Response to AEMC Draft Rule Change Proposals
Electricity Transmission Revenue Requirements

September 2006

Table of Contents

Executive Summary

This submission contains a response from the Energy Action Group (EAG) and Energy Users Association of Australia (EUAA) to a number of issues raised by the Australian Energy Market Commission (AEMC) in its Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 26 July 2006.

The response builds on two earlier submissions on matters arising from the AEMC's Issues Paper and the Rules Proposal Report. Those earlier submissions represented an integrated, comprehensive attempt by end-users to make a constructive contribution to the important matters under debate. It is with great concern that the AEMC has chosen to ignore the comments and suggestions made by the EUAA, the EAG. We are further concerned that once again the Commission has failed to provide evidence to substantiate its position, often asserting that what it is proposing is in the interests of end users when key end users are saying it is not. We feel that the Commission needs substantiate how it's entirely different approach on many important issues is consistent with the Single Market Objective, ie, the long term interests of consumers of electricity.

The EUAA and EAG strongly urge the AEMC to refer back to our two previous submissions where we raised issues about:

- Lock-in of RAB
- Regulatory intrusion and reasonable estimate test;
- Regulatory period and WACC;
- Information disclosure;
- Incentive mechanisms;
- Asset stranding and negotiation;

It is our considered view that none of these issues has been addressed satisfactorily in the Draft Rule Proposal. In respect of these, and the other issues raised in our earlier submissions, we urge the AEMC to bring forward proposals that meet the SMO. As the position stands, we consider that unfortunately for end users and directly contrary to the SMO, the AEMC's Draft Rule proposal will clearly and substantially shift the balance of the transmission regulatory regime in favour of TNSPs in a manner that will act against the long term interests of end users with inevitable additional pressure for higher prices.

In addition the Draft Rule proposal raises additional issues that are of concern to end users. We note with concern that the AEMC has not only continued to retain the reopener and pass through provisions but also reintroduced a contingency provision in the draft rules. In respect of resubmission of revenue proposals the AEMC has failed to address the lack of the ability to cap the period of time that is lost where the initial proposal is not compliant with the requirements of the Rule. Nor is there any constraints that would limit the ability of a TNSP to radically alter their proposal to the extent that they are, in effect, submitting a new Revenue Proposal. Finally the Draft Rule proposal alters the confidentiality provisions in such a way that they will impact adversely on the transparency of the regulatory process.

Introduction

This submission contains a response from the Energy Action Group (EAG) and Energy Users Association of Australia (EUAA) to a number of issues raised by the Australian Energy Market Commission (AEMC) in its Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 26 July 2006 .

The response builds on two earlier submissions on matters arising from the AEMC's Issues Paper and the Rules Proposal Report. Those earlier submissions represented an integrated, comprehensive attempt by end-users to make a constructive contribution to the important matters under debate. The submissions provided a critique of the broad ranging proposals covered by the Issues Paper and subsequent draft rule proposal. Most importantly, the earlier submissions put forth constructive ideas and attempted to 'add value' by referring to quantified examples from existing regulatory practices in Australia as evidence to support our proposals and recommendations. It was a concern to us, as key representatives of end users, that this was missing in the AEMC's own work on this important review.

It is with great concern that the AEMC has chosen to ignore the comments and suggestions made by the EUAA, the EAG. We are extremely concerned that once again the Commission has failed to provide evidence to substantiate its position, often asserting that what it is proposing is in the interests of end users when key end users are saying it is not. We consider that the Commission has failed to take account of the several decisions made by the MCE, recommendations by the MCE commissioned Expert Panel Report, as well as dismissing the contributions of end users (but without really saying why it has done so).

We feel that the Commission needs to explain to end user groups why it has not accepted our suggestions and arguments and show how its entirely different approach on many important issues is consistent with the Single Market Objective, ie, the long term interests of consumers of electricity.

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

- why the proposed Rule changes were necessary;
- how they will act to improve existing regulatory practice or impact on end-users; and
- how the Rule changes would facilitate achievement of the Single Market Objective (SMO) specified in section 7 of the National Electricity Law (NEL).
- fails to provide the AER with the flexibility that it requires to determine as to whether what is being proposed is the most efficient means of achieving the required infrastructure needs, access to network owners and related party transactions;
- fails to provide an explanation as to why the network owners need to have major reopening provisions in the draft Rule changes after the release of the draft determination.

We are further disappointed to see that the AEMC has not enhanced the quality of its own Rule change decision by demonstrating, through quantified and specific examples, how the proposed changes are going to meet the Single Market Objective.

Instead, the AEMC has continued to present general qualitative arguments supported by reference to academic theory on regulatory economics. We consider the absence of 'hard, factual' evidence that supports qualitative argument and theory to be a serious failing by the AEMC that reduces the value and robustness of the proposed changes. It also makes the proposals far less convincing and far more difficult to support.

The proposals contain no evidence to demonstrate that achievement of the SMO will be better facilitated than with the current arrangements Indeed, as we have detailed previously in our submissions, there are reasons to believe that the changes to existing regulatory practice contained in the proposed rule change will significantly weaken incentives for efficient investment by:

- taking pressure off TNSPs to reasonably forecast business conditions and be held accountable for those forecasts by allowing a TNSP to request re-opening of a revenue determination if actual costs exceed the forecasts; and
- 'lowering the hurdle' for TNSPs to demonstrate that their revenue proposals are based on 'efficient' costs by requiring only that forecast cost be 'reasonable' – with no primary objective of being efficient, as has previously been the case.

The EUAA and EAG have participated in a wide range of regulatory determinations and have found that the previous regulatory determinations and access arrangements processes were far from being clear or transparent and that one could not compare one regulatory determination with another across the industry, nor could we compare the outcomes of two determinations relating to the same company. These proposed rule changes will do nothing to change this outcome. Rather the proposed rule change will perpetuate this significant problem while at the same time severely reducing the ability of the regulator to be able to undertake an effective review of the regulatory determinations in the energy sector. This will result in a poorer outcome for end users and is not in their long term interests.

The draft rule changes have been predicated on the basis of creating investment certainty but we ascertain that contrary to that objective they create more long term uncertainty in a less than transparent manner. In particular, the proposed rule changes and the draft regulatory principles have failed to address issues around the RAB, the WACC and depreciation. These three components of the building block approach to incentive regulation constitute around 70% of the revenue requirement of the regulated transmission company.

The EUAA and EAG strongly urge the AEMC to refer back to our two previous submissions where we raised issues about:

- Lock-in of RAB
- Regulatory intrusion and reasonable estimate test;
- Regulatory period and WACC;
- Information disclosure;
- Incentive mechanisms;
- Asset stranding and negotiation;

It is our considered view that none of these issues has been addressed satisfactorily in the Draft Rule Proposal. Some of these will be addressed further in this submission taking into account the proposed changes in the draft rules along with issues arising from the amendments to the Draft Rule Change Proposal. In respect of these, and the other issues raised in our earlier submissions, we urge the AEMC to bring forward proposals that meet the SMO. As the position stands, we consider that unfortunately for end users and directly contrary to the SMO, the AEMC's Draft Rule proposal will clearly and substantially shift the balance of the transmission regulatory regime in favour of TNSPs in a manner that will act against the long term interests of end users with inevitable additional pressure for higher prices.

The Failure to Address Issues Surrounding RAB, WACC and Depreciation

In response to the proposed rules EUAA and EAG note that major consumer bodies expressed severe concerns around the legal definitions of RAB, WACC and depreciation.

Regulated Asset Base

The regulated asset base accounts for some 70% of users expenses in respect of the transmission revenue requirements. The EUAA and the EAG believe that the draft rules which specify a set of guidelines to TNSPs provide:

(a) too much latitude when making a revenue application; and

(b) allow the regulated entity to change the information requirement going from one regulatory period to the next, facilitating regulatory gaming. This problem is compounded by the reopening provisions in the draft Rule changes where the networks (but not end users!) are allowed to completely reopen the draft determination draft Rules 6A.26.8 Submission of revised methodology

We have always been and remain opposed to the 'lock-in' of regulatory asset values, based on values previously determined by jurisdictions and the ACCC, plus 'roll-in' of prudent and efficient actual capital expenditure. No entity in a contestable market can have a return on assets guaranteed.[1] This is an unfortunately and costly (to end users)

[1] Australian regulatory practice has always emphasised that regulation of energy networks should provide outcomes that "mimic" the outcomes of a competitive market.

consequence of regulatory precedent in Australia. We have great difficulty seeing how the AEMC can justify this given that it is required to satisfy the SMO.

If the AEMC persists with this approach it should be made conditional on the AER retaining powers, and flexibility, to undertake a prudence and efficiency review in circumstances where this appears warranted. The AEMC in the draft rule proposal has, in fact, moved the other way by removing the *ex-post* review. How can end users have confidence in the process when there is effectively no review of a TNSP's performance in *ex-ante* forecasting and how can regulators assess their performance and effectiveness without a thorough evaluation of the previous determination?

If a TNSP has made a poor investment decision, or where execution of the investment was poorly managed, we consider that the AER should be obliged to exclude roll-in of any inefficient or imprudent investment cost. The Rules should not allow poor management to be protected, or require end users to bear costs associated with poor management by a TNSP. Again, we fail to see how the AEMC could support this and still satisfy the SMO or even the historical intent of Australian regulatory practice?

Reasonable Estimates Test

It is our view that restricting the AER to assessing the 'reasonableness' of forecasts without placing 'prudence' and 'efficiency' as a clear and high priority in the 'reasonableness criteria' specified in *Draft Rules 6A.6.6, 6A.6.7* and *6A.14* could create perverse incentives that encourage even greater 'strategic behaviour' by TNSPs. Implementing an 'accept if reasonable' requirement is also likely to weaken the effectiveness of the AER's review of expenditure proposals.

In particular, we note that the AEMC's 'reasonable estimate' proposal is a significant and important departure from the current requirements in the Rules that require the AER to assess whether proposals meet the criterion of *efficient investment given efficient operating and maintenance practices*.[2] The proposal also represents a substantial departure from requirements specified in the Gas Code, for which the *overarching requirement is that when Reference Tariffs are determined and reviewed, they should be based on the efficient cost (or anticipated efficient cost) of providing the Reference Services*.[3]

We again point out that the emphasis on efficient costs is consistent with the original intent of energy reforms, whereby regulation was meant to 'mimic' the outcomes achieved in a competitive market. This was closely aligned with the policy objective of ensuring that energy infrastructure was provided on a competitive basis. It seems to us that a change to an essentially legal term such as "reasonable" without maintaining the primary emphasis on 'efficiency' greatly risks skewing outcomes back towards the interests of regulated businesses, allowing them to become less efficient and more

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

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

profitable at the expense of end users. This would reverse the (desirable) policy objectives of energy reform and would be contrary to CoAG's energy reform principles, to the MCE's objectives and would not satisfy the SMO. These are serious concerns and seem to put the AEMC at odds with CoAG, the MCE and the SMO.

The proposed Rule change should clearly say that efficiency will retain its primacy as part of the 'reasonableness criteria'; and require that demand forecasts be compatible with efficient expenditure forecasts. This would assist the AER withstand legal challenge that the AER's interpretation of 'reasonable' did not breach the 'Wednesbury principle.'

However, this would be very much a second best outcome and we strongly recommend that the proposed Rule change be amended to reflect the existing focus on efficient investment given efficient operating and maintenance practices; or be more effectively aligned with existing (and equivalent) provisions of the Gas Code with an overarching requirement that revenue allowances are determined and reviewed based on the efficient cost (or anticipated efficient cost) of providing the Prescribed Services.

Lock in of WACC Parameter Values

As we stressed in our previous submission, this is one aspect of the proposed Rule change that we completely disagree with and will again make the argument. The AEMC has retained the current requirement[4] that the regulatory period must not be less than five years for each individual TNSP but can be longer. The AEMC has also proposed that WACC parameter values, currently specified in the SRP, be 'elevated' to the Rules and fixed for a period of five years (to 1 July 2011),[5] subject to review at that time and every subsequent five years by the AER – and subject to an estimate of a risk free rate to be applied to individual TNSPs at each determination as required.

This is one aspect of the proposed Rule change that we completely disagree with. We believe this would will work substantially against the long term interests of consumers of electricity, i.e. contravene the SMO. There are two principal reasons for this.

The first is that, as the AEMC notes, *the rate of return has been subject to considerable debate in recent years,*[6] and the reasons for this debate are that:

- market evidence – limited though it is – suggests that Australian regulators have been excessively 'cautious' in estimating values for both the Market Risk Premium (MRP) and Equity Beta;
- Australian regulators continue to rely primarily on retrospective analysis of historic statistical market data to estimate the MRP and Equity Beta values even though the relevant parameters seek to forecast a value for WACC;
- UK regulators place greater weight on forecasts and opinions provided by respected financial market observers; and

---

4 The minimum regulatory period is currently specified in Rule 6.2.4(b) as *a period of not less than 5 years.*

5 Proposed Rule 6.2.4(e).

6 p. 63

- every regulatory decision in Australia since 2000 has highlighted views from respected financial market observers that future expectations are likely to be lower than past experience (on which the regulators base their estimates for MRP and Beta).

This means that end users are paying more than they should be in network charges.

The second reason is that there is some evidence that the continuing debate on the above issues is leading to progressive, if small, improvements in the explanation by regulators of their WACC decisions. Virtually all regulators now present information sourced from financial market observers in their decisions, which highlight the differences between the 'cautious/conservative' decisions of regulators and the more 'realistic' views of financial market observers. We believe that continuation of this debate in a transparent manner, as part of regulatory determinations, is important and could eventually produce outcomes that are consistent with the long-term interests of end users.

It is also fundamental to any regulatory determination and should be debated as part of it, not locked up in 'black letter law'. The Rules should, however, clearly specify the manner in which economic regulation is to take place. Beyond that the regulator needs to be given discretion to determine key parameters as part of the review process.

In the Draft Rule Proposal the AEMC has failed to provide an economic argument to justify a five-yearly lock in and review of WACC parameters. The more rational approach is to adjust WACC parameters as new data becomes available, rather than having five yearly reviews by a body, such as the AEMC, which is not the regulator but a Rule maker, which has no particular qualities to determine matters, such as the WACC parameters, that require the experience of a regulator. We believe that the AEMC taking on this role is, in fact, contrary to the decisions of the MCE that created a single national regulator, the AER and a separate Rule maker, the AEMC. The AEMC's approach will severely curtail the ability of the Regulator to examine these parameters in the context of its determinations.

The setting of the rules on a five yearly basis will create significant distortions between the different TNSPs depending on when their determination falls in respect of the WACC review. The parameters could well be significantly different between a business that has its determination set immediately following a WACC review compared with a business whose determination is completed just prior to a review.

This decoupling of the WACC from the regulatory process shows a failure of the AEMC to appreciate the important links between regulatory determinations, setting key parameters and the subsequent performance of the regulated entity over the subsequent regulatory period. We are very concerned that the AEMC's proposed decoupling will detract from the performance of TNSPs over time.

The setting of the WACC parameters in five yearly stints would also lead to relatively large "steps" in the parameters compared with the present situation where the parameters are adjusted in accordance with developments in economic theory and current values. It is hard to see how the AEMC can argue that this will improve investment certainty or "mimic" the situation faced by entities in competitive markets.

If the AEMC persists with this proposal it is even more essential that the regulatory determinations for all the TNSPs be undertaken in unison.

Depreciation

Under the Proposed Rule TNSPs will propose depreciation schedules that must be accepted by the AER provided that they accord with principles set out in the Rules namely:

- each asset (or group of assets) is to be depreciated over its economic life; and
- each asset is to be depreciated only once, and the total sum of the allowed depreciation over the asset's life is to equal the initial value at which the asset entered the RAB.

There is no requirement that the schedules adopted conform to normal accounting practice.

We consider that the ability for TNSPs to choose their own depreciation schedules provides considerable scope for TNSP's to game the regulatory process. It would be easy, for example, to increase the revenue stream in the early years with appropriately chosen write down periods. TNSP's can pick and chose how they want to depreciate different asset classes both within and between periods. In addition, we query how this accords with the AEMC's objective of creating investor certainty given the flexibility compared with private sector entities.

An example of how such flexibility can be used to enhance a service provider's revenue stream in the short term was demonstrated under the Gase Code when the ACCC accepted GasNet's proposal to reduce the life of the asset of the Longford to Melbourne gas pipeline from thirty years to twenty years. The same result can be achieved under the Draft Rules with heavier write downs in the initial years for example.

It has not been lost on the EUAA and EAG that the Australian incentive based regulatory arrangements are design to emulate competitive outcomes and regulatory determinations are made using real numbers (inflation adjusted) while the regulated entities actually operate in the nominal world. The resulting regulatory determination for a Network Service Provider understates the actual annual returns to the business and the shareholders.

Regulatory intrusion and reasonable estimate test

The EUAA and EAG consider that the Draft Rules severely restrict the ability of the regulator to ensure that price resets meet the SMO.

Again the AEMC has ostensibly taken this approach on the basis of a need to create investor certainty. In this respect, we have serious reservations about the robustness of an

assumption that *a more intrusive regulatory approach* would create a risk of under-investment. There is no evidence, of which we are aware, from any jurisdiction or any regulated utility sector in Australia to support this asertion. Nor has this ever been the case in the more than 20 regulatory reviews with which we have been involved.

On the contrary, there is evidence that all regulated utilities recognise the benefits to be derived from exercise of strategic behaviour; and regulated utility investment is at historically high levels – despite protestations from regulated utilities that regulation is too 'heavy-handed' and 'interventionist' and discourages investment. Despite these criticisms by regulated utilities, the level of 'under-spend' against forecasts approved by regulators has been generally consistent for privately-owned utilities and is certain to increase for those government-owned utilities that have learnt the 'hard lessons' of preparing poor forecasts in their first regulatory periods.

In respect of the "reasonableness test", it is our view that restricting the AER to assessing the 'reasonableness' of forecasts without placing 'prudence' and 'efficiency' as a clear and high priority in the 'reasonableness criteria' specified in *Draft Rules 6.2.6(b)(3*) and *6.2.7(b)(2)* could create perverse incentives that encourage even greater 'strategic behaviour' by TNSPs. Implementing an 'accept if reasonable' requirement is also likely to weaken the effectiveness of the AER's review of expenditure proposals. In order to defend against an appeal that a TNSP's proposal was 'unreasonable', the AER may have to demonstrate that a TNSP had not given adequate weight to a relevant factor of great importance, or had given excessive weight to a factor of no great importance such that 'the proposal was so unreasonable that no reasonable person could have come to it' (i.e. the so-called 'Wednesbury principle').[7] This could mean that the AER may not be able to withstand legal challenge to rejection of a forecast expenditure estimate (for example) based on a 'reasonable', but conservative, set of engineering assumptions derived from 'reasonable' technical assessment using a 'reasonable' framework but had a very low probability of occurrence – even if this resulted in an estimate of cost that was very clearly excessive compared to similar activities for which (lower) actual costs were known.

Rather than a benefit to end users it is a potential gold mine for the asset owners and managers, and the legal fraternity.

Asset stranding

The Rule Proposal provides that the AER will have the power to remove assets from the RAB, which are the subject of commercial stranding, but only where the TNSP has not taken steps to either:

[7] The 'Wednesbury principle' refers to the error of law that the decision was unreasonable in the sense laid down in *Associated Picture Houses, Ltd v Wednesbury Corporation [1948] 1 KB 223*. That ground applied where a decision maker had not given adequate weight to a relevant factor of great importance, or had given excessive weight to a relevant factor of no great importance. The basis for such a conclusion is that the decision was 'manifestly unreasonable' in the sense explained in the Wednesbury case, namely that 'the decision was so unreasonable that no reasonable person could have come to it'. (See *Minister for Aboriginal Affairs v Peko-Wallsend Ltd (1986) 162 CLR 24 at 41*).

- enter into contractual arrangements with the user to manage stranding risk (for assets where construction is committed to after 16 February 2006); or
- to offer a prudent discount to such users in appropriate circumstances.

The ability of the AER to remove assets from the RAB is limited to assets that the AER determines are no longer contributing to the provision of Prescribed Transmission Services and where the current value of those assets exceeds a certain threshold. The AEMC is proposing a threshold of $20m (in 2006 dollars).

We note that this proposal has some similarities with arrangements implemented for electricity and gas distribution in some jurisdictions – particularly Victoria, where virtual 'cast iron' guarantees have been given to distributors (and water utilities) to offset asset stranding risk of what are deemed to be initially 'prudent'[8] investments. Similar arrangements have also (effectively) been implemented in other jurisdictions, although they are not as clearly articulated by the relevant regulators.

In essence, the Victorian ESC (or ORG initially) has stated explicitly that utilities may recover the value of any stranded assets created by an initially 'prudent' investment through accelerated depreciation. Stranding may be created through 'bypass' (which can be avoided by negotiating a lower access price with the bypasser) or by change in user consumption/demand patterns. End users (still connected to the system) effectively pay for the stranded asset through incrementally higher access and usage charges.

TNSPs are already in a privileged position, compared with entities in contested markets, in that they are guaranteed a return on assets that go into the RAB. The ability to pass on sunk costs in almost any circumstance is a further windfall that reduces the pressure on management to perform. The ability to do this is, by definition, absent in competitive firms and Australian regulators ought to emulate this practice. The AEMC ought to develop Rule changes that ensure they do.

Revenue Re-Open

We note with severe concern that the AEMC has not only continued to retain the re-opener and pass through provisions but also reintroduced a contingency provision in the draft rules. These provisions are to target unforeseeable events. However, the existing pass through and contingency provisions already cover unforeseeable events. The revenue cap re-opener was originally conceived in the SRP as an alternative to pass through provisions, an area that in our view is already generously catered for.

We further note that the AEMC had previously not adopted the AER's 'contingent project' regime for capital expenditure, because it did not adequately address the potential need for necessary major capital projects that may have either have been unforeseen or, planned, but the timing was uncertain. Rather, the Rule Proposal provided that the revenue cap could be reopened in specified circumstances where a TNSP needs to undertake significant capital expenditure which was not provided at the commencement

[8] The initial investment is presumed to be 'prudent' if the decision to invest was based on 'reasonable information' available at the time and taken in accordance with Good Industry Practice. Once accepted for 'roll-in' to the regulatory asset base, the investment is deemed to have been 'prudent'; and that decision is not subject to further review.

of the regulatory period. This was said to increase flexibility for infrastructure responses to market needs. Now the AEMC is proposing that both options be included which we find perverse.

The re-opener and contingency provisions reduce the incentives on a TNSP to implement projects efficiently. The pass through provisions are already more than adequate to provide for unforseen events and the re-opener and contingency provisions just provide another free kick, again at the expense of end-users.

While we acknowledge the need for a *force majeure* provision, we consider that what is preposed is a substantial step away from creating effective incentives for efficient investment that is unnecessary and very likely to produce outcomes that are detrimental to facilitating achievement of the long-term interests of energy users.

Resubmission of Revenue Proposal

The EUAA and EAG note that the AEMC has amended the Draft Rules to remove some of the rigidity suggested for the Regulatory Review process while retaining the requirement that a review be completed within eleven months. We also note that the Draft Rules have failed to address the lack of the ability to cap the period of time that is lost where the initial proposal is not compliant with the requirements of the Rule. While we agree that reviews should be undertaken in a timely manner, this is not (nor should it be) the primary aim of determinations, which should be to achieve a soundly based and effective regulatory determination. The Regulator must have sufficient time to investigate, evaluate, consult and consider. Particularly when the Regulator is faced with obstacles to deadlines not of its own making, this need to be recognised. Accordingly, we are opposed to enshrining such a time period in the Rules.

Rigid timelines can provide a strain on the resources of both the Regulator and other stakeholders. The problem has now been compounded in the Draft Rule with the removal of the (justifiable) requirement in the Proposal that a TNSP resubmit a compliant revenue proposal no more than one month after the AER so notifies the TNSP of its determination. As presently proposed a TNSP can, in effect, be putting forward major changes some seven and a half months into the fixed time period. This would put unjustified pressure on the regulator and other interested parties, especially end uers.

EUAA and EAG have experienced extreme frustration in many jurisdictional regulatory determinations as a result of late or non-availability of information or reports highly relevant to the determination due to time constraints. This deficiency almost completely excludes end user participation in the final determination. For the AEMC's Rules to sanction such as outcome would be an ironic result given the SMO.

Revised Revenue Proposal

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

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

> *…by allowing the 'presumption' of approval not just to apply to the initial consideration by the AER of whether a proposal is acceptable, but requiring it also to be applied in considering the regulated entity's amended proposal lodged after the release of the draft determination, the AEMC approach does not provide any incentive to reduce regulatory game playing by entities lodging proposals.*
>
> *Indeed, the regulated entity has an incentive to make an ambit claim at the commencement of the process in order to discover whether it lies above the regulator's estimate of a reasonable range, and if it does, to flush a counter proposal out from the regulator in the form of a draft determination. Under the Gas Code and under the AEMC's draft Rules, this search process is at no bargaining cost to the regulated entity as it retains a capacity to make a final offer in response to the draft determination. Under the current interpretation of the Gas Code (and presumably the same would apply to the AEMC draft Rules), the regulator must accept such an offer if it lies within the regulator's estimate of a reasonable range. The final offer will not of course be less than that proposed by the regulator.*[9]

The AEMC's Draft Determination, in addressing these concerns, noted that strategic behaviour was a fact of the regulatory process. This is an extraordinary comment and almost tantamount to an admission of defeat on the key matter of strategic gaming by regulated entities, which is fundamental to attainment of the SMO. What the AEMC has failed to recognize, however, is that these incentives for strategic behaviour are far greater under an approach where the TNSP can be rewarded for seeking out the regulator's view on outcomes likely to be deemed reasonable through its ability to submit a revised revenue proposal.

It goes without saying that this further compounds the problem identified in the previous section in respect of the ability of the Regulator and other stakeholders to have the opportunity to undertake the detailed analysis required in the time available to finalize the determination.

Propose – Respond Model

We are extremely concerned that despite the MCE at its meeting on 19 May 2006 agreeing to adopt the recommendations of its Expert Panel on pricing principles and a 'fit for purpose' decision making framework the AEMC in the way the Draft Rules are framed so as to effectively retain a 'Propose – Respond' model.

[9] Draft Expert Panel Report, p 76

The Expert Panel in its Report found that:

> *There is little doubt that a propose-respond model (particularly in the form proposed by the Productivity Commission) would lead to a systematic increase in the returns to regulated entities relative to the consider-decide model.*[10]

We agree with the conclusion of the Expert Panel and believe that any model that places such constraints on the Regulator will invariably ratchet up prices.

Moreover, the AEMC has 'rebadged' its Rule change as 'fit for purpose' and then commented that in this case 'propose-respond' is "fit for the purpose". This seems to us to be an extraordinary approach to take and flies in the face of both the Expert Panel and the MCE.

Publication of Information

The whole rationale for network businesses to be regulated is because they are monopoly businesses. As mentioned above, the Australian incentive regulation arrangements aim to emulate competitive outcomes. One of the best ways to ensure consumer confidence in the regulatory arrangements its to maximise transparency. This must entail the full disclosure arrangements for the performance, financial and related party business arrangements of the regulated entity in the public domain.

As a matter of principle and good regulatory practice, energy monopolies ought to be under tight and strict information disclosure requirements that force them to disclose all information related to their monopoly activities unless they relate to commercial transactions with competitive businesses. This obligation should stem from the privileged monopoly position they enjoy.

As we noted in our earlier submissions, the current information disclosure and reporting arrangements implemented by the ACCC are totally inadequate. No coordinated public domain records exist for performance of any TNSP prior to 2001. Several TNSPs have (effectively) treated the current reporting obligations as optional – by declining to provide information to the ACCC. Each TNSP is free to choose the format (and parameter) used for reporting even the simplest measures (such as energy throughput). And, finally, the TNSPs retain the option of claiming 'commercial confidentiality' as a basis for not reporting information – or restricting the power of the AER to publicly report information provided.

We believe that the AEMC's proposals will do nothing to address these pre-existing deficiencies.

As a minimum, the proposed Rule changes should be amended to require:

- the AER to develop, in consultation with TNSPs and end users, effective and enforceable guidelines and procedures that define, and precisely and clearly specify, the information that must be provided to the AER;

[10] Draft Expert Panel Report, p 68

- these requirements and the timing of information provision be rigorously and consistently enforced (with tough penalties and sanctions for non-compliance);
- reliable and verifiable information about the actual costs incurred in providing services, including for un-regulated activities, and the levels of service performance.

We further consider that, at a minimum, the AER should be given the same powers to obtain and enforce information provision by the TNSP as other Australian regulators, such as the Australian Securities and Investment Commission (ASIC), ACCC and the Australian Taxation Office (ATO).

Further, the Rules should limit discretion in allocation of costs and interpretation of performance information as tightly as possible. This would appear to be the only way of minimising the exercise of 'strategic behaviour', obfuscation and/or confusion over information disclosure.

We are extremely concerned to see that the Draft Rules not only fail to address our earlier concerns but have introduced a number of changes that impact adversely on the transparency of the regulatory process. This particularly applies to changes to confidentially provisions which will significantly impact on the Regulator's ability to consult on a revenue proposal or access arrangement and publish the information. These potential draconian changes to the Rules have the effect of significantly diminishing transparency, consumer involvement in regulatory proceedings and would appear to be completely contrary to the SMO.