider that the proposed ten step approach is adequate in that it does not provide an alternative if the regulator considers the application to be unreasonable, and that the changes proposed will not lead to greater certainty but rather they have the potential to create more uncertainty rather than reduce it, and can lead to increased litigation.**

**What is supported by the MEU is for the regulator to be able to make a decision as to what is an appropriate opex program, supported by the application and its reasons, independent reviews, the historic performance of the TNSP (trend analyses) and the use of exogenous benchmarks. In many ways this replicates the current approach used by all regulators in assessing an appropriate level of opex.**

### **5.1.5 Approach to tax**

As noted in section 4 above, the MEU supports the setting of a notional financial structure for the purposes of setting revenue. Setting a notional ownership structure allows the benefits of tax imputation to be included into the return on capital calculation, without imposing any constraint on a specific business.

### 5.1.6 PTRM

As noted in section 4 above MEU agrees that establishing a fixed method of setting the return on capital is appropriate, and that it should reflect the notional business, rather than attempting to reflect the requirements and capital structure of specific businesses. This allows the regulated businesses to establish their own capital structure without regulatory interference.

In section 2 above MEU raised a note of concern that, in that allowing the regulated business freedom to set its own capital structure might lead to a higher risk entity. This poses a risk to consumers, and the MEU recommends that AEMC examine this matter in order to reduce the risk to consumers that a regulated business might fail and result in loss of supply or increased costs as a result of such financial failure.

### 5.2 Reopening of Revenue Cap for Capex

The proposed draft Rules includes for the TNSP to seek a reopener of the revenue in the event that there is an essential project to be constructed that was not forecast at the time of the regulatory review.

This issue has an impact on a number of other aspects relating to roll forward of RAB, the basis of the initial setting of capex at the review, the review of capex ex post to prove prudence and efficiency and the incentives to control capex. Each of these issues is addressed in the following section 6.2 on capex incentives.

**The MEU does not consider that the financial penalty on a TNSP is very large should such an urgent unforeseen project arise, particularly when many TNSPs now develop their forward capex program based on a probabilistic approach to future network needs. The MEU only would countenance a capex reopener when all capex allowed in the review has been fully utilized.**

### 5.3 Pass through Arrangements

The MEU is very concerned at the use of pass through elements in to the AARR. Such costs are not permitted in competitive enterprise, with those businesses continuing to be subject to competitive pressures.

An example of not passing through costs was where Virgin Blue resisted for some period of time the pass through of increased oil costs, despite the fact that its only competitor, Qantas, quickly initiated a pass through of these costs. Businesses do not necessarily pass through legitimate increases where

they can see a competitive advantage by not doing so.

The AER initiated a review of the pass through costs and we attach a response prepared for that review by MEU addressing our concerns. This is attached as appendix 2.

#### **5.4 Other Issues**

It is noted that the TNSP is required to provide certification of its proposed costs and key assumptions by an “independent and appropriately qualified expert (Rule S6.9.1(e) and (f) and S6.9.2(e), (f) and (g)).

This requirement is totally unacceptable and unnecessary. Any expert retained by the TNSP will support the views of the TNSP, and the TNSP is unlikely to provide any statement from an expert which would criticize or undermine its proposal. Thus such certification is not only a waste of time and cost (which is ultimately borne by consumers).

The regulator must include in its own costs and timeframe the sourcing of independent expert review, and this must be exposed to the review of Interested Parties to ensure that nothing has been omitted from the review and that it has been properly conducted.



## 6. Incentive Mechanisms

### 6.1 Service Standards

The principle of incentivising a party to achieve better outcomes is fully supported. The consumer's long term interests are achieved if there is a balance between cost of, and minimization of constraints in, the transmission network. An incentive regime will assist in reaching this balance.

There is one major impediment to achievement of this outcome – that of excluding the market benefit of reducing generator market power (i.e. the ability to raise prices) through augmenting the transmission network. The AEMC must examine the Regulatory Test and bring it into line with the market incentives included in the Chapter 6 review. A failure to do so will minimize the ability of the TNSPs to provide a service which provides the maximum benefit to consumers through incentivisation of TNSPs.

The MEU supports the current AER service standards, and endorses the continuing review for identifying a performance measure which incentivises the TNSP to provide maximum “up-time” of the network when it is most needed.

The AEMC proposes that only 1% of the MAR should be at risk in the incentivising of service standards. At the Public Forum, it was suggested that perhaps 5% of the MAR should be at risk. This was considered too high by the TNSPs as this amount constituted perhaps 25% of permitted opex, whereas 1% of MAR only exposes 5% of permitted opex. This calculation is somewhat misleading as service standards are impacted by **both** opex and capex.

Depending on the assumptions, the revenue from capex is of a similar magnitude to that of opex in the AARR build up. A review of the more recent ACCC decisions shows that opex is between 25-30% of the AARR, and the revenue from capex is in the same order of magnitude when averaged over the five year regulatory period. Allowing for the opex and revenue from capex being of a similar size, this would lead to a 5% of MAR at risk being balanced by only 10% of opex and 10% of revenue from capex being at risk. When considered in full, a suggestion of 5% of MAR being at risk is not excessive. When applying 1% of MAR at risk the impacts on opex and revenue from capex is miniscule.

### Recommendation:

**The MEU considers that 1% of MAR at risk for service standards is too low and the amount at risk could readily be increased to 5% of MAR being at risk. As the incentive is symmetrical it provides a real incentive on the TNSP to outperform, whereas the lower powered incentive does little to create the environment where the TNSP will spend to improve service standards.**

## 6.2 Capex incentives

The ex ante approach sets a given amount of capex the purpose for which is at the discretion of the NSP. There is still a need for the regulator to assess the prudence and efficiency of all capex invested at the next review. The risk to the consumer of such an approach is that there is no requirement that the capex paid for within the regulatory period is actually used, although the actual approved capex will be rolled into the future asset base.

This approach encourages the NSP to maximise the amount of capex included in any one period and to underspend the capex as there is no penalty for doing so, yet there are gains to be made by doing it. This could easily result in the capex for one period being developed on the assumption that a specific project is highly likely to proceed but the NSP decides to put the consumer at risk by deferring the project to the next period. In this way the consumer is put at risk because of the potential failure of the network due to the delay in using the capex but still providing a return on the unused capex.

One fundamental reason for excessive capex claims by NSPs is that the return offered by the regulator is too high thereby encouraging over investment. This was discussed above in more detail.

The AEMC proposal incentivises the TNSP with regard to capex, by

- there being no ability to optimize the RAB in the future
- rolling in the actual capex incurred, with the AER having the power to elect to review all or some of the capex for prudence and efficiency
- Permitting a re-opener if large amounts of capex are required and was unforeseen
- not reviewing ex-post, the ex-ante capex included in the AARR and so precluding a “claw back” of capex revenue (e.g. as included in the Transend decision in 2003)

The principle of ex-post optimization does create a degree of risk for the TNSP, and this will lead to sub-optimal investment. On balance the MEU supports the first leg of the capex incentivisation proposal.

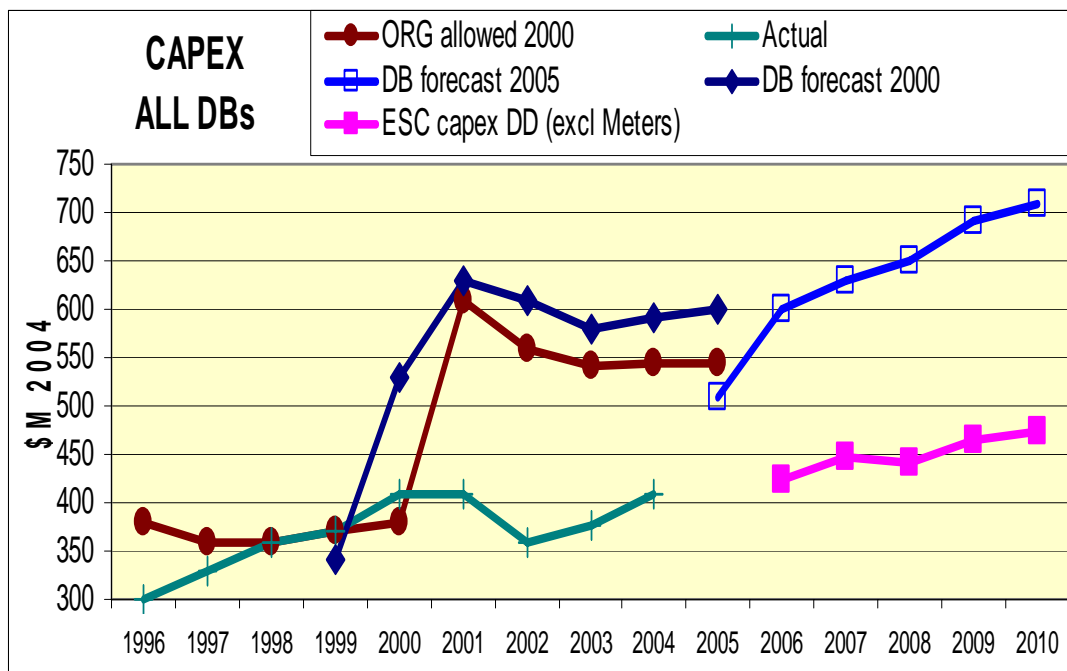
The second leg (i.e. that there should be some ability of the AER to verify that capex has been prudent and efficient) is essential. An ex-ante review does not require that the TNSP has completed the Regulatory Test for each project – indeed it would be difficult to do so as many TNSPs now rely on the probabilistic approach to assessing capex needs. The Rules still require that the capex be prudent and efficient. This test must be carried out or any capex will be permitted into the RAB. The AEMC must require the AER to verify within bounds that capex to be rolled into the RAB is prudent and efficient, and if this is not carried out ex-ante, then it must be carried out ex-post.

One solution for this is that as the test for prudence and efficiency must be carried out by each TNSP prior to commitment of a project, that a facility (similar to that used for demonstrating quality standards) be implemented by the AER, with an annual review of ensuring that regulatory tests have been adequately carried out during each year.

The third leg of the capex incentive program is that there be a re-opener of the AARR if there is a large unforeseen capex requirement. This appears to be reasonable as it supports the principle of ensuring a reliable transmission network. However it is unidirectional only – in favour of the TNSP. There is no countering balance of eliminating capex (and reducing the AARR) if capex thought to be needed is not used, and so the benefit of retention of unused capex remains a penalty on consumers. As well, as the TNSPs tend to use a probabilistic approach to assessing future capex needs, there is no certainty that some (if not all) of the capex already included in the AARR is not already included in the allowance.

There is a solution and that is that no re-openers are permitted until all permitted capex is expended and then a re-opener is permitted for a specific and urgently needed project.

The outcome of the proposed fourth leg of capex incentive of accepting unused capex as a marker of the efficient usage of capex, is that it provides an incentive on the TNSP to maximize its allowance for capex, and to under-use the allowance during the period. This can be clearly seen in the following graph which shows the actual outcome from this approach used in Victoria and identified by the ESCoV.



Source: ESCoV

The proposed approach has been used in Victoria for 10 years, and what has resulted is over claims by the DBs for larger amounts of capex to be included in their AARR which they then fail to use, retaining the revenue from the unused capex and taking this to profit. The MEU sees this approach as providing an active incentive to over claim, and it was this that led the ACCC to include the claw back provisions in the ElectraNet and Transend decisions. The proposed approach will only be successful if the original amount of capex is set at a competitive low level.

However the AEMC comments that there is an asymmetry of risk to consumers if the capex (and opex) is set too low, as it could lead to lower reliability of the network, which has a greater impact on consumers than if too much capex (or opex) is granted. This implies that the capex (and opex) would always be set above the minimum possible and so creating an inevitable payment of an incentive.

The AEMC states that it is a service that is provided by the TNSP, rather than the use of assets. Following this principle through, there should be no incentive on assets (as is proposed in the case with incentivising capex and perhaps opex); rather, by following the AEMC approach the attention should be totally dedicated to incentivising the provision of the service.

**Recommendations:**

**The MEU supports the principle of no future optimization, but this support is only provided if other recommendations are accepted.**

**The capex must be demonstrably prudent and efficient, and either ex-post review is undertaken or an approach similar to instituting a quality program to demonstrate that the TNSP actual capex is prudent and efficient as required by the Regulatory Test.**

**There should be no re-openers until all capex has been used, and then only for a specific and urgent project.**

**The MEU is of the view that the proposed incentive on usage of capex will lead to regulatory gaming at the review, and that therefore there should be no incentive on the efficient use of capex as such, rather the incentive should be dedicated to service levels to which capex is a significant contributor. Such an incentive is achieved by the amount of MAR at risk being increased as suggested in section 6.1.**

### **6.3 Opex incentives**

The MEU supports the principle of there being an opex incentive scheme.

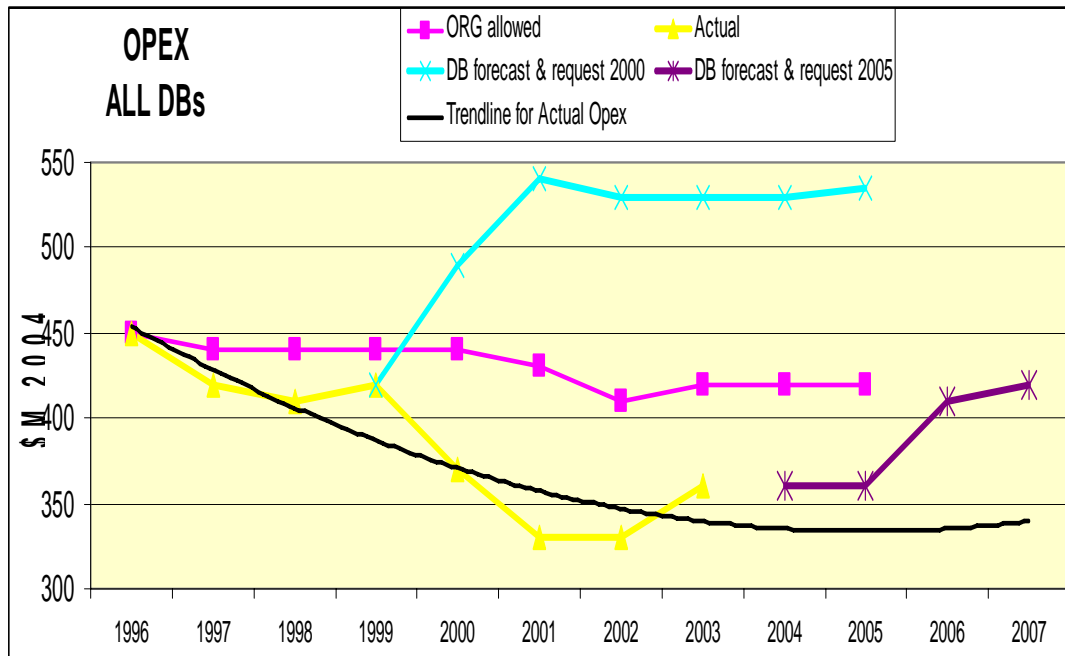
The practice of regulated businesses so far is that the businesses underspend on opex in the early stages of the regulatory period and then ramp up the opex in the latter stages, commenting that the early savings proved unsustainable. This approach limits the actual amount which might be perceived as efficiency gains (and therefore to be shared) to being able to hold all of the early savings, and attempting to demonstrate the need for higher opex in the future.

The benefits of this approach is three fold.

1. It allows the business to show the opex savings are unsustainable and allows the business to retain all of the benefits rather than share
2. It demonstrates that opex efficiencies are difficult to achieve, and thereby saves any future sharing
3. It allows the business to demonstrate a higher future benchmark and so justify a higher allowance for opex.

Each of these is a positive incentive not to use an incentive program where the nett benefit will be the need to share savings, and keep all savings.

The following graph (from the Victorian review of distribution pricing) shows this process well.



Source: ESCoV

The approach allows the regulated business to hold all of the savings made in 2000-2003 (as unsustainable). The DBs substantiation for new opex for the 2000-2005 period is shown to be totally overstated but was adequate to convince the regulator to hold opex at about the same level. Of great interest is the forecast for future opex for 2000 (less than 12 months ahead of the review) and the actual opex incurred in 2000. There is a 25% error in forecasting in favour of the DBs, yet they aver that they are best suited to forecast opex needs.

With such positive incentives and a track record of ensuring a minimal amount of opex sees the incentive program, great care will be needed to ensure that the TNSPs are not similarly incentivised to maximize opex savings but reduce the benefit sharing from an incentive scheme.

**Whilst the principle of incentives is supported, the practice shows that incentive schemes for opex are utilized to maximize retained benefits for the businesses just as cleverly as the businesses game other aspects of the regulatory approach.**

#### 6.4 Commercial negotiation incentives

The AEMC has identified that the TNSPs, rather than negotiate with a potential new connection, attempt to have the associated costs rolled into the RAB. The AEMC sees this a "bad thing". The MEU is not as confident as the AEMC about this matter and this has been addressed above in section 3.

What the AEMC is attempting to do by its proposed changes is to allocate costs of transmission which use assets dedicated to specific customers (i.e. generators and large users directly connected). The incentive program is intended to force the TNSP to have such dedicated assets separately assessed and force the TNSP to negotiate with the connecting party a separate agreement rather than allow the new assets to be rolled into the RAB.

What is being totally missed in this assessment is that most connections and augmentations at TNSP connection points and increasing capacity upstream of the connection points are the result of the DNSPs seeking greater throughput.

There are some new connections for generators and these are addressed by the allocation of entry charges at the connection point, as are dedicated new consumers required to pay exit charges for the assets used at the connection point.

There is a stated concern that such dedicated assets might be stranded at a future time, and as there is to be no permitted re-optimisation of assets in the RAB, then all consumers will pay for the stranded assets. To overcome this problem, the AEMC is proposing to incentivise increased usage of negotiated agreements for new connection assets and augmentations to accommodate increased flows.

Rather than create an incentive scheme, it would be more transparent to require all connections with dedicated assets to be negotiated and overseen by the AER. Those augmentations initiated by DNSPs should be rolled into the RAB, as there is likely to be a large number of consumers using the assets. The DNSP should be required to equitably allocate the costs of transmission entry/exit between each customer connected in proportion to their demand as is currently done – this would readily accommodate appropriate sharing between embedded generators, any large users and the multitude of small users.

In the negotiation for the dedicated assets, a realistic assessment of the likely life of the connection can be made and incorporated into the agreement. If subsequently the assets are used by more than the original connector, then there is a clearly discounted asset value to be included in the RAB if this occurs. The AER can assess whether the TNSP has attempted to minimize any stranding risk before taking any action to assist the TNSP to minimize the costs resulting from stranding if such occurs.

**MEU is not convinced that there is sufficient justification to warrant a separate incentive scheme for what is likely to be a small element of the total provision of service.**

**On this basis we do not support an incentive scheme for encouraging TNSPs to negotiate services.**

As noted in section 5.1.3 above, allowing the regulated business to set its own depreciation schedule to reflect economic life of the assets involved, does create an incentive for the business to negotiate services rather than roll the assets into the RAB which currently depreciates the assets over the technical life of the assets.

However if the Rules require the regulator to accept the depreciation schedule proposed by the business for the PTS assets, then this incentive for negotiated services is lost and encourages a greater use of PTS.



## 7. Commercial Negotiation Arrangements

The single market objective imposes an obligation on a TNSP to connect any consumer seeking connection, as the transmission network (as part of the NEM) is for the achievement of “an efficient, reliable and safe electricity system for long term interests of consumers” (AEMC report page 9). To enable the execution of this obligation on the TNSP requires it to be cooperative with a consumer (or its representative) and not obfuscate.

The current Rules allow for the TNSP to nominate a cost for it to investigate a proposal for connection. Acceptance of the fee for investigation must impose on the TNSP to complete the investigation in a timely fashion, and to provide the necessary information to ensure that the party seeking the connection can assess the costs for reasonableness and an understanding of the implications of the application for connection.

The current Rules only address the resolution of disputes between NEM Participants. The introduction into the new Rules for the ability of any party negotiating with the TNSP to access the Chapter 6 dispute resolution process is fully supported.

For the AEMC proposals for negotiating to be successful the negotiation must proceed in a cooperative manner, and any needed arbitration must be rapid to implement and fast to reach resolution.

There are three aspects of negotiation that create conflict and delayed resolution.

These are

1. the lack of provision of information in a timely fashion
2. obfuscating by one party
3. a lack of commitment or resources to seek a timely outcome.

The proposed Rules do apply a time constraint on the arbitrator (30 days) to reach a decision. The Rules then go on to allow the arbitrator to extend this time, without any constraints. Thus if a party is of a mind to do, it can cause the extension of the arbitration indefinitely, subject only to the consideration of the arbitrator.

The new Rules require the TNSP to provide the same pricing for a negotiated service which applies to all network users, absent a material difference. The provision of this information may not be readily available to an aspiring new connector. The AER should be required to provide such data to an applicant for connection in the event that the TNSP does not do so.

## Recommendation

It is therefore recommended that the AER should

- continue to be involved in the process and oversee the arbitration to ensure that time lines are kept and that the parties do not prevent early resolution from occurring;
- have the power to terminate the arbitrator appointed if the arbitrator is not adhering to the timelines expected for resolution.
- be required to obtain pricing information from a TNSP in the event that the TNSP does not provide this to a new connection applicant.

## 8. Savings and Transitional Provisions

The MEU supports the approach that the existing Rules should continue for each TNSP until they are due for their next review. Thus it would be expected that all TNSPs (other than perhaps PowerLink) would continue under the existing Rules until their next scheduled review. If a TNSP seeks to have a revision to its current arrangement then the TNSP should be subject to any new Rules applying at the time in relation to the matter being reviewed.

As it is likely that the new Rules will not be fully in place by the time PowerLink is due for review, then PowerLink should be reviewed under the old Rules, and its revenue adjusted as the old Rules require until its next review.

Such an approach will give a degree of certainty to both the TNSPs and consumers.

The AEMC proposes that the asset base for each of the TNSPs as at 16 February 2006, will be assumed to apply to prescribed services. Implicitly this leads to the conclusion that all of the assets comprising this asset base will be assumed to provide prescribed services, but those investments made subsequent to that date will be excluded from the asset base if they do not comply with the new definition of prescribed services.

As decisions have been made for investments to proceed under the current Rules, but are not yet completed and therefore permitted into the RAB as they would have been under the old Rules, it is recommended that the cut off date for exclusion of assets from the RAB should be made for a point in the future, allowing for commitments made now, but costs not incurred.

However, there has as yet been no decision made as to what will constitute the difference in definition between prescribed services and other services. Until that definition is published and agreed to, all decisions to invest must be assessed under the old Rules

### **Recommendation**

**The MEU recommends that only investments formally committed to after the publishing of the differentiation between prescribed services and other services be assessed under the new Rules and all investments committed prior to this date should be included into the RAB (subject to the current controls of prudence and efficiency) on the assumption they are for prescribed services.**

**Investment decisions made after that date should be assessed under the new Rules.**

## Appendix 1

### Data sourced from Commonwealth Securities Web site

Sector	Sub-sector	ASX code of typical company	Beta 27Feb06	Sector dividend yield 27Feb06
<b>All ordinaries</b>			<b>1.08</b>	<b>4.3</b>
<b>Consumer discretionary</b>				
	Automobiles and components	OEC	1.02	6.2
	consumer durables and apparel	GUD	1.75	5.3
	consumer services	TAH	0.93	4.3
	Media	PBL	1.51	4.5
	Retailing	HVN	1.18	4.6
<b>Consumer staples</b>				
	Food and drug retailing	WOW	0.62	3.8
	Food beverage and tobacco	LNN	0.58	4.3
<b>Energy</b>			<b>0.96</b>	<b>3</b>
	Energy Equipment and services	HZN		
	Oil and Gas	ORG		
<b>Financials ex property</b>				
	Banks	CBA	0.86	4.3
	Diversified financials - resources	BNB	1.19	3.5
	Diversified financials - holdings	SOL	1.19	3.5
	Insurance	AMP	1.58	4.2
<b>Property Trusts</b>			<b>1</b>	<b>6.9</b>
	Investment trusts management and development	WDC	1	6.9
		CEQ	1	6.9

<b>Sector</b>	<b>Sub-sector</b>	<b>ASX code of typical company</b>	<b>Beta 27Feb06</b>	<b>Sector dividend yield 27Feb06</b>
<b>Health Care</b>	Equipment and services	SHL	1.19	2.8
	Pharma & Biotech	SIP	1.81	2.3
<b>Industrials</b>	Capital goods	COA	1.11	4
	Commercial services and supplies	BIL	1.11	4
	Transportation	ADZ	0.9	4.7
<b>Info Tech</b>	Software and services	CPU	1.82	4.6
	hardware and equipment	KYC	1.15	4.4
	Semiconductors	LGD	1.15	0
<b>Materials</b>			<b>1.39</b>	<b>3.1</b>
	Chemicals	ORI		
	Construction materials	ABC		
	Containers and packaging	AMC		
	Aluminium	AWC		
	Diversified metals and mining	BHP		
	Gold	NCM		
	Precious metals and minerals	ERA		
	Steel	BSL		
	paper and forest products	PPX		
<b>Telecommunications</b>			<b>0.44</b>	<b>5.7</b>
	Diversified Wireless	ENG HTA		
<b>Utilities</b>			<b>0.31</b>	<b>5.2</b>
	Electric	HDF		
	gas Multi	ALN SPN		
<b>Unclassified</b>		BQF	<b>1</b>	<b>6.9</b>

## Appendix 2

Response prepared for AER on the matter of pass through of costs

### *Major Energy Users Incorporated*

*73 Longview Road North Balwyn Vic 3104*

*Ph: (03) 9859 9138, Fax: (03) 9859 2301, Email: [davidheadberry@bigpond.com](mailto:davidheadberry@bigpond.com)*

February 2006

Mr Sebastian Roberts  
General Manager  
Transition Group  
Australian Energy Regulator  
GPO Box 520  
Melbourne VIC 3001

Dear Sir

#### **MEU Inc Response to Pass-throughs and Revenue Cap Re-Openers Position Paper**

Attached is the Major Energy Users Inc response to the above referenced Position Paper.

Major Energy Users Inc is the umbrella body for expressing the views of the Energy Markets Forum (NSW), Energy Consumers Coalition of SA and Energy Users Coalition of Victoria when addressing national issues which would impact on each of these regional groups of energy consumers.

Yours sincerely

Mark Gell  
Chair, Major Energy Users Inc

# **MAJOR ENERGY USERS Inc**

On behalf of

**ENERGY MARKETS REFORM FORUM,  
ENERGY CONSUMERS COALITION OF SA,  
ENERGY USERS COALITION OF VICTORIA**

**COMMENTS**

**ON THE**

# **PASS-THROUGHS AND REVENUE-CAP RE-OPENERS**

**Position Paper**

**A part of the  
Statement of Principles for the regulation of electricity  
transmission revenues**

**A SUBMISSION TO**

**AUSTRALIAN ENERGY REGULATOR**

**February 2006**

The views expressed herein are those of the Major Energy Users Inc on behalf of the Energy Markets Reform Forum, the Electricity Consumers Coalition of South Australia and the Energy Users Coalition of Victoria.

Assistance in preparing the submission was provided by Headberry Partners Pty Ltd and Bob Lim & Co Pty Ltd.

## INTRODUCTION

### The MEU Inc interest in this AER review

This submission has been prepared by the Major Energy Users Inc (MEU) which represents the combined views of the Energy Markets Reform Forum, the Energy Consumers Coalition of SA and the Energy Users Coalition of Victoria. The MEU organization represents the larger users of electricity in the states of NSW, Victoria and SA, currently representing some 30% of the electricity used in SA and NSW, with only a slightly lesser proportion in Victoria.

The MEU includes such companies as OneSteel, BHP Billiton, Visy Paper, AMCOR, Orica, Seeley International, Tomago Aluminium, BlueScope Steel, Kimberly-Clark, Mitsubishi Motors, Holden, Toyota, Adelaide Brighton Cement, Ford, Air International, Unidrive and Zinifex (formerly Pasminco). As the members of the three groups also have a significant number of suppliers, as well as operations in other States (including Tasmania and Queensland), they therefore require that the actions taken by the MEU and the groups individually should provide support to their suppliers and related operations.

Further it should be noted that each of the companies comprising the individual groups and MEU, are employers of large numbers (in total, measured in 10,000s) of residential consumers of electricity and gas. As it is in the interests of each of the member companies to support their employees (particularly those members located in regional centres where each company is the dominant employer, such as Ford in Geelong, OneSteel in Whyalla and Newcastle, BlueScope Steel in Wollongong and Hastings, Zinifex in Port Pirie, Kimberly Clark in Mount Gambier and Holden in Elizabeth) the three groups and MEU can also lay claim to indirectly representing the interests of large numbers of residential consumers as well.

The companies in the group (and their suppliers) have identified that they have an interest in this AER review as the **cost** of the distribution networks services comprises the largest cost element in their electricity bills.

Electricity is now the main source of energy required by each MEU member in order to maintain their operations. A failure of supply of electricity effectively shuts down any business operating, and MEU members are no different. Thus the **reliable supply** of electricity is an essential element of each member's business.



With the introduction of highly sensitive equipment required to maintain operations at the highest level of productivity, the **quality** of electricity supplies is becoming increasingly important. The variation of voltage and introduction of harmonics by even small amounts now has the ability to shut down critical elements of many production processes. Thus MEU members have become increasingly more dependent on the quality of electricity supplies.

Each of the businesses represented by MEU has invested considerable capital in establishing their operations and in order that they can recover the capital costs invested, long-term **availability** of electricity supplies is required. If reliable supplies of electricity are not available into the future the investments made by each business will have little value.

It is therefore essential that AER addresses the issues which impact on the cost, reliability, quality and the long term availability of electricity supplies to industry.

### **The AER review**

The AER invited submissions from interested parties addressing the AER's Position Paper relating to the regulatory accounting methodologies to comment on the methodologies which might be used.

The AER has reached some preliminary conclusions:-

- 1) The AER considers that it is appropriate for the AER to adopt a revenue adjustment mechanism to enable it to adjust a TNSP's revenue allowance within a regulatory period in the face of material cost impacts of exogenous events.
- 2) The AER favours the introduction of a pass-through regime into the SRP. The key desirable features of such a regime should be that the pass-through rules should only allow recovery for an event:
  - that is not already provided for in the TNSP's allowance
  - that is identified in advance with its scope precisely defined
  - that is beyond the control of the TNSP
  - that has a material financial impact on the TNSP
  - that affects the TNSP, and not the market generally
- 3) The AER considers that it is preferable to implement a materiality threshold mechanism. The financial impact of events specified in any pass-through mechanism should cater for significant rather than smaller costs arising from cost fluctuations that arise from the normal operations of a TNSP's business.

- 4) The AER proposes to adopt a materiality threshold of 1 per cent of the TNSP's average maximum allowed revenue for a financial year, estimated at the time of the revenue cap determination. A TNSP would be required to demonstrate that the cost impacts of the exogenous event exceed this level, before an application was considered. If this test is met, then the AER proposes that a TNSP will be entitled to recover the full efficient cost impact of the event.
- 5) The AER proposes to adopt the following pass through events:
  - a) a change in taxes event
  - b) an insurance event
  - c) a service standards event
  - d) a terrorism event
  - e) other events (subject to the approval of the AER before a revenue cap begins)
- 6) Only a TNSP would be able to initiate a pass-through application.

The AER then provides a methodology (Appendix A: Model Pass through Mechanism) as to how it sees the actual operation of the mechanism.

## THE ISSUE

In its Position Paper, the AER provides an opening statement<sup>18</sup> that:-

“The SRP detailed the ACCC’s preference for a ‘revenue cap re-opener’ mechanism to take account of events that could significantly alter the level of revenue required to fund efficient investment.”

It goes on to state that<sup>19</sup>:-

“The formulation of detailed pass through rules by the ACCC (similar to the mechanism in the appendix to this paper) and favourable industry responses to those rules have led the AER to reconsider its approach to dealing with the cost impacts of exogenous events.”

These statements raise **four fundamental issues**.

1. The ACCC states that its desire to permit a “revenue cap re-opener” mechanism is predicated on the assumption that by allowing this to occur will “fund efficient investment”. There is no connection at all between funding investment (whether efficient or not) and being able to reduce risk by passing the costs for these risks onto another party, other than that by passing both the cost **and** the risk to another party allows the regulated business to retain its profit margin.
2. Why should the TNSP be eligible for recompense for “exogenous events” which change their revenue? Many such issues are confronted by all businesses each year yet there is no automatic right to pass these costs through to consumers. The competitive market factors many of these into the market risk premium for which the regulated business are paid in full (i.e. already compensated) through the WACC.
3. That the ACCC received “favourable industry responses” to its proposal is not surprising in the slightest, as all TNSPs (and DNSPs who would seek the same rights) would of course welcome the opportunity to formalise their ability to increase their revenue and reduce their risk profile while maintaining their favourable profitability profile. This unbalanced factor should not be used to support the AER decision.

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<sup>18</sup> AER Position Paper page 4

<sup>19</sup> Ibid page 4

4. There is an inherent assumption by the AER (and ACCC) approach to exogenous events, in that they assume that such events will inevitably lead to a cost increase. This is indeed a brave assumption, as there are examples (e.g. reduction in business tax rates in 1999, subsequent reductions in insurance premium after the massive 2002 rate hikes, etc) where there have been significant reductions in costs.

Implicitly, the risks inherent in a business should not be arbitrarily and uniquely allowed to pass through to consumers without examining the essential balance between the risk and return. Why should a business which has a return which is balanced by a risk profile which does not allow the pass through of exogenous cost increases, be then entitled to pass through such costs and be permitted a formal mechanism to do so?

Despite the fact that there is an essential balance between risk and return, this matter is not even addressed within the Position Paper. Yet the risk/return balance is **fundamental** to all business dealings and commerce.

What the AER is proposing is that the regulated businesses should be permitted to enjoy a profitability which is at least equal to if not greater, than the market generally yet they should be provided with an additional and wide ranging ability to increase revenue but at the same time suffer no reduction in ability to match profits with those who do not have the same automatic right to pass through costs as such businesses are constrained by market pressures.

### **The need for consistency with a competitive market**

Regulation is a surrogate for applying competitive pressure on a monopoly enterprise, which by definition is not subject to competition.

This means that the rules for regulation **must** ensure that there is no special benefit granted to a regulated enterprise which allows it to garner a better return than an equivalent enterprise operating in a competitive environment.

### **The risk return balance**

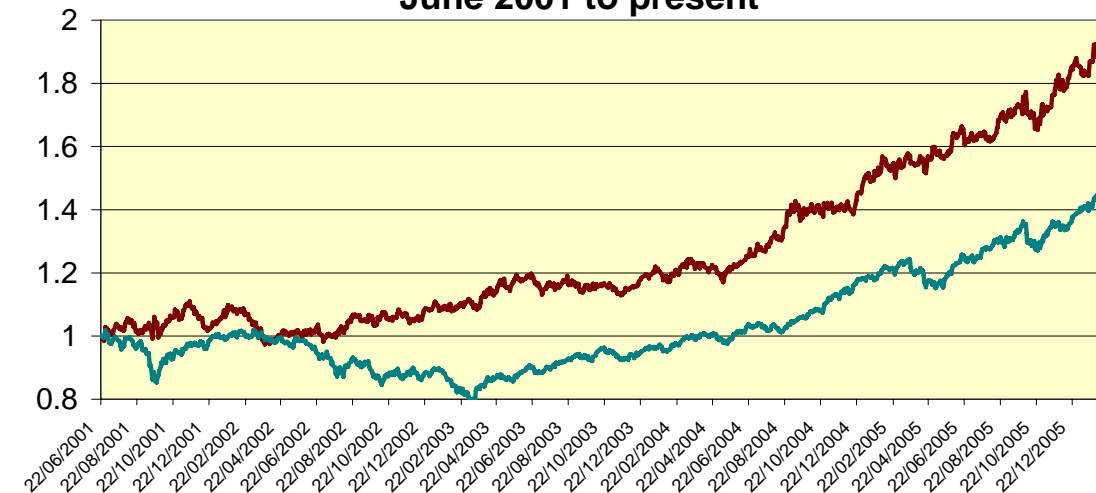
The current returns awarded by the ACCC (and AER by using the ACCC SRP) to the electricity businesses are based on the returns calculated by the CAPM formula using inputs (ERP = 6.0 and equity beta = 1.0) which result in regulated electricity businesses receiving the average of all returns on equity (capital gain plus dividend) extant in the Australian equities market. As no business listed on the Australian stock market is **permitted by fiat** to be awarded increases such as proposed by the AER (and previously by the ACCC) then unless the AER

reduces the return on equity input elements to CAPM, then there is no basis for it to grant any pass-through of costs, as enterprises in the competitive environment do not have this facility. This is taking all risks from the regulated business, as well as removing any incentive for the business to seek to be more efficient. It inculcates a 'cost-plus' mentality.

For the AER to permit any pass through of exogenous costs it must reduce the return it awards to reflect the lower risk the regulated enterprise has by dint of its ability to pass through such exogenous costs directly to consumers.

It requires only a cursory glance at the profitability of the regulated market sector to see that regulated businesses do in fact already enjoy a distinct advantage over the businesses operating in the competitive environment, and increasingly so over recent years.

### Movement of Utilities index (red) relative to ASX 200 (blue), June 2001 to present



Source: CommSec

The companies included in the Utilities index comprise over 90% of the index and include AGL, Alinta, APT, DUET, Envestra, GasNet, Hastings, Spark, and SPI AusNet. The market risk premium<sup>20</sup> earned by this group was some 11% of which 5.2% is dividend. Comparing this to the ASX 200, the market risk premium is some 6% with a dividend of 4.3%. Interestingly equity betas for the two classes are 1.08 for the ASX 200, but 0.31 for the Utilities index. All of the

<sup>20</sup> These figures for MRP are derived from CommSec data, and equity betas and dividend are sourced from CommSec.

companies in the Utilities Index were granted a MRP of 6% and equity beta of 1.0 by the regulators.

Thus it can be clearly seen that companies in the Utilities index are already outperforming equivalent companies in the competitive arena.

### **Quality**

The quality of goods and services provided by companies operating in the competitive environment is always increasing. This is axiomatic, as in order to retain market share, an enterprise must continually strive to improve its product or reduce its cost. This is most readily seen in the computer business (computers are better and cheaper now than even 2 years ago), the auto industry (cars are safer and have more features than a decade ago, yet the cost in real terms is the same) and the white goods industry.

It is **competitive pressure** that drives the quality up and the costs down. Yet the AER is proposing that for no increase in quality of service from the TNSP, it is permitted to increase its costs through this pass through mechanism.

### **Price of goods and services**

As noted above competitive enterprise must continue to strive for lower costs to hold its market share. In real terms most manufactured goods have a lower cost today than before. A typical commercial enterprise will internally set its budgeted costs of manufacture per unit at a lower level for the current year than in the previous year, knowing that if it attempts to operate at the same cost per unit it will suffer loss of market share – its competitors will be seeking to reduce its costs in order to increase market share. Increase in market share results in the additional production being provided at marginal cost so that the profit for each additional item sold will be greater.

Market share growth is dependent on both price and quality of product. A reduction in price with an increase in quality is essential to increase market share, whereas the achievement of only one will result in maintenance of market share, and non achievement in both will result in market share loss, with a resultant loss of profit.

It is expected that commercial pressure will result in lower costs, including a requirement to absorb any exogenous costs. If the revenue for a regulated enterprise is fixed for a given period then, absent it absorbing such additional costs (or accepting the risks for absorbing these additional costs) during the

period, allowing a pass through is effectively allowing the regulated business to increase its profitability at no additional risk.

Such an approach does not replicate the competitive environment.

### **Conclusion**

**The MEU is of the view that the ability to automatically pass through the cost impact of exogenous changes must be balanced by the risk profile of the business, and its profitability compared to the general market. Regulation must impose some constraint on a regulated business to perform better. Absent such pressures then the return granted must be adjusted to reflect the lower risk profile.**

**Notwithstanding its general approach to excluding the right to re-open the revenue cap, the MEU can identify circumstance where a re-opening might be in the interests of consumers, such as where the security of the supply network might be compromised. Despite the increased costs, it would be in the interests of consumers to retain the security of the network.**

## **AER PRELIMINARY VIEWS and MEU OBSERVATIONS**

The AER provides six headings under which it presents its preliminary views – these views are noted above.

### **Preliminary view 1 – the need for adjustment for exogenous causes**

“The AER considers that it should adopt a revenue-adjustment mechanism to enable a TNSP’s revenue allowance to be adjusted within a regulatory period in the face of material cost impacts brought about by exogenous events.”

The MEU has stated above that in principle it does not support the ability of a TNSP to be entitled to pass through to consumers additional costs for which the consumers have expected the TNSP to have effectively included in its cost structure. This view is predicated on the principle that there are competitive pressures in the competitive market which either eliminate the ability to pass through such costs, or at least provide some pressure to minimise the cost to consumers.

An example of such an approach in the commercial world was the rising cost of fuel for airlines. Whilst Qantas immediately increased its costs to reflect the higher cost burden of this exogenous impact, Virgin did not do so for some time. By following this approach Virgin minimised the cost impost of fuel rises to consumers. Under the pass through provisions proposed the TNSP would be entitled to receive full value of such an exogenous impact from the time it occurred. As noted in the section above, MEU can accept that in certain circumstances there may be a need to pass through costs, particularly where the security of supply to consumers may be affected.

A major concern of MEU is the ability of a monopoly provider to use its power to leverage a better solution for itself. Such an approach occurred at the Dalrymple Bay Coal Terminal, where the threat of reduced performance was used to force the regulator to increase the WACC. The outcome was that DBCT was granted an increase in WACC and then proceeded to augment the outload facility. This example clearly shows that despite a regulator carrying out its role with due diligence and defining an outcome which is in keeping with the market, a monopoly provider can exert unreasonable (political) pressure to secure an improved outcome for itself.



Thus by providing an ability for a TNSP to be able to exert pressure on a regulator through a re-opening mechanism provides the TNSP with a greater ability to force an outcome which increases its profitability at the expense of consumers. It unnecessarily exposes the regulator to political and other pressures.

**On balance the MEU considers that there may be some occurrences where there is a clear need for a sensible and closely limiting ability for there to be a re-opener of the revenue cap to permit proper examination of a proposal to adjust a TNSP revenue cap.**

The ability to pass through costs should not be left to the SRP alone. The right for a re-opener should be enshrined in the Rules and the constraints on the re-opener should likewise be enshrined in the Rules.

Leaving the right to a pass through arrangement in the hands of the regulator exposes the regulator to unnecessary risk and criticism. Leaving flexibility of the Rule and its application and coverage at the discretion of the regulator is not good practice. The regulator should only be permitted to enact a Rule and not create the Rule.

**The MEU considers that the Rules should contain the requirement for a pass through mechanism and stipulate the constraints that apply. The SRP should only detail how the Rule will be applied.**

## **Preliminary view 2 – limiting the reasons**

“The AER considers that the SRP should be revised to reflect a preference for a pass-through regime. The key, desirable features of such a regime should be that the pass-through mechanism should only allow recovery for an event:

- not already provided for in the TNSP’s allowance
- identified in advance with its scope precisely defined
- beyond the control of the TNSP
- that has a material financial impact on the TNSP
- that affects the TNSP and not the market generally.”

The AER offers a degree of constraint on the ability of a TNSP to secure the right to the pass through provision. However, these constraints are relatively wide reaching and effectively allow for almost anything without

requiring the TNSP to actually be required to identify these issues before hand.

### **Exclude if need should have been foreseen**

The first constraint must be that the issue is one where a competent TNSP operating in the Australian transmission network business could not have been able to foresee the requirement at the time of the reset.

An example of this is the recent pass through permitted Transend by the ACCC for expensive network support for Hobart supply from the centre of Tasmania. The Gordon Power Station was originally built for the express purpose of supply to Hobart and support in the event of the failure of the main transmission supply from central Tasmania. The potential for this specific need was not publicly raised as an issue during the reset yet Transend was fully aware of the need. TasHydro was able to use its monopoly power (as the only possible supplier for the purpose) to price the service at a high level, imposing unnecessary costs on consumers. Transend knew of the need to support the Hobart supply because it sought and received approval from the ACCC for capex to construct the duplication of supply from central Tasmania. If this issue had been raised during the reset as a specific matter, potentially other alternatives (such as securing Government direction to its wholly owned generation business, or obtaining a relaxation of the Code for the period until the augmentation was constructed as this is what had been happening prior to the reset) could have been canvassed during the reset process.

### **Exclude if already included**

The proposal includes for constraining pass through for what has been excluded from the approved revenue. With the increasing use by TNSPs of the use of the probabilistic approach to setting a capex requirement, there are few defined projects included in the capex. Combining this with the ex ante approach to approving capex will further cloud the ability of the regulator to verify what is and is not included in the approved revenue. A competent financial engineer will be able to ensure that the regulator will have almost no ability to decide with certainty that the work has not been included in the TNSP allowance.

**It is therefore recommended that rather than rely on an assessment as to whether the cost was included, the test should be whether a competent**

**TNSP operating in Australia should have foreseen the need.** This approach avoids the need to delve into what is included in the allowance.

The TNSP has the right under the ex ante and probabilistic capex approach to vary the program of capex investment. Thus before there is any ability to include costs for an urgent project, the capex should be revisited to assess the ability of deferring other projects including the potential impact on consumers of deferral. Thus the capex program already approved could well include for the new project without the need for a re-opener.

**It is therefore recommended that the current approved capex must be assessed to identify whether the new project can be included within the allowance without the need for reopening.**

In such a scenario, the actual capital expended should be reviewed, along with current commitments in order to identify the maximum capital committed to the current period. Current projects will need to be assessed for slowing down the rate of expenditure, and projects not commenced in the current program must be reassessed in light of the need to insert the new project, with a view to deferring current and planned projects, either by slowing down progress or deferral. This approach is one which is typical of capex programs in both private and public enterprises.

Only the actual amount of capex needed within the current review period should be included in the analysis both with and without the new project. Only the difference of capex (if any) should be considered for pass through.

There is already accepted the potential for the TNSP to earn and retain capex and opex unused during a regulatory period. The implication of the pass through event is that the TNSP should be able to retain the benefit of these under-runs in revenue, even if such have been unearned and purely caused by an over supply of revenue by the regulator. The incentive schemes put in place provide a benefit for improved performance and to retain unused funds.

Whilst there is acceptance by consumers for an incentive program to reduce costs and improve services, there must be some responsibility (onus) on the TNSP to fully ensure that they have attempted to foresee every possible future cost and to minimize the use of any pass through provision. We see such an incentive would be on the basis that any under

run in opex and capex must be fully utilized before a pass through of additional costs will be accepted, and that any pass through will be limited to the net increase in revenue required, and not the full amount estimated.

**The MEU recommends that any pass through amount must be netted off against any unused revenue before a pass through is permitted. This shares the risk of the event creating the need for the pass through to be shared between TNSP and consumer. To balance the exposure to the TNSP and consumer, we would add that where the pass through event is a negative pass through event (i.e. would result in a reduction of the revenue) the TNSP is permitted to retain the saving until the next revenue reset.**

### **Must be definable and quantifiable**

Before a pass through event can be accepted the TNSP must be able to fully define the extent of the change and to quantify the cost of the change causing the need.

If the event cannot be defined then it cannot be costed. If it cannot be costed then the cost cannot be passed through to consumers.

It is unreasonable for consumers to have to include for additional costs if the cause and extent of the costs cannot be defined and quantified. This approach follows the sensible legal principle that damages cannot be imposed until they are quantified.

Such definition of the need for costs must define the cause of the need and include for any steps that the TNSP can take to mitigate the need for the costs within the period. Further the definition must include reasons why the TNSP should not be liable for the costs and why the TNSP could not have reasonably foreseen the likelihood of the need itself and the resulting costs for the need. This approach follows the legal principle that the claimant for damages must have taken all reasonable steps to minimize the cost of the damages.

### **TNSP is assumed to be competent**

The TNSP is assumed to be competent in the business of owning and operating a transmission network. There is therefore an expectation that the TNSP will be best placed to identify the needs for the ensuing five years after the review by the regulator which sets the revenue cap.

The TNSP must therefore define why it was beyond its ability as a competent transmission network operator and a competent business manager, that the event causing the need for the pass through could not have been reasonably foreseen, and the costs for resulting from the event are payable under the revenue cap.

This requirement obviates the right of the TNSP for matters which might arise in the future where the costs from the event whilst foreseen but outside the current period need to be added to the current revenue. For example if the event concerns the bringing forward of new generation, then the connection costs should be paid by the generator. If the generator desires to be connected to a location where there is insufficient capacity to give a reasonable expectation of being able to take the output to market, then the augmentation might be considered to be a connection cost and so a cost to the generator. Where the augmentation cost would pass the regulatory test for augmentation, then it is possible that as it is the generator which initiated the project bring forward, then perhaps the generator should be liable for the cost of the capital for the augmentation until the augmentation can be included in the revenue. This would obviate the need for the pass through process.

**The MEU recommends that the TNSP must demonstrate that it is competent and has reasonably assessed that the event causing the pass through into the current period could not have been foreseen by a competent TNSP and by a competent business. Further, the TNSP must demonstrate that it has sincerely attempted to get the costs minimized or paid by others which caused the event to have to be considered within the period.**

### **Beyond control of the TNSP**

The event leading to the pass through must have been caused by parties external to the TNSP and its contractors and employees. It must not have been foreseeable and that the costs have been mitigated as suggested above.

### **Only affecting the TNSP**

There are many exogenous events that affect all businesses. The risk of these events is included in the market risk premium (and contingency reserves) and is therefore included in the WACC calculation. It is unreasonable for consumers to have to pay additional costs for a TNSP

when the consumers themselves are exposed to the same event that the TNSP believes it should be recompensed for.

This view is especially compelling when comparing the outperformance of regulated businesses when compared to the general market performance. Regulators have already stated that where there is doubt as to what allowance should be included in the revenue, they have stated that they will favour the regulated business rather than give the benefit to consumers. This particularly has historically applied to the CAPM inputs but also to allowances for capex and opex.

**The MEU concurs with the AER that a pass through event should only apply to matters which are the province of a TNSP.**

The MEU would see that such events would include a change by the jurisdiction which results in increased costs to the TNSP. There have been such events in the past such as increased reliability provisions (e.g. N-1 being increased to N-2) which arise from changes to regulations or at law, and increased electrical safety or technical requirements.

However, the AER suggests that pass through should encompass (see section 4.3) the following events:-

- a change in law or taxes
- terrorism or force majeure events
- insurance
- network control ancillary services payments.

A change in law or taxes, if applied generally, should not be the basis of a pass through. Such changes apply to all businesses and are intended to impact all to the same extent. At most, such changes which impact exclusively on a TNSP should only be considered. Such a law as applied in Victoria where PowerNet was required to pay land tax on easements is an example of where a pass through might be justified.

It is accepted that electricity transmission is a target which can maximize the impact of a disruptive event. Equally there are other targets which are exposed to terrorism impacts where the owners do not have the safety net of a pass through provision. This then raises the issue of equity where a business operating in a competitive environment is not given any protection against loss of earnings or payment of rectification yet it is proposed that a TNSP should be so protected.

If the TNSP was being provided a lower return on its assets in place of a market based return, then there is some logic in providing pass through protection. However as seen earlier the regulated businesses are earning returns well above the competitive market (as defined as the ASX200) indicating that they should be entitled only to the same terrorism protection afforded the market generally.

Force Majeure is protection against being unable to perform to a contractual obligation. There is no penalty on a TNSP if it fails to perform, other than it loses the revenue lost by not being able to perform. Force Majeure does not entitle a business to recover foregone revenue. It is therefore difficult to see how Force Majeure can be a basis for receiving costs through a pass through mechanism.

Insurance is a payment to another party for the transfer of risk. If an event occurs the insurance is to provide the funds for rectification. Insurance often requires the insured party to accept some of the costs (the deductible) but the frequency of insurance claims can be assessed and the cost of the deductibles incurred can be factored into the allowed revenue. There is a cap on the extent of the insurance payout and the size of the cap increases with increasing premiums. The experience of a TNSP should lead it to an appropriate balance between the risk of the cap being exceeded and the price of the premiums. Providing this is reviewed correctly, there is some logic in there being a pass through in the event the insurance cap is exceeded. This concession is only provided as the risk to consumers for the business not carrying out the needed rectification works is probably likely to exceed the losses incurred by consumers from an extended failure to provide service.

However there seems to be the view that should insurance premiums rise during a regulatory period, then this should justify the right to a revenue increase utilizing the pass through provision. Insurance premiums do rise (as they did after the HIIH crash) but they also fall (as they have in more recent times). It is noted that the TNSPs have not sought reduced revenue as a result of falling insurance premiums.

Insurance premiums also rise and fall as a result of the propensity of the business to seek payments from the insurance company. To a certain extent, therefore, the TNSP itself has the ability to impact its own insurance premiums, and deductibles. A well managed network is less likely to be seeking insurance payouts than a less well managed business. Insurance is a cost not just to TNSPs but to all businesses. Transmission

networks are not exclusively targeted by insurers for volatile premiums – this affects all. It is within the power of the TNSP to influence the insurance premiums and so this should not be the basis for a pass through trigger.

Network control ancillary services payments are the cost to the TNSP for not providing sufficient network control assets. The TNSP is provided with capex and opex in order to manage and operate the network to the required standards. In conjunction with NEMMCo the TNSP is best equipped to evaluate and forecast the network needs to provide adequate network control. The provision of adequate network control therefore lies within the power of the TNSP to manage. To allow the TNSP to receive a pass through payment due to its failure is not appropriate. By requiring the TNSP to take full responsibility for its forecasting and network design to provide adequate network control this incentivises the TNSP to perform this task properly.

**The MEU is of the view that the listing of events it provides in section 4.3 that can trigger a pass through, provide too wide a scope for triggering a pass through application. MEU believes that the only triggers for a pass through event should be:-**

- **A change in law, regulation or taxes which impact the TNSP exclusively**
- **Exceeding a reasonably set insurance cap**

### **Preliminary view 3 – the need for materiality**

“The AER considers that it is preferable to implement a materiality threshold mechanism. The financial impact of events specified in any pass-through mechanism should cater for significant rather than smaller costs arising from cost fluctuations that arise from the normal operations of a TNSP’s business.”

The MEU agrees with the AER that there must be materiality to an event for which there is a request for a re-opening. This materiality should be based on the net amount of funding required after all of the adjustments made above are incorporated into the cost of the event.



The requirement to have a materiality limit is essential else there would be the opportunity for the TNSP to seek re-openers every time it sees the opportunity to increase revenue and profitability.

It would seem sensible that there be a limit before a TNSP can seek additional revenue, as the costs of granting the requested pass through amount could be greater than the amount sought.

**The MEU considers that there should be a materiality requirement before a TNSP can request a re-opener. This creates an incentive on the TNSP to accommodate the event within its revenue cap and to ensure that there is sufficient funding at risk to warrant the costs incurred in a re-opening.**

#### **Preliminary view 4 – materiality is assessed at 1% of revenue**

“The AER considers that it is appropriate to adopt a materiality threshold of 1 per cent of the TNSP’s average maximum allowed revenue for a financial year, estimated at the time of the revenue cap determination. A TNSP would be required to demonstrate that the cost impacts of the exogenous event exceed this level. If this test is met, a TNSP will be entitled to recover the full efficient cost impact of the exogenous event.”

The AER suggests that the materiality limit be 1% of the annual revenue, and a pass through event with costs greater than this limit can be considered.

In the AEMC forum discussing the regulation of transmission revenue proposed draft Rule changes, a TNSP made a comment that 1% at risk for incentives was considered a relatively large amount of funds to have at risk, pointing to the relatively high value of the return on capital included in the revenue stream. On the other hand consumers pointed out that 1% was not a large incentive to encourage active participation by the TNSP in improvement of service standards.

Based on this reasoning by the TNSP, it would appear that 1% of annual revenue is a significant amount to a TNSP. Thus it would appear that the 1% materiality trigger is at the lowest end of a reasonable range. Consumers (who have to pay the passed through amount would see this 1% as too low (and low-powered), just as it is seen as too low for a strong incentive program.

**On balance the MEU considers that the materiality trigger should be 5%, matching the consumer view that the incentive program should be based on a similar amount.**

### **Preliminary view 5 – limiting the scope**

“Pass-through events would be limited to:

- (a) a change in taxes event
- (b) an insurance event
- (c) a service standards event
- (d) a terrorism event
- (e) other events (subject to the approval of the AER before a revenue cap began)”

The AER has proposed a number of events that it considers should be the only triggers for a pass through event. Some of these (change in taxes, insurance, and terrorism) are addressed under preliminary view 2.

The additional pass through triggers suggested are for a “service standards event” and the all encompassing “others approved”.

The AER position paper adds in the “service standards event” as a pass through trigger, but nowhere is there an explanation as to why this is included, and for what reason.

If the intention is to permit a pass through on the basis that a law or regulation has been enacted that will result in an increase in service levels and performance, then this is acceptable as it is equivalent to a change in the base requirements for the TNSP service envelop and would not be included in the allowed revenue. If it is for any other reason, then the pass through should not be permitted.

The “other permitted” category should be deleted. This allows the AER discretion as to what may be allowed as a future pass through. The purpose of the changed Rules is to provide greater certainty. Whilst the TNSPs see this a greater certainty to them, the Rules change should also provide greater certainty to consumers who pay for the provision of this monopoly service. The regulator should not be permitted to create Rules, but should administer the Rules.

At most the AER discretion to incorporate a pass through in a regulatory decision must be closely proscribed, and the Rules should detail what the

essential elements can be to allow the AER permission to insert a pass through provision.

**The MEU accepts that a service standard pass through will only be accepted if the increase (or decrease) in service standards is enacted at law or by regulation. The Rules should provide very clear guidance to the AER as to the circumstances which will allow the AER discretion to include a pass through provision in a regulatory decision.**

### **Preliminary view 6 – open only to the TNSP**

“Only a TNSP would be able to initiate a pass-through application.”

On face value alone, this preliminary view is inequitable.

The AER attempts to support this unbalanced view on two grounds:

- (1) It will prevent spurious time consuming claims from consumers
- (2) It will only apply to large scale disasters that threaten investor returns or the viability of the electricity transmission industry.

The AER avers that the materiality requirement will prevent all other claims, and anyway only the TNSP could evaluate the costs (premium or saving) due to information asymmetry. Thus the AER, on pragmatic grounds considers that only the TNSP could sensibly initiate a pass through claim.

As a TNSP would prefer to retain the revenue for its shareholders, to cover poor management or work practices, or to make incentive bonuses, there would be virtually no basis for a negative pass through event. A reduction in corporate taxes alone could pass the materiality trigger, yet the AER has decided that this should not be permitted. In fact the AER does not even suggest that negative pass throughs should be used to offset positive pass throughs.

The MEU accepts that allowing any party to claim for a pass through (negative and positive) could result in spurious claims. This can be prevented by limiting the parties that can seek a pass through to those who were involved in the regulatory reset. It could be further constrained by limiting a pass through claim to be initiated by the AER at the valid request of an interested party or one which had been involved in the regulatory reset.

That the AER proposes to close off any one else other than the TNSP for initiating a pass through because of a fear that such might be spurious shows very limited thinking and lacks balance and fairness. It neglects the rights of those who pay for the service and benefits those who are paid and are seeking to transfer not only the risk to those that pay, but also the costs that result, and without any benefit such as a reduced rate of return on capital involved.

**The MEU considers the AER exclusion of consumers from initiating a pass through as inequitable. The MEU considers that the AER should have the obligation to pursue a pass through application that is initiated by a consumer who was involved in the regulatory reset process, providing that the conditions which also proscribe the ability of the TNSP to initiate a pass through apply equally to the consumer initiated pass through application to the AER.**

## MEU CONCLUSIONS

The AER states that this pass through approach will provide an environment to encourage investment, yet nowhere in the position paper does the AER point to any evidence that there is a real lack of investment, nor does the AER point to the extent of additional investment that will occur as a result of permitting pass throughs.

The AER has a preliminary view that there should be a number of bases for initiating a pass through, although it requires the pass through application to pass a materiality test.

On detailed analysis of the position paper the MEU is of the view that the potential for pass through proposed by the AER is too wide in some respects and too constraining in others.

The MEU conclusions in relation to each of the preliminary views are:-

### **Preliminary view 1 – the need for adjustment for exogenous causes**

On balance, the MEU considers that there may be some limited occurrences where there is a clear need for a sensible and closely limiting ability for a re-opener of the revenue cap to permit proper examination of a proposal to adjust a TNSP revenue cap.

The MEU considers that the Rules must contain the requirement for a pass through mechanism and stipulate the constraints that apply. The SRP should only detail how the Rule will be applied.

### **Preliminary view 2 – limiting the reasons**

The reason for a pass through must be because:

- It affects the TNSP uniquely
- It is beyond the control of the TNSP
- It is not included in the revenue
- It could not have been foreseen by a competent TNSP/business
- It can be defined and is quantifiable
- Reasonable attempts have been made to mitigate the costs

- Rescheduling of capex cannot prevent the over run in capex by including the new project
- All opex and capex surplus to running the business have been used (i.e. there will be no surplus opex or capex at the next reset)

### **Preliminary view 3 – the need for materiality**

There is a need for materiality before a pass through event will be considered.

### **Preliminary view 4 – materiality is assessed at 1% of revenue**

Materiality at 1% of allowed annual revenue is too low, and should be as high as 5%.

### **Preliminary view 5 – limiting the scope**

The scope for triggers for a pass through event should be limited to changes in taxes, the Rules and regulations which impact the TNSP uniquely and which are not common to all business.

A trigger might also be the exceeding of an insurance cap payout where the cap is seen as reasonable.

### **Preliminary view 6 – open only to the TNSP**

The AER must initiate a pass through event if requested by a consumer, and if the request meets the other triggers for a review.