



**TRANSCRIPT
OF PROCEEDINGS**

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AUSTRALIAN ENERGY MARKET COMMISSION

**PUBLIC HEARING RULE PROPOSAL
DRAFT - NATIONAL ELECTRICITY AMENDMENT (ECONOMIC REGULATION OF
TRANSMISSION SERVICES) RULE 2006**

MR J. TAMBLYN, Chairman
MS L. CARVER, Commissioner
MR I. WOODWARD, Commissioner

TRANSCRIPT OF PROCEEDINGS

AT MELBOURNE ON WEDNESDAY, 8 MARCH 2006, AT 9.09 AM

CHAIRMAN: Good morning, ladies and gentlemen. Can I welcome you to this, the AEMC's first public hearing, and today we'll be dealing with our rule proposal on electricity transmission revenue regulation. Before making a few opening remarks, let me just introduce myself and my fellow commissioners. I'm John Tamberlyn, the chair of the AEMC. I have with me Liza Carver and Ian Woodward, my two commissioners, and we're very much looking forward to hearing your views on the proposal we put out for comment. I'd like to thank you all for attending, travelling to be with us, and we look forward to hearing from you and to have the chance to question you and understand the views that you put forward.

Before going through some introductory remarks, I'd like to go through a little bit of housekeeping. First of all, all of you should have a copy of the agenda which was available outside. The structure for the agenda is we'll have a series of presentations from key stakeholder groups with interests in this matter. Each presentation will be followed by a period for questions and comments from the floor, about 10 or 15 minutes for questions and comments.

We will be recording the proceedings today and putting a transcript on our web site. So we would ask you to identify yourself by name and your organisation when you're making comments, and we also have microphones available. We'd ask you to wait on the microphone so that we can hear what you are saying to us. I'll be chairing the hearing today, and I would ask you to make your comments through the chair so that we only have one conversation going on at a time.

Could I also ask you to turn off your mobile phones just so we don't have any interruptions, and I mention that the toilets are outside, down to the left on either side of the lift wells, and if there are any other administrative matters, we've got a number of AEMC staff here present today that can help you with those matters.

The agenda today will commence with a brief overview of our rule proposal by Commissioner Carver. Liza will spend about 10 or 15 minutes just giving you or reminding you of the highlights of the proposal. We'll then have a presentation from a transmission network owner, followed by a presentation from the Energy Users Association, and then a presentation from the MGF, the Generators Forum. Each of those are followed by questions. We'll break for morning tea at about 10.45 for 20 minutes. We'll then have a presentation from the Major Energy Users Group, from the ERAA, the retailers association, and another transmission network operator presentation.

So that's the order of business. Liza, as I say, will give you an overview first up. But before that, I'd just like to make a few opening comments just to give you context for the important review that we're doing and some context for this morning's discussion.

I just want to emphasise that in conducting this review, we have deliberately adopted a very consultative and listening approach. Before we formed views about this review and the rule changes that might be appropriate, we put out a number of consultation papers and listened to you and your views about what needed to be done before we put our proposal which we are now to discuss on the table. This consultative listening approach is going to be a focus of the AEMC's

work. Rather than telling you what we think and ask you for your comments on our views, we want your views first as a process for forming our own views about what needs to be done. So you'll see that is a characteristic of the way we'll conduct this review and future reviews that we'll do.

I also want to emphasise that this rule proposal that we've put out for comment is now the first step in the formal rule change proposal which we are required to go through under the National Electricity Law which is a process involving further submissions, a draft determination and a final determination. So this is the start of that process, and we will be listening carefully to the comments that you make at each stage of this formal process as we go forward.

So I want to emphasise that the rule proposal that we've published represents our current thinking on what needs to be done, but it's not our final view and we are still listening to the comments that you make on that proposal. In particular we want to understand if you feel that we have not hit the mark, we've got something wrong, we haven't understood the regulatory market commercial user implications as we put in the rule proposal. We want to hear about that. We also want to hear though what you think we should do about the problems that you identify in our current proposal. So let's be focused on what needs to be done to improve the rule proposal. In particular I want to emphasise we're not here today to defend what we've put out. We're here to listen to what you think about what we have put out.

Can I just say a couple of quick things about the chapter 6 review and the rule change process. As you know, we've divided it into two phases. We are currently dealing with the revenue determination aspects of the rules and what needs to be done in that regard. We have put on a separate time path a review of the pricing structure aspects of the transmission regulation rules, and that process will conclude in December 2006. This process is scheduled to conclude in June 2006. So that other process has got some distance to travel.

Can I also make the point that following the MCE's development of new governance arrangements and institutional arrangements for the energy market involving the establishment of the AEMC and the AER, we now have clearly and deliberately a rules-based approach to developing the regulatory framework and a process for reviewing and changing those rules. So we have developed our process in our proposal in that context. We believe our current proposal is consistent with a rules-based approach as required by the MCE and the National Electricity Law. It also appears to us to be consistent with the submissions we've been receiving from stakeholders.

However, the balance that we have struck in our rule proposal between guidance to the regulator and discretion to the regulator is a matter of judgment, and it's a matter on which we would like to hear your comments today.

I'd just like to mention a couple of things that we've used to guide the development of the rule proposal and will guide our finalisation of this process. First of all the national electricity market objective is the high-level touchstone. The work that we do, the rules that we develop must satisfy that object of an efficient, reliable, safe electricity system. That will promote efficiency in both the

network sector and also the wholesale and retail market sector hopefully for the long-term benefit of all users.

We've also developed a couple of other themes. We want to align the incentives of transmission network operators with the needs and interests of other network users in the marketplace and ultimately with the interests of final consumers. So that's one important objective, alignment of incentives. Promoting incentives for efficient investment is another objective and theme that we have for the delivery of reliability, security and safety in supply, and ultimately as well delivering greater certainty, clarity and transparency in the regulatory framework and its process to develop a clearer and more certain regulatory environment for investment and operation, and for users of transmission network services to understand the basis on which prices and services are being delivered to them.

So they are the guiding themes that we have used. That's the background from me on the context in which we are conducting this hearing today. I'd now like to hand over to Liza to give you the overview of the proposal before we go through the agenda. Thank you.

MS CARVER: Thank you, John. I'll be brief because we are fundamentally here to listen to you, but we thought there may be some value in providing just a fairly high-level overview of the key elements of the package. Firstly what we've sought to do is provide a complete and clear framework for regulatory decision-making, and in that respect we have adopted a proposed respond process in the context of a codified post-tax building block CPI minus X revenue cap regime, as you will all now be aware.

We've also adopted a fixed time frame for regulatory decision-making to provide certainty both for the proposing TNSP users and the AER in the process that must be undertaken before a determination is made by the AER. You will have seen that in the rules, we had provided for, in a number of areas where the AER is to develop guidelines, models and schemes for example. So two incentive schemes that are elements of the proposal, and that the AER must develop those instruments through a codified consultation process set out in the rules.

In the handout you will have found, hopefully on your seats I think, we have provided you with a number of schematics which represent elements of the package we put together, and the first schematic which I'm just going to move through fairly quickly is the actual schematic of the process for the making of a revenue cap proposal by a TNSP, and the consultation and decision-making process that the AER is to step through before making its final determination.

In respect of the scope of what the package seeks to regulate, there has not been any fundamental change in our view from the current rules. What is proposed is that a revenue cap will apply to the revenues of what we have redescribed as effectively shared use of system services. We have also, as you'll be aware, introduced a new regime for the negotiation and resolution of price in respect of connection services and non-standard use of system agreements, and agreements for services associated with augmentations.

Now, I said a new regime for the negotiation and resolution of disputes regarding prices. The rules in respect of the quality characteristics and the obligation to engage in good faith negotiation in respect of things, particularly connection services, reside in chapter 5, as many of you will be aware, and those remain untouched obviously, only fairly minor consequential amendments are being proposed to chapter 5 of the rules.

I think a key question for us in this phase of consultation is whether the definitions we proposed for prescribed services and negotiated services, which I just put up on the display, whether we've got that right. I was asked outside about 10 minutes ago how we three commissioners viewed what we had done in the draft package, and I think it's fair to say that we regard it as our best view of the right package, but we are extremely conscious that we have been required under the statutory timetable to develop it in a very short period of time, and we may well have failed to understand particularly operational questions and issues that we need to understand in order to take this draft package of rules to an appropriate set of final rules, and I think this is one area in particular we're very keen to hear from TNSPs and users to work through whether there are improvements that should be made to the draft.

The form of regulation, we have sought to provide a clear and complete form or framework for the regulation of revenue of prescribed services, and as you will have all been aware, we've adopted a post-tax building block CPI minus X revenue cap regime. In that respect we are obviously largely embracing current practice, and we have benefited enormously from the previous work of the AER in developing the SRP. For those of you who have worked through the detail, you will have found areas in which we have augmented the SRP because we have sought to provide a complete framework for the regulatory process for determining the revenue cap on prescribed services.

While we've sought to provide a complete framework, there are many areas in which we think the AER should have both the role and opportunity to evolve the role in respect of certain - the guidelines, if you like, and models for various components of the building blocks model, and where we propose that in the rules, there are areas in which the AER is to develop guidelines or models in respect of the post-tax revenue model and publish it, the performance incentive scheme, the efficiency benefit scheme, the model for rolling forward, the RAB, the pricing criteria for negotiated services, and the development of the guidelines that would deal with the information that must be put forward by a TNSP in making its revenue proposal. That's not a complete list of the AER guidelines, but they're probably the core ones.

Again in your handout, we've included a schematic of the framework for regulating the revenue of prescribed services. This schematic I think is particularly useful because it does - I can see people squinting. It's small print. I apologise for that. But it does take you to the relevant specific rules or clauses in the rules that deal with the various elements set out.

What are the key elements of the framework for regulating the revenue of prescribed services from our perspective - there may be others from your, but I've just listed a few of them. Obviously we'd

sought to roll forward and lock in RAB values as the SRP proposed as well. We have sought to lock in the capital asset pricing model and certain WAC parameters with the AER to conduct a review of the parameters in five years' time. We provided that the business is to put forward and have determined its reasonable estimates of forecast opex and capex, and that whether or not those forecasts are ultimately considered reasonable or not is to be assessed by the AER against very clear criteria - well, we've sought to make them clear criteria.

The TNSPs may propose a depreciation schedule, but those schedules have to be in accordance with the principles in the rules. We provided for a roll-in of actual capex at the next reset, but with the discretion for the AER to conduct a prudency and efficiency review, if it deems that appropriate, and we've provided a limited reopening regime in respect of capital expenditure that has not been provided for which represents more than 5 per cent of the value of the RAB, but only where that capital project relates to reliability, regulatory obligations or has satisfied the market benefits test limb of the regulatory test.

We've provided for a pass-through regime. There's very little original if anything in what we've done on pass-through. I think we'd sought to take from the best of the models round the country including the paper published by the AER in January, and the regime in South Australia under the EPO, both instruments providing what we thought was a good basis for developing a pass-through regime.

I've referred to the network performance incentive regime and efficiency benefits scheme, and we have a very limited incentive regime to promote better management of the risk of commercial stranding in respect of large-scale network elements that are dedicated to one or a small group of network users.

For the consultation process, I think one of the areas in which we're particularly keen to get feedback is in respect of whether we got the decision-making criteria for the AER correct. So for example, where we provided for a discretionary option for the AER to conduct prudency and efficiency reviews of capital expenditure against specified criteria, have we got that criteria right? Another obvious, very important area of decision-making criteria are the criteria for assessing whether forecast opex and capex represent a reasonable estimate, and again we're very keen to hear people's submissions on those questions, and probably the third category of particular significance is the criteria for decision-making by the AER on reopening of a revenue cap.

As I've mentioned, we provided for a more what we hope is commercially orientated and negotiation dispute resolution regime for non-prescribed negotiated services. We've invoked the use of commercial arbitration rules rather than chapter 8 of the rules which we don't think is very appropriate for what is fundamentally often just a commercial dispute about charges, and obviously related to that, once you set up a regime of revenue regulation of a class of services whereas other services are subject to commercial arbitration negotiation regime.

You need to have clarity around cost allocation as between different services, and we've provided in

the rules certain high-level principles and then a mechanism whereby the AER will be required to develop more detailed guidelines on cost allocation and the businesses are then required, as part of their reset process, to come forward with a methodology that is consistent with the guidelines. In some respects in the cost allocation rules, we've plagiarised to a degree some of the lessons out of telecommunications, and that's it from me. Thank you very much for your time.

CHAIRMAN: Thank you, Liza, very much. That now takes us to the presentation stage of our agenda. As I've said, we'll have about a 10 or 15-minute presentation from each, followed by 10 or 15 minutes of comment and question from the floor, and we would ask you to identify yourself and wait for the microphone. The first presentation is from Gordon Jardine, who is the CEO of Powerlink. Thank you, Gordon.

MR JARDINE: Thanks, John. Thanks for the opportunity to be here today. Just to make sure everyone understands who I'm representing, I'm representing those five very fine organisations whose logos appear down the bottom, the transmission network owners that make up the national transmission grid in the NEM, which is aptly described as the backbone of the market.

The starting point for us and our businesses in the way that we look at these revenue regulations - in fact the starting point for our business full stop - is the fact that customers want a reliable electricity supply, and what has happened in reaction to that need is that jurisdictions and others have turned that into mandated reliability obligations on organisations like ours. So the elected representatives of the people, if you like, have said, "Yes, that's what they want. That's what they need, and one of the ways we'll make sure they get that is we'll impose mandated obligations on the suppliers," and that's the world that we live in.

The quote from the QCA really sums up the state of play in terms of where things are at in terms of customers' expectations of reliability these days, and I do have to say that my observation would be that in arriving at that conclusion, the QCA had a bit of a road to Damascus experience along the way. But they have come to that point, and that really represents the state of play that's now seen through regulators making contemporary decisions.

If you follow the logic from that starting point, then it's pretty clear that if you're a deliverer of that reliability, then you need a certain and predictable path for the revenue so you can fund the capex and opex, and that's us, and the other side of that equation is that if you're a receiver of that reliability, then you also need a certain and predictable path for the reasonable price you're going to pay. One of the things where there has been a paradigm shift, if you like, in recent years is that a strong recognition on the part of customers and regulators that this is not about rock-bottom prices of any old reliability. This is about high reliability at a reasonable price.

So where do we sit in terms of the proposed rules? If you follow the logic through, it's quite clear that if you're making rules around this sort of world, then giving weight to the certainty, since both the deliverers and the receivers are looking for that certainty, is the right thing to do. So the AEMC have come out and said, "This is all about delivering certainty," and our view is that that's exactly

what it's all about. They've read the situation quite correctly and reliability shouldn't be a raffle.

We have some qualifiers I guess. The first one is that not surprisingly, given the number of words that are involved in this exercise, there are, we think, some disconnects between the drafts and the principles, and Rainer will give a few examples of those later, and I guess we'll make a lot more of those clear in our submission. But we also think there's a couple of headline issues where the principles and intent should be revisited.

The first one revolves around this class of services. Out in the world right now we're dealing with, there are three classes and not two, and the third one is this class of excluded contestable unregulated network services, and it might surprise some people to know that there are lots and lots of these out there. It's a well-established regime in many states. I'm familiar personally with both the Queensland and South Australian situation, and all the new generators that have connected, all the new major loads that have connected in those states over the past five or six years have had the opportunity to make their own decisions about who they want providing those services, and those things have been negotiated very specifically to meet the needs of those connecting parties.

Our experience in dealing with that is that every single connecting party we've had to deal with has had their own very specific set of needs. Most all of them want things fast-tracked because they've left it fairly late to get this thing sorted out, and they're really keen to get into the market. Some of them want payment streams that are lumpy, flat, up-front weighted, back-front, back-end weighted. Some of them like to have penalty and bonus arrangements around the provider to encourage on-time delivery. There's a whole lot of them. Some of them want us to provide a fixed price where we take the risk on all the construction materials, like the steel and the aluminium and so on. Others want to take that risk themselves.

There is no two of these things that look the same. They're all very different and they're all negotiated in a way that delivers what the customer wants. What I'm saying is with the exception of some works within the substation, the rest of the connection assets for these new generator and opportunistic loads are contestable, and that's a well-established regime. We believe that needs to be preserved.

I've just identified some of the arrangements there, and just to give you a bit of a feel for some of the dimensions of this, some of these connection assets can be quite large. We're dealing with a prospective customer at the moment where the generator is located 240 kilometres from the grid connection point, and that particular generator is exercising its right to decide who it wants to own, operate and build that 240 kilometres of line.

We also believe that the arrangement should be symmetrical. If a TNO is off busy building shared network to keep the lights on, they might have the resources or the time to build 240 kilometres of line or some other distance for a new connecting generator. So that needs to be a symmetrical arrangement again as it is at the moment.

We do recognise that there are some grey issues around defining the boundaries of the three classes, but we think that's an issue that can be dealt with through this working party arrangement. One of the things we think is very important is that the working party does draw on that rich experience of lots of connections that are out there and works off a facts-based approach to this and not off some mythology that may exist out there.

The second area relates to contingent projects. The AEMC has put up a reopener scheme that talks about unforeseen capex that's needed. Contingent projects are actually foreseen but uncertain. So that's a different category in the sense of that things can be foreseeable, and they really relate to things like point loads that aren't included in the load forecast, but are known to be people who will make a decision within the regulatory period, and things like new smelters come into this category as a classic example.

We know for example in Queensland that there's a new smelter planning to come along and also a new refinery. Those customers haven't committed. But when they do commit, they want things to happen quickly. It's not just the connection assets. Point loads like that have impacts back up in the shared grid, and the shared grid needs to be reinforced when those big point loads come along.

The AER was on the right track in terms of recognising that there is a category there, and they recognise that in the SRP. But there is a category of those sort of things where you can foresee them, you can identify them up-front, but the trigger hasn't happened yet. But when the trigger does happen, things have to move. We're not talking about rolling back into the SRP model exactly in relation to contingent projects. We think the SRP model has some problems in it in the context of very long and extended time periods which are unwarranted, and a lot of complexities in there about trying to design efficiency regimes, and I'll talk about efficiency regimes shortly. There's a fair bit of overkill going on in that area.

But what we are talking about is a properly constructed contingent project model that recognises that these things are real, they're out there, and you need a way of dealing with them in a way that is responsive to the customer, and that's what this is all about. When one of these big loads comes along and they start building their smelter and you've got to reinforce the grid, you've got to be able to reinforce the grid before they've got that smelter up and running. That's what they expect and that's what they should expect, and that's what we should be able to deliver. But in order to do that, we need to be able to move in a very quick way once they fire the gun, because they move quickly and we need to move quickly. So a properly constructed regime built within the AEMC's proposed framework would need to allow very timely development as soon as the reg test was passed for the upgrade.

The big advantage in dealing with these up-front rather than coming back and dealing with them as a reopener is that right up-front, the regulator and the consultants are doing a lot of work on identifying what's in and what's not in the ex-ante cap, and so if they deal with this right up-front, they can give everyone regulatory certainty that the stuff that's in the contingent project bin is not in the ex-ante cap, that there's no double dipping. The problem with coming along later through a

reopener is that's the first exercise the regulator has to do, and they've got to go back and revisit the work that they'd done a few years previously. It's far better to do that all at once as one piece of work up-front and give everyone the certainty about what that's about.

The revenue treatment should be the same as the transgrid derogation. The reasons for that are well and truly documented in the transgrid derogation and the AEMC's reports they've published on that. So I won't go there. Reopener provision is needed for really left-field events; so for the really unforeseen events.

I just point out in relation to the reg test that there are lots of opportunities highlighted in yellow there for market participants to get involved in a contingent project on the way through. So by the time it gets to the bottom of that process, it should be a really, really short one to two-month period for the AER to then include that in the revenue cap. It shouldn't be another six or 12 months in the sort of extended time frames that have been showing up in the transgrid determination. There's just no excuse for not dealing with it quickly, because it's been out there. Everyone has had their chance to have a say.

Capex incentive, we have a difficulty with the notion that you can do an ex-post prudency review if the TNO has not exceeded its cap. So what we're saying is if you've got an ex-ante cap and you don't exceed it, then you shouldn't have to go through an ex-post review. In fact that was the basis on which the whole ex-ante thing was proposed in the first place, and that quote there comes out of the ACCC's document on the ex-ante cap.

There's a huge amount of work goes into these ex-ante caps to get them right up-front. Both ourselves - we're doing a reset application at the moment. The work going into that is about eight to 10 times what we did last time under an ex-post model. The regulator does more work as well. If we're going to deliver certainty, then you shouldn't be doing ex-post reviews in an ex-ante cap if the TNO is coming under it. If you're not going to do that, you might as well go back and just get rid of ex-ante and go to ex-post.

Capex incentive design, we think this is an overstated part of the SRP. We think the AEMC has got it right in that regard. Our big driver is these mandated reliability standards with the onerous sanctions. In other words, do what you've got to do, meet your mandated standards or lose your licence. That's what drives our capex. It's got very little to do with trying to sit around trying to wrinkle a few incentives out of the scheme. These days it's impossible to get incentives out of the scheme anyway, because we've got rapidly rising input costs.

If you go back two years or three years ago when this scheme was being designed, we were in a situation where you put a tender out and all the contractors beat each other up to get the work, cut their margins nice and thin. Those days are over. We've had our 30 years of buyers' market. We now into a sellers' market. The game is very, very different. The opportunity to earn incentives is negligible. The opportunities to get blown out of the water in contrast are really quite high. This is the aluminium price, and I could have put up copper, zinc, steel, contractors' margins, which is

actually steeper, any of the costs that are out there in terms of our input costs.

If you got your revenue cap set back in 02-03 when aluminium was 60 US cents a pound, then you've got build transmission lines and buy your conductors, which is where the aluminium goes, today the \$US1.20 a pound, you've blown your ex-ante cap. This would be characterised as you being inefficient because that's regarded as an inefficiency. That's how this model works. The model is all about a straight-line world where everything is a straight line. It doesn't happen like that. Costs are very volatile and it's not an ex-ante cap incentive design, it's an ex-ante lottery when out in the real world.

WAC - we think locking in WAC is a good idea, and dealing with WAC separately is very good, not doing it as part of everyone's reset. We also believe the BBB benchmark is right. It's supported by latest publication by Fitch in February 2006 which says:

Most of these transmission and distribution utilities will have to draw upon additional debt to meet their very high capex commitments.

Very true. So this is reflecting the real world, and I'm quite surprised in fact that the AEMC, given all the things on their plate, have been able to keep their finger on the pulse of what the ratings agencies are saying. But they've got it right, and I commend them on doing that. The cost to the average customer is minuscule. We've calculated this through to an average customer in South-East Queensland who pays \$737 a year. It will be 57 cents on their bill. They won't blink.

Final word - again, this is from the UK House of Commons where the regulator is pointing out that you really have to focus on the reliability of supply and not on cost bottom approaches. Thank you.

CHAIRMAN: Thank you, Gordon, very much. Now we're open for 10 or 15 minutes of questions or comments on remarks that Gordon has made. He's made a couple of quite strong points. So open to the floor for any comments or questions on those issues. Phil.

MR GALL: Phil Gall from TransGrid. I just wanted to be very clear, Gordon, on the negotiated connection assets. As I understood what you were saying - and what you're saying is that the contestable category is alive and well when it comes to connection assets rather than this proposed negotiation framework, and that they should be outside the reach of the regulatory regime. Is that right?

MR JARDINE: What I'm saying, Phil, is that there's a small amount of work in the substation that only the TNO can do, and that should get picked up by the negotiable services model that's proposed. The rest of it, the 240 kilometres of line and so forth, is out in contestable land. Customers choose, decide who they want to own and build it, and it may or may not be the TNO and the TNO may or may not want to do it anyway.

MR GALL: That's a bit clearer. That's our understanding, our position.

CHAIRMAN: Thank you very much. Other comments? Yes, David.

MR HEADBERRY: David Headberry from the Major Energy Users. One of the things that intrigued me, Gordon - and I must admit, I enjoy your presentations; we've seen a number of them, but it's regarding this issue of the contestable versus prescribed. On the one hand you say that the augmentation that's required for the big aluminium smelter is contestable and then on the other hand you say that you need to have - in your contingent program, you've got to have all of your augmentation on the works included in your revenue cap. It seems to be a conflict of interest there or a conflict between the two goals.

MR JARDINE: I'll clarify that. The connection bit of the assets for a major smelter or major generator are contestable. The shared grid upgrade - and that's what I'm talking about in the context of contingent projects. When a big point load comes along, it's not just the connection asset. They also have or need in many cases reinforcement of the shared grid. It's the reinforcement of the shared grid that should be in contingent projects and part of regulated services.

MR HEADBERRY: No. I can understand that. But surely following your logic that if a new customer comes along and wants to hook into the system, then following your logic, the augmentation of the shared network should be contestable as well because it's all sheeted back to the single point load.

MR JARDINE: The point load might be the triggering thing, but it's not their to decide because it's shared network. The thing with the connection asset, they can own it, they can operate it, they can decide who owns it. They can decide the maintenance regime for it. The difference with the shared network is the maintenance regime and the operating regime and the whole thing has to be dealt with across all classes of customers, because it's shared network. So you can't treat the two the same. They are different, they are distinguishable.

CHAIRMAN: Thank you. Ian has a question here.

MR WOODWARD: Thanks, John. Thanks, Gordon. I appreciate the presentation. Can I just clarify the proposition you're putting with respect to contingent projects. You made the point that under the ex-ante regime, a capex regime, and the importance of the contingent project bucket protecting against double dipping which is an important element in the issues related to users of your networks. How would you then see this left-field reopening actually meshing with the contingent project regime, and what would be the delineation line?

MR JARDINE: Contingent projects have this different to a trigger for reopening. Contingent project is foreseeable and foreseen. So we know that we're dealing with an aluminium that wants to connect somewhere in the next five years. So we know that. We just don't know when and we don't know when they're going to fire the gun. They may not even fire the gun. That's the issue. The other ones, the unforeseen ones, are things like if a terrorist came along and blew up half the

network, that's unforeseen and that would constitute in our mind a trigger for a reopening. So they're the two differences. One of them is foreseen; it's known, but it's uncertain. The other one is unforeseen and unforeseeable.

MR WOODWARD: So against the proposition that's in the draft proposal, then the reopening provision would be much more limited.

MR JARDINE: The reopener provision would be limited to unforeseen events, and I think it's been described that way anyway. Conceptually it might be different to what you've been thinking.

MS CARVER: I might just clarify that. In fact if you look at the rules - and I think I might have even used the word "unforeseen", and I apologise for that. If you actually look at the language of the rules, the reopening provisions are not limited to things that were unforeseen.

MR WOODWARD: That's what I'm trying to get at.

MS CARVER: The reopening regime is any project, foreseen or unforeseen, provided that it was not provided for in the cap.

MR JARDINE: The ex-ante cap, yes.

MS CARVER: And cannot be accommodated within, assuming there's always the possibility of course that halfway through a revenue cap period, savings had been made in other areas. So there are a number of limbs to be satisfied for the reopening mechanism, one of which is that it wasn't provided for at the outset, the second of which is that it cannot be provided for through other cost savings at the time of the application being made.

MR JARDINE: We're taking that broad category of things that you would lump in reopeners and striking it into categories; one being foreseen things which should go into a contingent bucket, and then the unforeseen ones which should still be sitting out in reopener land. The advantage we see in dealing with it as contingent projects up-front is that, as we pointed out, the regulator can clarify very quickly that it's not in the ex-ante cap. So the exercise of determining whether it's in or out of the ex-ante cap and it's not double dipping gets done at a time when they're doing a whole lot of rigorous analysis on the ex-ante cap up-front anyway. The problem with the reopener, you come back, they've got to go and do that analysis and try and start from square one. So there's a regulatory certainty and efficiency benefiting that.

The second benefit is that if you've got it in the contingent project regime and you can then start the thing as soon as you've done the reg test or very soon thereafter, you can be much more responsive to your customers in having to go back through a reopener which typically takes six to 12 months. So it's a regulatory clarity and a responsiveness benefit in having contingent projects.

CHAIRMAN: Do you have a comment to make?

MS CARVER: I'd actually like to ask Gordon a question because he mentioned the sort of regulatory efficiency. Would he agree that in fact there may be an inefficiency in a regime that requires you to identify and develop to the extent possible at the time project specifications and costings for all foreseeable contingent projects because of course one assumes that by their very nature, what may be identified at the beginning of a five-year period as a contingent project, the list of contingent projects is a lot longer than the list that might ultimately need to be built, and is there a regulatory inefficiency in having a mechanism that requires you to go through what is likely to be a great deal of unnecessary analysis in respect of the projects that never need to be considered ultimately.

MR JARDINE: The history and the experience is - and our experience in looking at about to put in a reset application is the contingent project list is really short, and Transgrid had the same experience recently, but the list is reasonably short.

CHAIRMAN: Let's go to questions from the floor. One over here.

MR DUFFY: Vince Duffy from Energy Division. I was just wondering, the BBB estimate impact was just transmission and didn't include an impact in distribution.

MR JARDINE: That was the transmission impact, Vince. We have very little impact on the delivered price of electricity.

CHAIRMAN: Other comments, questions? Bob Lim.

MR LIM: Thanks very much. I'd like to congratulate the AEMC on its first public outing and it seems to be going pretty well, and it's nice to be able to see all the panel members up on stage. Firstly I just want to make a few observations which perhaps Gordon might be able to respond to, not necessarily wearing the CEO's hat, but perhaps wearing the hat of a representative of some of the companies that you showed on the site right at the beginning.

Can you imagine a scenario whereby there is a highly successful investment bank - let's call it McDonald Bank - it's otherwise known as a billionaires' factory. It has an investment vehicle which invests in a number of utilities, including transmission network companies. It pays very high prices for those assets. It's highly leveraged, big debt. It charges huge management fees, performance fees, commissions et cetera, and it offers hybrid securities to baby boomers like myself at 9, 10, 11 per cent dividend rate - pretty high rate of return relative to elsewhere in the market, and also relative to perhaps perceived risk.

This investment vehicle needs to have a lot of debt serviced, a lot of fees need to be paid et cetera. I have a few questions in relation to the impact of transmission network companies arising from this sort of financial engineering that one sees at the present time involving ownership changes and financial engineering. One is are we going to see in the future a growing proportion of the earnings

of these companies going to service the debt and the ongoing management fees that we are seeing in some of those infrastructure funds? Are the assets going to be regularly revalued to book profits? I noticed the AEMC is locking in the RAB and obviously there are timing issues in that.

CHAIRMAN: Can I just comment, Bob. We do want to focus on the rules and the regulatory framework. So if you could come back to the subject matter.

MR LIM: The subject matter is really in terms of what are some of the implications of some of these ownership changes and financial engineering issues? Are they going to impact on the levels of high incentives that needed to be paid to get these businesses to make investments in networks or are there going to be sufficient earnings to make any investments at all? Is there going to be much gaming of care packs so as to allow a sufficient revenue stream to service those high debts arising from the financial engineering?

I think it's important for the AEMC rules to be informed by the developments that we are seeing in the financial marketplace. Would you like to make a comment?

MR JARDINE: I make two observations on that. The first one is that regardless of who owns the business, when you have a business operating under mandated reliability obligations, you are making nondiscretionary investments in your capital regardless of all the things outside in the outside world of the ownership. Regardless of the ownership, you are running nondiscretionary investments, because if you don't, you lose your licence. The owners don't want to go out of the business. So that's the first driver and that's the primary driver on our businesses.

How people go around and finance things, my observation would be that people who try and finance these businesses seek to optimise the financial structure and optimise the cost of capital. That's what they seek to do. I'm not fully aware of the intricacies of how they do that because I'm only a CEO of a poor government-owned business. I know that some of my colleagues have financial structures that have benefited from the wisdom of the people from the bank to which you refer or their cousins. I just don't think it's a driver in the context of how you run the business.

CHAIRMAN: Thank you very much, Gordon. I think that we can move on to our next presentation. Again thank you to Gordon. That was a very good presentation. We appreciate it. Our next presentation is from the Energy Users Association, Con Hristodoulidis. Con - sorry about that. We look forward to your presentation.

MR HRISTODOULIDIS: Thanks, John. I still apologise to my parents for not getting the surname right as well. So it doesn't matter. Again thank you, John, and to the other two commissioners for the opportunity to present today. Before I get into the presentation, I'd probably like to agree with Gordon and I think that customers and TNSPs are here playing the same game in that we do want reliable transmission services at a fair and reasonable price. I suspect where we probably differ a little bit in terms of what the proposed rules are in the marketplace that we're discussing today is the way we get to the fair and reasonable price. I suppose that's the point that

the commissioners need to find a fine balance between getting that fair and reasonable price and getting reliable service.

The other point I'd like to make before we start our presentation today is that I think we shouldn't be in any doubt that we're not here talking about the electricity transmission networks solely today. I think by the audience in the room that we have and the amount of people we have here, we're talking about all energy networks. I think what gets embedded in chapter 6 through this process is likely to apply to distribution networks in both gas and electricity and also transmission networks in the gas industry. So it's not just the electricity transmission network and the 57 cents that you spoke about. I think we're talking more about the 300 and I think 40-odd that is half of that cost that you pulled up or 370 - it was about 740 you put up, Gordon. So about 370.

So it is a fair chunk of money that we're talking about. It's not just the 57 cents, and it's important that we put that framework into place or that concept into place, because I don't think we'd have this crowd if it wasn't about those networks as well.

What I'd like to talk about today is a number of the issues that we have concerns in terms of the rules, and I'll go through them point by point, and then just talk about how we think that those changes that have been proposed in the rules are going to impact on end users. Before I do actually get onto the first one in terms of revenue versus price caps, there is one issue I think that we need to also talk about in the form of regulation that we have a proposed respond model with reasonable estimates. I think that that's a step towards certainty, but if we really wanted to get certainty I think that there's a great opportunity for the AEMC to actually move the transmission network regulation into one.

If it is the backbone and it is about delivering energy, I think that they all should be regulated at one time. It would reduce the regulatory costs which users have to pay for at the end of the day, and I think we'd get a better outcome, and a lot of the rules that we're going to discuss today would be easier to wash through the system. We put that forward in our submission to the AEMC during the issues paper, but there was no comment in the documents that are out at the moment, and I think that we'd be looking for some sort of comment about why we have a proposed respond model but we don't move to a model where all networks are regulated, all transmission networks are regulated at once. Similar to what's happening in the UK. I think there are some significant efficiencies to be had if we move to that type of model, and that's a question I pose to the commissioners today for an answer down the process.

Moving on to the issue of price versus revenue caps, I think that again the draft proposal is actually just making an assumption that we have a revenue cap. There's no discussion or analysis whether revenue caps is the best form of reply in the CPI X model and actually driving the businesses to actually look for efficiencies in their operations. There is some evidence of price caps in Australia we've used. The EEC here in Victoria have used price caps and potentially and prima facie, you could argue that they've been able to drive some more efficiencies out of the distribution networks here in Victoria than what a revenue cap model has done so.

I had a revenue model back in 2000 I think it was in the distribution network. They changed it to a fairly convoluted hybrid revenue cap model. In the more recent scene, they moved to price caps. So I think that we do need that analysis to look at whether a revenue cap or a price cap model actually is the best form of applying the CPI minus X, and as I said, prima facie, the price caps seem to be driving businesses closer to matching their costs with their customer classes. So I think that's an important aspect of the work that still needs to be done.

In terms of information requirements, the rules do provide for two new guidelines to be issued by AER and we welcome those two new guidelines. But I think more needs to be done. As the rules currently stand, there's an option for TNSPs to actually opt out of the reporting requirements, especially when it comes to performance reporting. The ACCC in its previous form, now that the AER produce two annual performance reports, if you look at the data in there and try and do some sort of comparison, it's very difficult and it gets back to the fact that the way the TNSPs have been reporting the information to the ACCC back then and the AER going forward is very muddled.

Some businesses report on the amount of line they've rolled out. Some businesses report on the amount of energy that flows over those lines. How can you compare the performances of different TNSPs in different states when they're reporting on different parameters. So I think they need to be tightened up. We need better and more coordinated definitions on how they should be reporting, clearer obligations on the reporting requirements and more transparent public information. I think it's important for end users and other stakeholders who want to compare the performance that that information is in the public domain. So I think we can go further on the information requirements as contained in the current draft rules.

In terms of regulatory decisions, we've moved from this concept of an efficient investment to a reasonable estimate of costs. I think that that's going to cause a fair bit of angst. Nobody really knows what a reasonable estimate is. It's never been tested. It's a new concept. We've had the current wording where it requires the businesses to estimate what they perceive to be efficient. We've had five to seven years of that concept. It's well understood in the industry, and personally I don't think it's led to any under-investment in the transmission network, which I'll put some numbers up later to show that hasn't. We don't think there's been any under-investment, and again the draft rules or the draft proposals don't explain to us why we need to change from an efficient outcome to a reasonable estimate outcome.

I think before we move to reasonable outcome, we need two things: (a) why we need a lower benchmark; and (b) how we're going to define reasonable outcomes, otherwise we're going to end up in courts fighting for a term for a number of years, and who wears the costs of those regulatory and legal costs? Users. It gets passed through to users. So it's an unwarranted cost I think from a user's perspective to have those types of outcomes.

Return on capital - there's two aspects there; locking in WAC. I think it's a ridiculous concept to lock in WAC for a five-year period. The whole idea of having this form of regulation is to try and

mimic competitive market outcomes. I think that any business operating in the manufacturing industry that's listed on the stock exchange would love to have the WAC locked in, the rate of return locked in, the guaranteed return on their capital. It would be fantastic. I think they should all go and lobby the government for such an outcome.

If we're going to have a fair and reasonable outcome on return on capital, I think that they need to be estimated at the time of the regulatory reset, and it has to be based not just on historical information as is currently the case, but also on future forecasts by market analysts. The UK have moved to a model where it's a mixture of historical versus future values or these parameters. I think that we should also be doing a similar thing. We should be taking it out of the rules. We shouldn't lock into the rules and have the AER every five years come and examine it and put possible rule changes through.

If we're going to go through the costs of having possible rule changes every five years, we might as well just go through the process of the regulatory reset period determining what is a fair and reasonable rate of return on capital. We don't believe that the WAC should be locked in.

One particular thing that Gordon mentioned is the credit rating downgrade. That Fitch report is a very good report, but unfortunately it only looks at one sector. It doesn't compare the network sector against the commercial sector. If we're going to have again a fair and reasonable rate of return, which is what is expected from a commercial operator, then we shouldn't be setting a benchmark credit rating based on a level of debt that's beyond the benchmark. The benchmark debt level servicing level is 60 per cent. That's what we should be setting the benchmark on.

We shouldn't be moving the benchmark or downgrading the credit rating because some TNSPs decide to actually gear themselves above the benchmark, and I think that's a significant problem and a significant issue that the commission needs to address in its draft determination. I think that the credit rating should be based on commercial analysis as opposed to just a partial analysis of the networks.

The incentive scheme - again we'd talked about this issue of reopening versus contingent projects. What's interesting about the draft proposals is only the TNSPs are able to reopen the cap, and it specifically says other stakeholders are not allowed to approach the AER to have the recap reopened. Why the asymmetry? The only explanation that's offered is that other stakeholders will come along with frivolous claims. Why won't TNSPs come along with frivolous claims? They're there to protect their interests and to make a rate of return. Why wouldn't they come along and ask for the revenue cap to be reopened and moved upwards?

I suppose I pose the question to people like Gordon and other TNSPs, if we see aluminium prices drop during the regulatory period, would you go along to the AER and have your capex reopened and have it devalued because aluminium prices have fallen down? I don't think so. If they're going up, of course. I'd be there knocking on the door in the first five minutes. So if we're going to have a reopening, it should be open to anybody to seek a reopening and a reassessment of the revenue

cap.

Personally we'd prefer not to have it reopened because it does create a system where the TNSPs don't have to look hard at the time of the reset. They know that if they get the demand forecast and the capital required to meet those demand forecasts from, they can always go back cap in hand through the regulatory period and have the allowance looked at. o there should be no reopening provisions. However, if you're going to have it, it should be symmetrical.

What does this all mean in terms of what I've just discussed? The whole reason we're here today is to determine whether the draft proposals meet the single market objective, and I think that our view is that it doesn't. It's not in the long term interest of users. Why do I say that? Our preliminary estimates of what the rule changes do in terms of prices for transmission solely is an increase of 15 per cent on your 57 cents, but if we translate that across the whole network system, you're talking about a 25 to 30 per cent increase in costs for users, and that's a significant cost when you're operating in the competitive environment. What do the users get for that in return? There's nothing in the draft rules that actually raise the bar in terms of service standards.

Yes, we had the minimum standards set in the rules in terms of reliability, but there's nothing in the rules to say we will give the TNSPs an extra bucket of money to raise the level of services. Yes, I agree, Gordon, what the QCA review said that we do need improvements in service standards, but combining with giving Energex and Ergon more money in that distribution review, they also increase the service standards requirements. There's legislation put in place that Ergon and Energex have to be at a high level of service in terms of spending that money. These rules do not provide for any improvements in the service standards regime we have in place at the moment. So we get an increase in price, no increase in service. We don't think that's a fair outcome for users and it does not meet the single market objective.

The other point of it is, are investment levels too low? Do we need to give these businesses more money by changing the parameters because they're not spending enough at the moment. They're not getting enough to spend on investment. As currently stands, all the regulatory reviews on TNSPs that the ACCC have approved, they've been given approximately 5 billion dollars to spend. That's a fair whack of money, and what's also interesting about that money that they've been given, the last performance report that the ACCC produced on these performances, you find that across the networks, the transmission networks, they've underspent the capex by 26 per cent. To me that's a prima facie case that they've got enough money and they're spending enough on the network. They don't need any more money.

What does it mean? They're underspending on opex, and in terms of revenue, they're actually getting a 1 per cent increase in the revenue than what's been allowed. Will the TNSPs come back to the AER now and have their resets reopened and make sure they match the MAR with what's currently happening in terms of practices? I don't think so. This is why other stakeholders should be entitled to reopen if we had a reopening provision.

Just a bit of an illustration about what will happen. Currently the way we have the rules set in terms of the forecasts that come forward from the TNSPs, the AER has to make sure that it's an efficient amount of money to meet their service obligation in an efficient way. So what you get is that green line with the AER or any other state regulatory in energy will set a level of capex spending against the forecasts. If we move to a reasonable estimate, which is a lowering of the benchmark in terms of efficient outcomes, then what you'll find is you'll get these big increases in terms of the red line from the forecasts, and the AER's hands will be tied. They will have to provide that amount of money to the TNSPs without question.

All the business has to do is prove it's reasonable. If they can prove it's reasonable, which is not a very high benchmark, and it's going to be tied up in courts, you're going to get this huge increase, and that's where that 15 per cent increase in costs comes to users. That is not a fair and reasonable outcome and it doesn't meet the single market objective.

So as I said, prima facie evidence suggests that the current regulations haven't dampened investments. So what are the likely outcomes? There'll be a transfer of wealth from users to TNSPs without any improvement in service standards. We'll continue to receive the same service standards that we're currently receiving, and that will mean that Australian industry competitiveness will be damaged. We're talking about car manufacturers, other manufacturing businesses who are operating not only on a national scale, but operating in an international market, and any increase in that cost decreases the competitiveness, and it also therefore decreases the Australian standard of living.

If we're talking about a single market objective which is in the long term of interest, that's the type of stuff that we should be assessing. In summary, we don't believe that the proposals do meet the single market objective as they currently stand.

CHAIRMAN: Con, thank you very much for that. Open for questions. Before we do that, can I ask - commissioners, any points to raise with Con?

MR WOODWARD: If I can. Thanks, Con. I very much appreciated your presentation. Can I just come back to the issue on the information requirements just to get a little further clarification on that. As you know, in the draft rules we've proposed sustaining the current rule arrangement or rule powers for the AER for information, and adding a couple of guideline areas which you commented on. In suggesting that there may be an issue, is that based on your analysis so far of the pervasiveness of the powers that are already there in the rules or is there a particular concern that that power somehow or other is not operationalised? I'm just trying to understand what specifically is the issue on the information side.

MR HRISTODOULIDIS: There's probably two aspects of it. First of all is the aspect of at the time of the proposals, and we saw I think just last week - there's some AER people in the room - that there were some guidelines released in terms of confidentiality. So a lot of information at the time of the proposal tends to get locked up in confidentiality clauses. So as users when we're trying

to make an assessment of what the TNSPs are proposing is fair and reasonable in terms of price and service offerings, it's very difficult because we don't have access to all of the detailed information.

Then on the flip side in terms of the performance reporting on an annual basis, as I've mentioned, there is no standard definition on how they should be reporting their performance. So when we're trying to compare - and even to get that table that I produced before in terms of capex, opex and the mark, it was very difficult to extract that information. It's not readily available and it's not easily available for users to actually make that performance assessment. So I think that we need tighter rules around definitions, obligations. As I said, in one year, one of the TNSPs actually opted out of the performance reporting regime. So you've only got one user with the data on that TNSP. So they're the type of things I think we need tightening in the rules to give us a better opportunity to assess.

MR WOODWARD: Thank you for that.

CHAIRMAN: Liza, do you have a point to make?

MS CARVER: Just really a quick point of clarification in respect of the comments on the reasonable estimates. I think there's reasonably widespread misunderstanding of what the rules actually provide for, and when you actually look at the provision, what it says is that the business must propose and the AER must assess a reasonable estimate of forecast capital and operating expenditure according to 10 criteria which are applied by the AER. Number 6 of those 10 criteria is whether or not the costs are efficient costs. I think it is quite a material misconception to suggest that a reasonable estimate proposal within the proposed rules somehow abandons the notion of efficient costs.

I think it's very important when people make their submissions to us in respect of this draft package that people look at the actual language of the rules and perhaps address us on the detail. Thank you.

MR HRISTODOULIDIS: Just in responding to that, I'd like to add from our point of view, when we were reading the draft proposals plus the accompanying explanations that there didn't seem to be any analysis in the work to say why we're changing from the current way we're assessing forecast cap and opex to the reasonable estimates, I don't think we've actually made the case that the current definition does not meet the single market objective and/or that the reasonable estimates definition with those 10 criteria are actually going to enhance the single market objectives to what we currently have in place, and I think that's an important hurdle that the commission must meet.

MS CARVER: Perhaps we've been reading a different draft determination. My recollection is there's about 10 pages of discussion of the various ways of approaching this question.

MR HRISTODOULIDIS: Yes, but there's no analysis of the failure of the current approach. That's what I'm saying. Those 10 pages don't actually outline to us that the current approach has actually failed us.

CHAIRMAN: Thanks for those comments, Con. Now, to the floor. Gordon, yes. Could you just identify yourself.

MR JARDINE: Yes, Gordon Jardine, Powerlink Queensland. I just need to challenge the number you put up in relation to transmission costs going up by 15 per cent, and you did explain where you got that from eventually. But the number we talked about in relation to the WAC and the BBB rating, that contributes 0.6 per cent. The other 14.4 per cent is a consequence of that very arbitrary red line you drew about where reasonable cost estimates sit relative to the supposed efficient cost estimates. I mean, that's just an arbitrary line - fickle line; draw it anywhere and come up with the number you want to would be my assessment of that.

MR HRISTODOULIDIS: Actually that line wasn't arbitrary. That line was from a particular TNSP's forecast that they'd put recently to the ACCC in terms of - I took the business' name out, but that is an actual line of what they saw in terms of capex.

MR JARDINE: In a few weeks' time, Powerlink will be putting up a capex application which will be a bigger number than last time. But - - -

MR HRISTODOULIDIS: I'm happy to draw the red line for you.

MR JARDINE: A lot of it will be traceable back to the aluminium graph, the steel graph, the contractor's margin graph and all of those graphs. I mean, there's a huge price effect happening in capital works, not only in transmission; in minerals, mining, everywhere around the place. The line is arbitrary.

MR HRISTODOULIDIS: Gordon, can I just add that the aluminium price also is a price that the building construction industry and the car industry pay, too, which operate in a competitive market, and they can't go cap in hand to the regulator and say, "We want capex because the aluminium price has gone up." What they have to do, operate in a competitive market, find other cost savings in the businesses to actually be able to pay for the increase in their import costs from aluminium, and that's what the CPI minus X regime tries to do.

MR JARDINE: They operate in a world of discretion and investments, we don't. That's the difference.

MR HRISTODOULIDIS: But that's the whole idea of the CPI minus X regime, actually drive you to find those efficiencies.

MR JARDINE: But you can't find them by not building. That's the problem. The other issue relates to your single-year sample of capex. You need to look at capex over the whole regulatory period.

MR HRISTODOULIDIS: I'd love to, if you reported more regularly.

CHAIRMAN: Just let Gordon make his points.

MR JARDINE: Again in three weeks' time, you'll see a document hit the table from Powerlink that says we overspent this regulatory period by 22 per cent. So you won't have any underspend to complain about there. Finally the 57 cents, if you want to extend that to the distribution networks, distribution networks' contribution to price is around four to five times the transmission network. So the effect of the BBB rating on distribution networks is about 2 bucks 50, less than a cappuccino.

MR HRISTODOULIDIS: I'm sure you'll buy me afterwards.

CHAIRMAN: Thanks very much, Gordon. Other comments from the floor? Yes?

MR CRAWFORD: Garth Crawford from the Energy Networks Association. I just wanted really as a point of clarification to the panel as much as anyone else. You raised in your talk, Con, the prospect of a new five-year rule change on WAC parameters. As I understand the actual rules, what they say is that the parameters are locked away for five years, and then after that, the AER essentially does a review which applies to all transmission businesses.

MR HRISTODOULIDIS: That is correct. Yes, that's the point I'm making. I said if they're subject to a review by the AER in five years, if the AER determine that the parameters need to be changed because circumstances change over five years, which is likely to happen, we have to go through a rule change process because they're locked into the rules. Take the credit rating, say the AER in five years' time do their assessment and say that the credit rating should be either upgraded or downgraded again. The only way you're going to get it changed in the rules if that there's a rule change.

MR CRAWFORD: Could I clarify that.

MS CARVER: That's actually not correct. Again I will just make the observation I made a few moments ago. It's going to be most constructive for us as we go through this exercise if people look at the actual rules and comment and make submissions about what is there, and rules provide that the various elements of the capital A set pricing model are to be those that are in the rules if and until the AER changes them, subject to that review. So there is no need for a subsequent rule change process to change the components of the WAC.

MR CRAWFORD: Thanks, Liza. That confirms my understanding.

MR HRISTODOULIDIS: Can I just add then, in terms of getting back to the point I made about having the transmission networks all regulated together in a five-year period rather than each year having a different state transmission network regulated, you wouldn't need to lock the WAC in the

rules, because all you could then, every five years you'd come along, review the whole network as a whole, and also at the same time review your WAC parameters. So it would seem in terms of regulatory costs, it would be a lot less, and therefore cheaper for users.

CHAIRMAN: Let's take that point on board. You've made that point. Thank you very much for that. Other comments from the floor in this session? Bob Lim.

MR LIM: My name is Bob Lim from the Major Energy Users. Just a point of clarification with the panel, if I may. Commissioner Carver talked about efficient costs, and I absolutely agree that we need to establish that costs are efficient. Commissioner Woodward talked about information provisions. But we need to be very well satisfied that the information provisions allow the AER to establish that the costs are efficient, especially when it comes to establishing related-party transactions are efficient, robust, arm's length or transactions involving some of the financial engineering that I've talked about, which are confidential, can be established as robust and arm's length and are efficient.

CHAIRMAN: Well, on that - - -

MR WOODWARD: Sorry, John, can I just comment on that. If I can just build off a comment that Liza made a moment ago about the details of the actual draft rules. In what we've posited in the draft proposal, the combination of the reasons document and the draft rules looks at an information regime in a legal sense of the rules level that is existent and then the addition of some areas. We are looking for commentary back from stakeholders, users, market participants, TNOs and other stakeholders as to the actual operationalising of that information disclosure regime within the draft rules themselves.

So I think it's very, very important for respondents in the submissions certainly to raise the issues of potential for information asymmetry, but then to go to the details of the legal regime that's in the rules to ensure that the powers which certainly on many readings are extremely wide, and it may be a question that may be raised that it's not the rules power, but how these are operationalised, and people may have views as to what should be put into the rules with respect to operationalising them. So I think it's very, very important to get to the very specifics of that.

MR LIM: If I could make a comment in response to that, certainly I absolutely agree with you, but for example in the gas code, it is not all that clear that related party transactions are able to be penetrated by the regulator. So I raise that as an issue that in so many legal areas, there are contestable grey areas that can only be proven in the courts.

CHAIRMAN: But to emphasise Ian's point, if in this matter that you're concerned about, you see issues in the current information provisions which we're adopting which are not adequate to the point, please raise them. The gas code is under review. I believe the Productivity Commission has commented on that very point, and they're awaiting the MCE's response on the gas rules. Dealing with transmission rules, you might look at the specifics and make a comment on how your point

might better be addressed. Thank you for that. Other comments from the floor? This side is happy. I think that concludes that session. Thank you very much, Con. Next presenter is going to be Russell Skelton who is the manager marketing and trading from Macquarie Generation for the MGF. Thanks, Russell.

MR SKELTON: Transmission must be important. There's a lot of people here. Firstly just thank you, commission, for the opportunity to make some comments on behalf of the MGF. What I thought I'd do is the MGF made a fairly brief submission. We don't have as much at stake as most of the people in this room, and what I thought I'd do initially is just give the commission the score in terms of what we thought had been achieved, and then just raise some subsequent issues which I've categorised as unresolved.

The issues the generators raised were those that you see there. In the area of the regulatory obligations, we believe that that's been appropriately defined in the rules and that we're relaxed. The form of regulation, we didn't believe there was any real need for any change, and so we're fine with that. The stability and transparency, I think it's a key issue for generators operating in the electricity market which is effectively created by the transmission network, is the ability to be able to predict with some confidence in advance as to what the likely investment behaviour of all players in the market that affect that market are likely to be, and an important element of that from our perspective is the ability to predict likely investment of TNSPs along with others.

Given that desire, I guess our view is that it's important for the regulatory regime that the TNSPs are exposed to is clear, it's transparent and stable, because that will aid our ability to predict the likely future investment behaviour with some confidence, and in our view, we believe that's been largely achieved. The other question which is related to that is the level of regulatory discretion. If the rules may be fixed and clear and predictable, but give a large area of discretion for the regulator, that's effectively the same as having quality defined rules, and in our view, the balance between the discretion for the regulator and prescription in the rules I think is fairly reasonable in terms of it being predictable and understandable for generators who are not very good experts at transmission investment particularly.

Just coming to some of the issues, however, where we believe the issues are still unresolved, and they're largely unresolved because they're part of an ongoing process which hasn't been concluded. The first one of those is the issue of reasonable boundaries. Last Friday I think it was, the AEMC published an issues paper which dealt with in part the whole issue of reasonable boundaries. So we acknowledge that there's a review that's under way, but I think one of the concerns that we have is that reasonable boundaries and transmission investments are alternative solutions to the same problem which is emerging transmission congestion. Therefore we believe it's important that the two alternatives are compared on the similar and economic basis, because they're two options for spending money or doing something that will have effectively just - to address the same problem.

Therefore we think it's important that the interactions between the transmission revenue regulation, which is the matter before us today, the regional boundary processes and congestion management

regime must be considered. We understand that you're on a deadline and that deadline is in law. So you'd better comply with that deadline I guess, but I think what we'd like to suggest is to the extent that it's possible, I think that the final view that you come to on transmission revenue regulation ought to countenance the sorts of things that you expect to be emerging from those two other processes to do with reasonable boundaries and congestion management.

I think we wrote to you last week with a little case study which gives an illustration - and that's all it was - of how those two regimes can interact fairly closely and in potentially some unexpected ways. You can make that public by the way. That's not a secret document.

The next issue is the regulatory test. We believe the AER have done a very good job of getting the regulatory test into its current form and we think it's a very good basis for assessing transmission investment. But the difficulty we have with it is that it's sort of a circular definition. In the rules it's defined as the test promulgated by the AER, and the AER is required to promulgate the test. So basically the regulatory test is whatever the AER decides it is at any point in time.

I think that creates a risk of a lack of stability and predictability that would apply as to the transmission revenue regulation rules in general, and that's an issue that I think needs to be examined. I don't know whether you see that as part of your current set of issues, but I know that the - who are they? - the MCE have written to you talking about regulatory test principles. I think one of the possibilities that needs to be examined as to whether the regulatory test ought to be elevated into the rules have a similar outcome as what's currently available to us as you're proposing in the revised revenue regulation rules.

The incentive mechanisms, we note that you've given the AER the unenviable task of coming up with some incentive mechanisms; a fairly challenging task and I wish them well. We agree that that's a smart thing to do; that we ought to encourage operational efficiency, and in particular maximising the capability of the network at times of high market demand. But there's a but, and the but is to do with the fact that all of the players in the market also want to manage their risks created by trading in that market, and one of the key elements of being able to do that, particularly with transmission outage is being able to be confident of how predictable they are.

So in a sense, one of the tensions will be create some incentives for TNSPs to minimise their impact on the operation of the market when they do work on transmission lines, but if they come up with a plan of doing some work in our view in terms of managing risks created by that intervention, that necessary maintenance, predictability is very important. So if someone tells us there's an outage that's going to occur in a month's time we get ourselves organised on the basis of it, we may enter into hedging arrangements to deal with that, and then the day before the outage starts, it's cancelled. It doesn't make us feel all warm and fuzzy. I suggest to you that that uncertainty will at some point be priced into the market. It's a risk that will ultimately end up being an additional cost to consumers.

The other difficulty created with a short-term incentive is the risk of TNSPs intervening in the

market in the short term to manage their exposure and creating a problem for others. So our view is that whilst we agree with the notion of incentives to keep the capability network at its maximum, we think they ought to be more longer term in nature and not necessarily focused on what's happening on the half hour on the day.

On the transmission pricing, again that's another task you have, and our proposition there is basically don't change it unless you really need to. Interconnection investment which is a subject that gets a bit of publicity, particular interest seems to be QNI, and currently that's subject to the regulatory test which requires the demonstration of economic benefits. In our view it's important that remains the case, and I think one of the - and I'll illustrate this hopefully shortly. One of the issues that I think is that the long-term outcomes ought to be economic, and there's potential scenarios where responding to short-term surpluses of energy in a particular location - eg Queensland - may end up over the longer term resulting in a suboptimal level of investment than could otherwise have occurred if it was examined on a different basis.

The other point we'd like to make is I've heard it quoted that the market currently is a loosely connected set of regional markets, and therefore we need lots of new interconnection. Let's get into it. I guess our simple proposition is the current levels of congestion do not indicate that we have a problem that needs to be solved. Just two pictures on that: one is for the financial year 04-05, the amount of congestion that's occurred on various interconnects. New South Wales Snowy the top left, Victor Snowy the top right; the bottom right is Victor South Australia, but you need to be careful about believing that too much because for some time, Nemco restricted players on the interconnector to manage some concerns they had about the capability of NRG as a plant, and the topical one is the one between Queensland and New South Wales; into Queensland rarely congested, and into New South Wales, congested just over 5 per cent of the time.

But the key thing is what's happening with prices when that's happening - I had a very good graph of prices. They've edited it out. It's probably my inability to use technology is the real problem. There it is. Sorry, my fault. The left-hand side is prices into Queensland. Don't worry about that, that never happens. Prices that matter flows into New South Wales, and the big bar is most of that - almost 95 per cent of the time, the prices are in a range of zero to \$50, in other words, the price difference, and that zero to 50 which is on the next graph below, most of that is between zero and 10. So what we're saying is that the price differences at times of congestion are not significant. There are times when the price differences are significant. I acknowledge that, but they don't happen very often. So our view is we're not looking at an indicator of a need for major new interconnector upgrade which customers have to pay for somehow. Thank you. That's all I need to say. I'm an easy one.

CHAIRMAN: Thank you, Russell. Just a couple of clarifying points. We do understand the relationship between this transmission pricing and the revenue review and management of network congestion and boundary change. We are doing a range of project work in parallel with this review.

MR SKELTON: I understand that.

CHAIRMAN: We'll try and take account of interactions as we can. On the regulatory test question, we don't regard the regulatory test per se as being the table with this chapter 6 review implications of the regulatory test for investment and revenue determination we have to have regard to. We do have a rule change proposal from the MCE on principles to apply for the regulatory test. The question of the AER's role and the role of the rules is not on the table.

MR SKELTON: Would it be helpful to put it on the table?

CHAIRMAN: Well - - -

MR SKELTON: Right. I got the picture.

CHAIRMAN: Before we go to the floor, Liza or Ian, have you any comments or questions?

MR WOODWARD: Actually just building from that comment that you've made, John, and just to get a slightly clearer view, Russell, you've clearly indicated that across your field of issues, the transmission revenue process stability transparency approach of the draft seems from a philosophical position to be consistent, and I'm understanding that to be on the basis of providing signals to generators about what is likely to happen in terms of networks.

MR SKELTON: And we're happy to leave the details of that to people who understand it a lot better.

MR WOODWARD: In terms of that flowing though in terms of the interrelationships, regional boundary, the issue raised on regulatory test incentive mechanisms, does the MGF have a view generally speaking about the level of codification that ought to apply in the rules across these kinds of matters?

MR SKELTON: The matters being?

MR WOODWARD: Things like the prescription of the regulatory test, the arrangements and circumstances on regional boundaries and the like.

MR SKELTON: I'd have to say that as an MGF, I'm not sure we've canvassed those issues within our group. So it would be presumptuous of me to tell you what the MGF's view is, but I believe that there's a number of people written to you as generators on the issue of what to do with the regulatory test review required by the MCE, and I think a number of those are suggesting some elevation of the regulatory testing and rules as a means of creating greater codification of that.

CHAIRMAN: Liza, any points? Open to the floor. Just before we go to you, David, any wider questions? Gordon? By the way, we do welcome other contributions.

MR JARDINE: Gordon Jardine. I just want to clarify something about transmission planning for the benefit of the audience. Like all the transmission planning we do, Russell, we don't look back at 04-05, we actually look forward, and that applies also to the national transmission - - -

MR SKELTON: I understand that.

MR JARDINE: The national transmission planning process that's coordinated by Nemco was published in the ANS.

MR SKELTON: I understand that.

MR JARDINE: Basically what the ANS says is that if you apply the currently regulatory test economics, then the benefits from upgrading QNI in any shape or form don't exceed the costs till about 09-10. I think that is the benchmark for what people are looking at in terms of QNI.

MR SKELTON: I accept that.

MR JARDINE: As long as that regulatory test and those economic settings sit there, that's the time frame that the planners are working to.

MR SKELTON: I think I understand that.

CHAIRMAN: Any other comments, questions? David Headberry?

MR HEADBERRY: David Headberry from the Major Energy Users. It's more of an observation rather than a comment. If we had exactly the same graph shown for the New South Wales to Victoria, South Australian region, I think we'd see a totally different story because we actually see congestion happening on a regular basis at Snowy, and Snowy uses its generators to actually constrain flows and so create price differentials.

MR SKELTON: I've got those. If you want to see those, David, I've got those in my bag.

MR HEADBERRY: Okay. I'd like to see them.

CHAIRMAN: Thanks for that. Any further comments from the floor? If there is not, it is morning tea. Thank you, Russell, very much. We'll break for about 20 minutes for morning tea, and then resume. Thank you very much.

ADJOURNED

[10.50 am]

RESUMED

[11.28 am]

CHAIRMAN: We'll now go into the second half of the agenda. Could I, just by way of starting

the session off, encourage wider participation from the floor. We do recognise that the proposal and the rule package we put out is a fairly challenging set of documents, but we do want to hear from interested stakeholders what their reaction is, where they think there are concerns with the proposal and the rules, what you would like to see done about it to address those concerns, and where you feel the rule proposal is on the mark and is addressing issues that you think need to be addressed. So again encourage wider participation. Not discouraging those that have been commenting. We appreciate that, but we'd like a wider contribution.

Let's move on to the rest of the presentations. The next presentation is from David Headberry who is going to make a few remarks from a user point of view. Thank you, David.

MR HEADBERRY: Thanks very much, John, and your team of commissioners for the opportunity of presenting our views from the Major Energy Users. Basically what were our goals for the review, and rather than just go through it, we want an economically efficient, long-term operating system. We want a true national electricity market. We want a transmission system that grows to meet our needs and reduces generator market power. After all, we pay for the transmission system. We should use that to make sure the generators are kept nice rather than screwing us all the time.

We want to have a secure supply, because we've actually invested more money than the transmission companies and the generators all put together. We hang off that. If we don't get electricity to our establishments, we are in dire trouble because we've got a major investment which is totally stranded. So we do want something that's going to be there for the long haul. We want a reasonable quality. We're not asking for a perfect system because we know that's not possible. We think that it's a good idea to have incentives to improve the service both in quality and in cost.

But we do want to see that something really comes - for the additional cost, we want to see a benefit. We don't want to pay for something and we get nothing for it. So we've got to have the evidence that the benefits really have been provided, and one of the things that we're a bit concerned about the current draft rules is that maybe the oversight is going to be a little bit reduced.

AEMC high-level principles, John, we think they're very, very good. We agree with those entirely. But we do need to remember that the transmission system, distribution system and all the rest of it, it is only there for us because we are the ones that create the national wealth. Having the most efficient transmission system doesn't achieve anything unless there's someone to use the output and the service that it provides to create national wealth. So we can never lose sight of the fact that that's what end users are about; creating national wealth, and we're the only ones that can do it, because the electricity industry can't do anything in that regard at all.

I think one of the concerns that we have - and it's not stated - is that the AEMC proposal implies a trend to lighter-handed regulation. Everyone thinks lighter-handed regulation is a great idea, but. One of the things, as Bob mentioned in one of the questions earlier on, was that infrastructure assets are owned by trust and other ownership vehicles, and in doing so, they create a great transfer of wealth away from the transmission assets towards the banks and those people at McDonald's Bank

and the like.

As Bob mentioned, there's trailing fees. There's millions of dollars that doesn't really go through and follow on from - and goes to the benefit of consumers. We think that those trailing fees and the like should be used for investment in assets. That's what we paid for and that's what we should be getting, not to enrich the McDonald's people. We see that part owners - you know, again you look at the number of these vehicle and they've been structured in such a way that it creates a problem for any regulator coming in to look into the way the system has been operated.

So what we would want to see is that the draft rules allow you, John, and the regulators to be able to drill underneath the apparent and avoid the problem that the Victorian regulator had with its appeals that it had late last year on the distribution review, and in fact the outcome of VCAT was very supportive of what the ESC was asking for. Because there's no reference to these ownership approaches and costs, we have to be very careful.

One of the high-level principles was to encourage investment. Do you know what the key driver investment is? It's money. So what we had a look at is how the utilities index has been going over the last five years compared to the ASX 200 which is the base line, and the red line - quite clearly, the red line is the one that really shows how the utilities index is tracked. When you convert that and put it into perspective and you look at who's in that utilities index - Duet, Hastings, Alinta, AGL and the others - they're the biggies at the top other than the government-owned ones, and what's more, they comprise more than 90 per cent of that index. They were all awarded an MRP of 6 per cent and a beta of 1 per cent. The ASX shows that an MRP of 6.05 over the last five years, and CommSec calculated a beta of 1.08.

When you look at the utilities index, it's a different story. They have actually shown an MRP of 11 per cent and have a beta of .31. So they're being overly rewarded compared to the rest of industry. Do we have to change the rules just to encourage further investment, and that's really the point we're coming to. Is there a problem? Where is the lack of investment that needs encouraging by all of these rule changes?

One thing I notice is that PowerNet still hasn't augmented to make Murraylink work better or to fix Haywood to make that work better either. But is that due to the regulatory approach? No, it's not. It's just because PowerNet doesn't have an incentive to do anything. Why should they? They don't get paid any more money to getting it fixed early. SNI we saw was defeated by Murraylink interests. I know they fought very hard to stop that. Then we go and look at what Electronet, you know, all of the biggies of the transmission business asked for and they all asked for higher capex and got it.

I looked up the Powerlink web site, and you've got about 20 projects running at the moment. So obviously getting money for investment isn't a problem to you at the moment. We see that the DBs consistently get higher amounts and ask for more money than they're allowed. So obviously they've got the access to the money. It's just being able to find the projects to spend it on. So the prime

reason for augmentation that it doesn't proceed has got nothing to do with the rules other than the regulatory test, and we need to address the regulatory test.

The regulatory test, we can see Snowy constrains the Victorian and New South Wales interconnector on a regular basis, and other generators do it because it makes a lot of money. We've seen the New South Wales generators do it consistently. The benefit of an augmentation of a transmission system is it reduces market power. We pay for it. But the ACCC in its wisdom decided not to include those market benefits in the regulatory test because they saw it purely as a transfer of wealth; nothing more, just a transfer of wealth, which would be an okay argument if there was equal payments for transmission. But that's not the case. End users pay the large proportion of all of the transmission costs. So if we're going to pay for it, we want to have a real benefit that comes out of it.

So the real driver, John, is not the issue of is there sufficient encouragement of investment in the current rules to change the rules, they've got to be for other reasons because - and as was mentioned earlier, we've got to look at the regulatory test.

Every good person always says there's benefits, detriments and other issues within a change that's been proposed, and there are good points, there are bad points and there are neutral points in this proposal. The neutral points, okay, the regulatory principles will be continued in most aspects, but we always knew they had some problems there. So we had to fix it. One of the concerns is that the cap-in inputs are going to be assessed every five years. That's okay if the changes are made and then those are implemented in the current review.

So if you've got a review extant at the moment and you change the inputs and it applies to a past decision, that's all right, because that's balanced. But if we don't do something and if it only applies to new decisions, then we're going to be lumbered with those decisions well beyond the five-year regulatory period. Because if there's a review done in 2009 which I think is Transend's turn, we'll be stuck with those cap-in inputs, and that will apply for another five years. So they'll be locked in for quite a long period. We think that's a problem, but we're happy to discuss that. We think it's reasonably neutral. We also see the need that you've got to protect previous decisions.

There are good elements. There is more time. The ACCC used to apply about nine months for a review. We're going to have at least 13. I think that's a great step in the right direction. There are going to be guidelines for applications, proposals, to be set, including what information is required and in what format. That's something that the ESCV has really led the way on, and they are to be congratulated. They do ask for information to be provided in a standard format, and that's a very good step forward.

The AER is to have oversight of cost allocation because we've seen, particularly in price cap reviews, that the applicant has been able to use the price cap approach to maximise revenue for doing nothing. There's greater attention to negotiation with end users for potentially stranded assets. There's a lot of money that's tied up in those assets that can't be used any more because end

users have had to go because of whatever reason, one of which may have been that the cost of power is too high.

We also approve the principle that the AER can remove stranded assets from the RAB, but we notice there are some constraints on doing that. We accept and agree that the discretionary elements of the AER are to be retained, but there is to be some guidance. It's a bit of a guided democracy I guess, and we are very supportive of the principle that there should be an incentive to have networks available when they're needed, and that will encourage an attitudinal change within the transmission businesses.

However, like the curate's apple, there are bad elements. We see that there are limited investigations into opex and capex claims, and Liza mentioned earlier on that there are some quite clear guidelines on what is an assessment of "reasonable". I guess the concern we've got is not so much what's there, it's how it's going to be used. "Reasonable" can be a much wider view than the way we've done it in previous times. So we would like to have that more closely controlled and maybe "reasonable" taken out, but something more type put in there.

One of the issues that we also notice is the depreciation rates are at the election of the TNSP. Why not, because after all, they're allowed to work out their own approach to their financial modelling. The concern we have is that you can use depreciation rates to create a very up-front cash cow, and that leaves future consumers at risk, because all of the money has been taken. There is no guarantee that there is still going to be the same attention to that detail in 10 or 15 or 20 or 30 or 40 years' time. I'll come back to an earlier point we made, that our investments as end users are there for 30, 40, 50, 60 years' time, too. When I was at Amcor, lot of people remember when I was at Amcor, our botany mill has been in operation there since the turn of 1900s. So that's well over a hundred years. So those sorts of investments are made in the long haul, not assumed to be just a five-year investment.

We've got the proposal that all capexes considered prudent and efficient to be rolled in. Don't have a problem with that, but cost overruns? If you're allowed to put cost overruns in there, then that reduces the pressure to be efficient in making sure that the capex has been spent wisely. So the project controllers suffer. There's no pressure to maintain project controllers.

Reopeners has been mentioned before for the unforeseen need for capex. It seems all right on the surface, but what happens to the other capex that's been approved and paid for, but not used? So it's very asymmetric. We have in the regulatory decisions - again we go back to the Victorian recent distribution review, there was something like some billions of dollars of capex approved, and I think it was something like 20 per cent of that capex was not used, and the benefit of that was kept by the DBs. Why not? Under this proposal, they could have come up with an unforeseen project and put it in and kept the benefit as well rather than use that unused capex for the unforeseen project.

Sorry, we had to go to two pages for the bad. Incentives are very low powered at 1 per cent.

1 per cent at risk is not really a heavy driver. I know it's nice to know that you're not going to lose more than 1 per cent, but if you have the opportunity to make more than 1 per cent, then why wouldn't you try. The constraints on incentive payments are being relaxed, and that's how we interpreted the rules. Maybe we need to be convinced otherwise on that.

There was another implied encouragement to increase beyond five-year regulatory periods at the ENSP election. If you allow them to reopen because something's changed, then there's going to be a greater drive if they had longer periods, and one of the big issues I've got for instance in more than a five-year regulatory period is Murraylink. Murraylink has got a 10-year regulatory period. It's got a high WAC. It's lasting in there. It was meant to deliver 220 megawatts of power transferred between Victoria and South Australia, and it can't, because PowerNet hasn't done any work to make sure that it does.

There is another discussion going on this afternoon, minimising prescribed services and increasing negotiated services. Again I've got a problem here, but we'll work our way through that. But one thing we need to remember when we look at that issue is over 99 or 99 and a half per cent of these negotiated services are going to be with the DBs. The DBs just pass through any costs. So there's no pressure to make sure that it's the most cost-efficient solution to the transmission augmentation.

So what's our assessment? It's the return, the amount and certainty of the return which drives investment, nothing else; not the regulatory environment. If you're going to make money out of it and you're going to get a high certainty of making money, you'll invest. We are concerned that there are funds being directed away from businesses through these trailing fees to merchant banks and the like. We're not sure we need to incentivise investment when the actuality doesn't reflect that need. We do have a concern about the regulatory test because that does prevent needed investment. The overall draft is a curate's apple of proposals, parts of it are good, but maybe there's a bit more bad in it than we'd like.

There are changes that are being proposed which have got unintended consequences, and we need to make sure that those unintended consequences are fully investigated before the rules are put firmly into carriage.

So what are our conclusions? Reducing regulation by a light-handed approach has not resulted in better outcomes overseas or even in Australia. Just have a look at the Competition Tribunal review of the Sydney Airport decision. It points very clearly to the fact that light-handed regulation of Sydney Airport has been a disaster for consumers. As consumers, we need to be convinced that by giving more freedom to the regulator businesses, which is one of the outcomes of this review, will provide a benefit, and we've got to know that that benefit has actually been delivered.

We need the regulators to examine the costs of the various ownership structures that they impose on consumers, and as a final offer, the Major Energy Users will actively participate in all future work in this to make sure we get these things sorted. Thank you.

CHAIRMAN: Thank you, David, very much for that.

MR HEADBERRY: I think I did it in the 15 minutes.

CHAIRMAN: You did well. Thanks for your comments. Any clarification points?

MR WOODWARD: If I can, I've got two, briefly, John. You made a couple of comments both throughout the neutral, the good and the bad, related to negotiation issues. One specific issue, David, I'd be interested in your view on is that the draft proposal creates a commercial negotiation process that's specific to chapter 6 as opposed to using the chapter 8 negotiation process. That was something that was foreshadowed fairly strongly in a wide range of submissions we received. I'm just wondering, notwithstanding your comments about powers and negotiation, as to whether or not you have a view versus chapter 8 versus what's been proposed in the rules.

MR HEADBERRY: Chapter 8 prevents end users from - there's no control of the negotiation with a participant because we're not participants and we don't want to be participants. We have no interest. We're too interested in making our pin nuts or widgets to be involved in being involved as a participant in the electricity industry. So any negotiation that we will have as end users with a TNSP or a DNSP, we need to have access to arbitration directly in our own right, not through chapter 8. If the rules don't permit us to have an arbitration of that decision or review of that negotiation, then we're back to where we've been all the time. So we would want to have that chapter 6 apply to us, and I'm not sure that it's very clear that it does.

MR WOODWARD: The second issue, in terms of the power of the incentives, you've suggested that 1 per cent is not sufficient. Do you have a view as to what ought to be the percentage?

MR HEADBERRY: My view is that we have seen in end user businesses that the sort of incentives that make things happen is going to be more of the order of at least 5, probably into 10 per cent. That might frighten a couple of the DBs and the TNSPs, but that's the sort of incentive that we look for as a basis for encouraging us to do something.

MR WOODWARD: Is that 5 to 10 per cent of revenue or asset base?

MR HEADBERRY: Revenue.

MR WOODWARD: Thanks.

CHAIRMAN: Thank you again for that. Turning to the floor, any comments or questions on David's presentation, and could I say any wider issues that people in the audience would like to raise about the proposal that was made and certainly addressing points that David has made. Comments from the floor. Yes, over there.

MR HALLAM: Tom Hallam, SP AusNet. Just a point of clarification for you, David. Our name

was dragged through the mud there on various occasions with regard to augmentation in Victoria. It just needs to be made clear that VENCORP controls augmentation in Victoria. They make decisions on whether the network is augmented or not. SP AusNet has nothing to do with it. So perhaps you should drag the right name through the mud in future. Thank you.

MR HEADBERRY: Yes, you're right. VENCORP does approve augmentations. In the ACCC review of Murraylink, they specifically said PowerNet had to augment the system to provide the flow up to the Victorian side of Murraylink. They didn't say it was VENCORP's problem. They said it was PowerNet, and they were going to make sure that PowerNet had the money to do it.

The issue of augmenting at Haywood, Haywood has been derated now for nearly two years, running at about 460 megawatts. In the good old days when the SEC ran it, it ran consistently at 500 megawatts or more. In my investigations, I have been told that the reason it hasn't been augmented is you're waiting to reset it up to the 500 as you're waiting for someone to come to look at recommissioning it, making sure that it can run at the higher levels, which it's been doing for yonks anyway. With regards SPI PowerNet being involved in the utilities index, that's a matter of record.

CHAIRMAN: David, can I bring you back as well to we are about the regulatory framework and what it can do to improve the regulatory decision-making, and the forecasting of capex. So let's focus on the rules.

MR HEADBERRY: That's what I've tried to, John, but I was using examples because they're real.

CHAIRMAN: Okay. Thank you for that. Other comments from the floor? Yes?

MR BENNETT: James Bennett, utilities. David, I am interested to hear that the major energy users would be happy to have a dynamic WAC that reflected the most recent decisions. I presume that's the symmetrical outcome, David, rather than a one-way decision.

MR HEADBERRY: Yes. As long as the input numbers are right - at the moment, they're not, but as long as the numbers are right, I think that it should be - because one of the big fears I've got is that in future, the market risk premium for instance is going to go above 6 per cent - well above 6 per cent - because it has done over history. What is going to happen if the regulators consistently use the 6 per cent and the real life example is that it's at 8 per cent, what is going to happen? You're not going to have enough money to be able to get funding for the augmentation. So we're going to have to pay the 8 per cent, the higher WAC then, so why don't we pay the lower WAC when it doesn't apply?

CHAIRMAN: Gordon.

MR JARDINE: I do need to comment about the 1 per cent incentive. What you have to understand and translate this into dollars is that the way the revenue cap is calculated, from the building blocks, the controllable opex in that is about 20 per cent of the total revenue. So 1 per cent

incentive on revenue is 5 per cent on opex year after year, and none of our businesses and none of the other businesses I deal with have any views in the world that they could ever achieve operating cost efficiencies of 5 per cent a year, year on year. In fact I notice that in BRW last week that Rio Tinto reported that their operating costs last year blew out by more than a hundred per cent.

So the point about the incentive is it's equal to 5 per cent of our controllable operating costs, and it's far and away the biggest incentive and the biggest driver in terms of efficiencies in the business. It takes much more focus and it's much more predominant than trying to get opex efficiencies, because none of us can get 5 per cent opex efficiencies in this sort of environment with rising input costs, rising labour costs, fuel shortages and so on.

MR HEADBERRY: Just as a by the by, I've said it is in both directions, Gordon. I'm not saying it's - okay, you might have that sort of amount at risk, but it's in both directions.

MR JARDINE: I guess my point is it's disproportionate to the rest of the operating environment.

CHAIRMAN: Okay. Other comments from the floor? If there are not, thank you very much for that presentation, David. I appreciate it very much, and we are now ready for Alex Cruickshank, manager NEM development, AGL, speaking on behalf of the retailers association. Thank you, Alex.

MR CRUICKSHANK: Thanks, John, and thanks for the invitation to come and speak at today's meeting. We have a very limited agenda of what we'd like to talk about, the generators, the exact level of WAC and other factors aren't that critical to retailers, but market impacts and incentives are, and I'd like to just talk about that today.

About four years ago now, work started on developing incentives for transmission companies, those that have been in the market long enough. About two years ago, a first set of proposals were put out, and the ERAA and the MGF put what was then the first joint submission up objecting to some of the aspects of that and arguing that it should be far more market-based. It's now two years we've been waiting and trying to develop up the proposal. So it's a longstanding issue.

Consequently the ERAA really does support the draft recommendation and the rule proposal that sets a clear time limit on the development of these performance standards and getting them into place, and the other aspect, which is to focus on the aspects that really do matter.

It's important to realise that performance incentives are only a part of the picture in terms of what the TNSP has to live with. I'm going to come to that a little bit later. They've got a number of different pressures on what they do, and you have to look at the whole picture. But it is a direct impact, and as Gordon says, it has a driver on what they do.

It's important - and this is one of the issues we've been trying to address over the last couple of years to avoid perverse impacts or perverse incentives or random punishment on TNSPs which can

occur if you don't set your performance incentives correctly, and that's an issue. Of course it's not an easy ask. We have a multi-network corporation. We've got a number of different owners, all of which are impacted by the whole network. So you can have an impact on a specific aspect of the network caused by someone else in the system.

If you compare that with the UK where it's much easier to have an incentive approach, because you've got (indistinct) the ERAA in general has always put the view that we do need to review transmission to address areas of inefficiency, and as I think Russell's presentation this morning showed, there was a series of areas where we're doing reviews at the moment, and we all believe in the exercise because it's the lowest-cost investment for the benefit of customers, but it's not lowest cost necessarily in terms of the amount of transmission you put in place. It's the appropriate investment so you lower the cost of the total cost to customers.

The second dot point there really flags the issue. The total cost to customers is the total cost of provision of the energy, the transmission service itself and the cost of retailing, and it's worth looking at the aspects of that. If you focus purely on transmission, which there's a tendency sometimes to do and there has been recently to do, you ignore the fact that transmission impacts the generation side of the business in terms of risk and the retailing side of the business in terms of risk. That's what a lot of our performance standards and incentive payments are about, and that's why we believe there needs to be a focus on that.

While it's appropriate to look at do you have enough augmentation, do you pay the right WAC, it's important and necessary that you also question is the operation of the transmission system adversely affecting the market and causing cost to consumers to rise. That's what I'd like to talk about.

The issue was not so much the absolute level of transmission investment. It's the unpredictability of the operations of the transmission system that causes us problems. While Russell put up a slide showing how little congestion actually occurs in the system, one of the issues is the congestion is unpredictable and has a large impact on the market. I liked two quotes from Gordon this morning in his presentation. "What we'd like is a certain predictable path." I've written that down as Gordon Jardine, 8 March, and the other one I like is, "The liability should not be a raffle." I thought that was another excellent quotation. That's the things we'd like to see as well in the presentation.

When you look at the context of incentives, we've got UoS agreements between generators and customers with the transmission companies, and up until now, they don't contain a great deal of actual transmission performance in those UoS agreements, and we believe that's an area for further work, and I actually compliment VENCORP in doing some work in that area at the moment.

Also the question of performance standards, there are very few performance standards in the rules that actually directly relate to the outcome of transmission companies. Generally the performance standards relate to the other connected entities, and that's one of the issues in the market that needs to be addressed.

There are some clear rule obligations, but it's worth remembering that the rules of chapter 4 and chapter 5 were written by the system controllers and the TNSPs themselves, and I think that heritage is reflected in the way they've been drafted. Although to be fair, that is being redressed. The last three dot points there are really the subject of this rule determination, and I think that's quite appropriate, and the last one of those, operations incentives, is where I'd like to go to today.

We've spent a lot of time and there's a lot of effort being put into the question of augmenting the transmission network to minimise the cost of energy, but most of the energy price impact on congestion comes when the network fails to meet its expected performance. So it's not the fact that the network isn't large enough. It's not transferring what it could transfer, and we believe that resolving that by operation of incentives is actually cheaper than augmenting the network. Again its predictable flows and economic outcomes is what we're after rather than unpredictable flows and non-economic impacts on the market is the concern.

If we look at the operating instance from this summer, this is just a grab really of the last three months of operation in the NEM and how often the network was constrained. We're looking at the nominal capacity and the actual capacity delivered during specific times during the day, and the duration is shown in the second column over. There are a number of events, a number of days, where specific interconnectors had reduced flows from their capacities. When you look at the analysis of that table, you'll see that 40 per cent of those situations, less than 10 per cent of the actual nominal capacity was available to flow between the regions, and of the remainder of these events, less than 50 per cent of the capacity was available. That's a significant reduction of flows between the regions during those periods.

Note this is not a reduction of availability. These lines are available. They were fully in service. It's just that stability and other constraints caused the flows to be limited between the regions. That's often to do with coincidence and other types of outages, and it's not simple to assess, let's be fair. It's not - any individual TNSP can't simply assess it. When you look at the price impacts that come out of that, you can see that we have high prices on an unpredictable basis in the NEM which lends itself to increased costs of contracts and increased margins for retails. At the end of the day, that's increased cost to customers. So that's an impact due solely to the riskiness of the business.

So we need incentives that cause TNSP not to reduce the flows or not to allow reduced flows on their interconnectors, and we believe that this is a far cheaper method of actually improving the stability of the NEM rather than augmenting of the network itself, and therefore less focus on the regulatory test, more focus on performance incentives would be a worthwhile exercise we believe. That's it.

CHAIRMAN: Thank you very much, Alex. Any clarifying points from the commissioners?

MR CRUICKSHANK: I see Phil has already got a question.

MR WOODWARD: Sorry, if I can just - Alex, just one quick question. You noted that obviously

a number of the areas that potentially relate to the incentives you've raised are outside of chapter 6 issues, and I would assume that if there are other reviews that we've got going, ERAA will put forward the view specific to those.

MR CRUICKSHANK: Absolutely.

MR WOODWARD: But does ERAA have a view with respect to the incentives that have been put in the draft proposal as to whether or not there are any specific changes or enhancements you'd like to see?

MR CRUICKSHANK: I think the draft proposal needs to consider what is the scope of the AER review, how it should be focusing very closely on the true market incentives. The performance standards and performance incentives at the moment tend to focus on things like availability and making it available at the time that it matters, and that's the sort of wording that's in your draft determination. So there is a move there.

I wouldn't want to say that you'd go above 1 per cent. I agree with Gordon there, that there's a danger in going too quickly to a high level of incentive payment when you truly haven't got a measure that you believe is reliable in terms of market impacts. So there's a clear requirement to move more slowly there. But I think the setting of a date and leaving a place, if you like, for a decent incentive regime is what you've done, and we believe that's appropriate.

CHAIRMAN: Phil.

MR GALL: Alex, for the sake of clarification - and I think resolving this market incentives issue is an important issue and it is part of the package that's on the table. The AER have got to come up with something within a certain time frame as I understand it. To be very clear about this, what I heard you say was that certainty about transmission outages seems to be now the predominant thought. Russell touched on this in his presentation as well, and he argued that in fact it's much more important for traders like yourself and the generators to be certain about what the behaviour of transmission companies is.

So to be clear, you're now not suggesting that the incentive regime should be linked in a way that makes us respond to price signals. You would rather, to be clear, be sure - and I think your words, you quoted Gordon, "certain predictable path, not a raffle". You want to be clear about what we're going to be doing in the future so you can establish your arrangements with confidence. Is that the kind of incentive direction we're going?

MR CRUICKSHANK: I think yes and no. I think it's fair to say that your essential statement that what we'd like is a nice, stable, predictable system, is correct, and that if you've got a choice of having an outage that is variable in time versus fixed in time, we'd prefer the fixed in time, and we'd like to know the network is there. However, given we're now putting network outages et cetera into pre-dispatch (indistinct) to know that if different network outage does occur, it's going to have a

nasty impact on the market. It has to be taken into account.

But in general if we know that the outage is to occur and we know the likely impact on the market, there is an opportunity for traders to actually respond to that and deal with it. The issue we do have is when we have a fixed-in-time outage that we ask to be moved and we're told it can't be moved, because it's fixed in time, and then it does get moved to another time which is then fixed in time, and we're unable to respond to that. So they're sort of issues.

But a lot of the price impacts you'll see that I flagged in the previous line, just to come back to it, some of those impacts are not single network outages. We're talking about multiple network outages. They're caused by constraints, just reductions, which is often due to stability outages and other things like that. So we're looking at a measure that needs to be a bit more comprehensive than just a simple looking at outages.

MR GALL: The impacts on that table that you had there, I thought you said that these were system normal, fully in service outcomes; in other words, there were no transmission outages.

MR CRUICKSHANK: No. The network elements there are all fully in service and available.

MR GALL: I just want to be clear on that.

MR CRUICKSHANK: But there are other outages in the network that have created issues.

MR GALL: Yes, but not on that table.

MR CRUICKSHANK: Yes. Not on that table.

MR GALL: Thank you.

CHAIRMAN: Thank you, Phil. Other comments from the floor? David.

MR HEADBERRY: David Headberry, Major Energy Users. Alex, I think you and I are in heated agreement about the issue of trying to have the network up at times when it's needed. So when you made the comment about scheduling or requesting a move of an outage or a time move of an outage, this was to avoid times when you know for certain or you have a very high expectation that there's going to be a high demand period. So what you're asking for is the TNSP to actually move its outage period to a time when any constraint that occurs will have a minimal price impact. Is that really what you're seeking?

MR CRUICKSHANK: That's the concept. I think as TNSPs would know, it's very hard to predict necessarily that any outage will have a price impact. In fact I remember at one stage there was an outage scheduled for a time when no flow was expected but it had a significant price impact. So it's not an easy thing to do.

MR HEADBERRY: Of course the generators use the opportunity to play games, don't they?

MR CRUICKSHANK: I'd never say that.

CHAIRMAN: Comment from you, Russell.

MR SKELTON: Russell Skelton from Macquarie Generation. Just a question for clarification, Alex. You see, in assessing those reductions in network capability, our observations - it's often very difficult - you can pass on this answer if you like - to figure out where the cause actually lay. Whether it lay with actions taken by TNSPs, whether it lay in actions taken by Nemco in particular. If you had to take a guess at what proportion were directly created by TNSPs versus Nemco, what would you guess at?

MR CRUICKSHANK: I don't think anything is created by Nemco. It's the way the constraint equations work, but I would say a significant number of them are caused by multiple outages in different regions which you could argue is caused by the constraint equations in Nemco rather than TNSPs. All of these are related to reductions in flows due to some interaction of constraint equations of which some are due to outages, but not specific on the element. There may be other elements in the network who have created outages.

CHAIRMAN: Thank you. Gordon?

MR JARDINE: One of the things that TNOs can do to better time their outages and whatever is to do them on overtime or to do them using - sometimes you can use live techniques. Both of those incur higher opex. Do you support the regulator allowing higher opex for that sort of approach by the TNOs?

MR CRUICKSHANK: It sounds like a dangerous question to answer, but let me address it this way. We support an incentive regime that balances off higher opex costs with reduced market incentives.

MS CARVER: I might just make a comment on that. Gordon, I was very pleased that you asked that question because it was something we very specifically turned our minds to, and in relation to the provisions relating to the forecast opex and the much maligned reasonable estimate, one of the 10 things that is to be taken into account in determining whether something is a reasonable estimate is precisely that question.

CHAIRMAN: Thank you. Other comments from the floor for Alex, questions? Yes, Con.

MR HRISTODOULIDIS: Con Hristodoulidis from the Energy Users Association. Just following up on that, Liza, comment you just made in terms of the new reasonable estimates, does that mean that the current process that we have in assessing forecasts do not take that into account?

MS CARVER: I think the answer to that is it's unclear because of course the current rules say nothing about how you determine forecast opex and capex.

CHAIRMAN: Thank you. Any other comments for this session? If not, thank you very much, Alex, for those comments, and we'll move to our next presenter which is Jim Wellsmore, senior policy officer from the Public Interest Advocacy Centre who will take a final or end user point of view. Thank you, Jim.

MR WELLSMORE: Thank you, John. Good afternoon all. Thanks to the commission for the chance to speak today. I actually don't have any slides, so I trust that won't inconvenience anybody too much. I mean, I could always write up my sort of scratchy notes, but perhaps it's best to wait until we get a proper submission together for the commission.

Perhaps by way of introduction, I should just say PIAC - we're a community legal centre in Sydney, and we have a small project. There's two of us full-time working on energy and water issues for household or residential users, and that project I should say also is funded by New South Wales government, although we're independent of them in terms of the policy positions that we develop and that we advocate for. We do occasionally tell them that we're wrong about things.

Our major interest I guess in network stems from the expectation that transmission will end up being largely reflected in distribution network arrangements, which someone mentioned earlier on today. I think a rough guess is that's about half of a household customer's bill. So when you look at transmission alone, it's not a big issue for us, and we haven't been involved in most of these issues previously, but somehow 50 per cent of my bill, it makes me much more keenly concerned.

I should also just say that there's myself and my colleague and a few other small user organisations that are getting our thoughts together on these issues. But what I'm going to say today pretty much just comes from the perspective of PIAC and not from the other sort of household user groups out there. We're particularly pleased - not surprisingly I guess, but we were particularly pleased to see the objects clause in the NEL coming into play and consumer benefit being seriously taken up by the commission in its work to date. It's a big issue for us. Community benefit - how many ways can you skin that cat, but in terms of a public interest approach to these things, we see no question at all about the necessity of keeping the lights on.

At the same time though for us, and particularly for PIAC, we're acutely aware of the issue of affordability. It's all right for the lights to be on for the neighbours next door that can afford it at any price, but affordability could be a big issue for some households; perhaps a very small number, but nonetheless it's a significant issue. At the end of the day, under-investment, over-investment, whichever way you want to look at it, we're the end of the line. We pay those costs no matter how you want to cut them up. We don't have anywhere we can pass those costs on to. There's no issues about international competitiveness for households. We just cop the whack and that's it - the w-h-a-c-k whack, not the other one.

So overall, looking at the proposal and from the commission, we actually, generally speaking, broadly speaking, are pleased with the work that's been done and pleased with the approach that's been taken. I'd have to say I guess we're still trying to come to terms with the volume of words that are in there and trying to come to grips with all of the fine details. But particularly around the issue of the weighing up of consumer benefit in the market and weighing up how discretion should be exercised, we think that on first glance, the proposal gets it pretty well as right as you could hope we think.

We're well aware that everybody out there or most of the stakeholders out there are expecting there to be a trade-off between incentives on the one hand and outcomes on the other, and within that, we're quite pleased that the regulator, the AER in the end, will still have a significant amount of discretion, some guidelines, some sort of narrowing of the scope of the task, but essentially still able to make decisions.

From our perspective, the point was made earlier about investment - from our perspective, we're a long way from being convinced that the regulators to date have been trawling the market and basically the argument of a capital strike if you like. We're just not convinced. On any given individual proposal, yes, I can appreciate that the proponents of a proposal that get knocked back will be unhappy, and that's fair enough. You should try for my position. We get knocked back nearly all the time, and we sort of argue for things - okay, retail it may be, but we're constantly out there arguing, "You should do this, you should do that."

So we think that generally regulator discretion has worked to deliver some pretty good outcomes on balance and again, yes, any individual decision I could point to an individual decision and say, "That's just going to produce some bad outcomes," but on balance we think it's about right.

It will be interesting to see how things develop though around the issue of prescribed negotiated services. We're quite interested in that, although again it's a pretty sort of small deal I suppose. From our perspective, we think it's appropriate that there be some bounds put in place for the market. We don't know that - I mean, take Gordon Jardine's comment before. There obviously are some areas of service provision that there's absolutely no reason why you wouldn't just want to let those things run in the marketplace. Equally though what we're concerned about is that there not be too many attempts to artificially create a market or to introduce proxies for the market in areas of services where it may not really be desirable, it may not really produce any greater competitive outcomes upstream or downstream. So it will be interesting to see how that one pans out.

The revenue cap, I guess we didn't really expect that sort of paradigm shift to really come into place. I think certainly in the views that we submitted to the expert panel, PIAC has expressed a preference for price cap. In terms of certainty I think that's the way to go. It's also much more transparent from the point of view of end users and particularly household customers. There's something like a weighted-average price cap, all those sort of high-bred models. But I'm not going to criticise what the commission has brought out so far because, as I say, that's I think the paradigm

that we're living with anyway.

We will want to do a bit more work on the WAC and the risk premiums and so forth. Again I think Gordon has put up some numbers, and perhaps at the end of the day we can disagree. Maybe instead of 57 cents I think it was, it might be 97 cents but, yes, that is a pretty small, almost insignificant issue really in terms of household bills. For us it's more interesting to sort of look at the idea that we want the AER to lock in these things for a five-year period, and that's actually something that again from the perspective of certainty for end users, for household users, that we're quite pleased about it. Of course if I think that they get the calculation of the final number wrong, then I'll think, "Gee, I wish they could revisit that in six months' time."

But I have to say equally from my perspective, the idea of locking things in for a five-year period to the extent that that can or should be done, it's pretty pleasing from the perspective of PIAC, and my colleagues in the community centre, we just don't - the amount of resources that the TNSPs and so forth put into some of these issues, we've got no chance at all of playing those games.

So to at least have some sort of comfort that that issue will be addressed again, but not in the next six months, not in the next 12 months, but five years down the track and we can sort of gear up for that perhaps. Again in terms of looking at - and the same thing applies for things like post-tax, pre-tax et cetera. It may not make a great deal of difference at the end of the day for customer prices, and we have to do a little bit more study in thinking about what that means for us. But it may in fact not mean very much at all. I guess in that sense you could almost take the approach, "We don't care." But as I say, again we're looking at a very good approach to try to build in some certainty and balance it up against some sort of discretion for the decision-maker.

We will have to do, from PIAC's point of view - and I assume the rest of the community sector groups - quite a lot of thinking on the capex issue. That from our perspective networks distribution as well as transmission. That is the big driver of prices in the current period and for the foreseeable future. It's interesting from our perspective to look at if you like the sort of contrast between, on the one hand, some sort of scope I guess for the businesses to open up the bidding, if you like, and to propose costs to then have the RAB then recalculated each year, as I understand the proposal, to allow for the annual slices of your total capex, and then at the same time or at the end of all that, to then have the businesses able to come back and say, "Let's just reopen the whole thing and let's have another look at a whole other bunch of capex that we suddenly found," and that might be a harsh way to characterise it.

I'm I guess speaking from experience that we've had in New South Wales where the distribution businesses where they go for a long period of time saying, "No, everything's right. Everything's right. Everything's right," then suddenly we have to massively overspend our capex and then come back to the regulator and ask for another 20 per cent on top of that, and then come back 18 months later and ask for another 5, 6, 7 per cent, and as I say, that becomes a significant driver of prices for consumers, and when you add it all up, you're talking about half of the bill, and that's before we get into what the generators are going to do and the wholesale market will do and the retailers with their

margins that they're looking for et cetera.

So as I say, we'll need to do a lot more thinking about that before we can give a really considered view to the commission. I'm obviously quite enlightened by the discussion we've already had today around the factors that will be applied to weighing up what is a reasonable estimate, and that's probably the area that we do need to focus on as other people have said, "How many ways can you slice that particular cake?" But clearly it gives us a bit of a direction to go forward.

Also just in closing, I think a related issue - we're actually quite happy with the way the commission has approached the question of contingent projects, and again that goes back to the little anecdote about New South Wales distribution businesses. We are actually quite pleased that there might be some larger hurdles to jump perhaps for some of those sorts of things. I again take on board the comments that were made earlier today about the difference between a project which is know, but which there is some uncertainty around, and it seems to me there's some parameters for that discussion to go forward. But at this stage in terms of what the commission has put up, we're very pleased to see that contingent projects have been dealt with in that particular way, and I think that probably concludes all I've got to say. Thank you.

CHAIRMAN: Jim, thanks very much for that. Any comments or questions from the commissioners?

MR WOODWARD: No.

CHAIRMAN: Liza? Okay. Open to the floor. Any points to raise with Jim or any broader points that you would like to put to us? You've I think stopped them in their tracks. Thank you for that. We will move then straight on to our last presentation which is from Rainer Korte speaking again on behalf of transmission network operators. Thank you, Rainer.

MR KORTE: Thanks, John. It seems like everybody is warn out already - no questions on that last one. So far in the public hearing, we've already heard quite a bit in terms of the views of transmission. Just in case it's not clear, our goals in this whole process have been to try and achieve greater regulatory certainty, and on the whole, we believe that the draft rule certainly takes us forward on that score, both in terms of greater regulatory certainty and ensuring that we have appropriate incentives for efficient investment.

We were keen to ensure that the draft rules were largely built on existing practice and experience, and that's what the commission has done. We're pleased with that. We think that the level of prescription on the whole in the rules is about right. We probably have some detailed issues to discuss, but on the whole it's about right. There are certain things that are a little more settled - for example, asset valuation where we've had the debate, and I think most people have agreed that the idea of ongoing five-year asset revaluations are undesirable. So things like that can be settled in the rules, and that's what's been done.

In other areas where it is appropriate, discretion has been left to the regulator, but we certainly strongly support the process arrangements that have been put in the draft rule where the AER will develop guidelines, will be bound by those guidelines. Everyone through transparent process will have the opportunity to influence the outcomes and that's a big step forward in our view. Of course as I understand it, the regime may have a need to continue to develop and will be able to do so through changes to the AER guidelines and through the rule change process, but as is appropriate, all interested parties will have appropriate opportunity to participate in that.

Gordon spoke earlier about the headline issues that we have, and I don't want to repeat what he said. I might just reinforce a couple of points, and then we have some more detailed issues that we'll certainly be addressing in our submission, and I might touch on a few of them here.

In terms of the capex incentive, the draft rules as we've heard propose a revised ex-ante arrangement. My understanding of the intent of the ex-ante arrangement was that you put an incentive in place and the regulator can rely upon that incentive that the company will do the right thing and seek efficiencies and hence avoid the need for an ex-post look-back. I haven't been able to really understand in reading the rule package why we have an ex-post arrangement proposed, along with the ex-ante which then means there's a potential for multiple looks at the capex estimates, both before and at the end of the period. As Gordon suggested, if we are going to have this arrangement - and I'd really appreciate a bit more clarify as to why it's there - then it should only be applied if the ex-ante allowance is overspent in the first place.

At a much more detailed level, I notice that the draft rule talks about capex having a requirement to be prudent and efficient. Other places it talks about prudent or efficient, and it's a bit unclear as to what those concepts actually mean. Are they different, and if they are, then I think we ought to be clear on what they are intended to mean in the rules.

We've had quite a lot of discussion about the reopening provisions, and I note that Con argued earlier that having a reopening provision was not a good thing. I think we support the intent of what the AEMC has done there in terms of allowing an opportunity if something comes up largely outside of the TNSP's control to be able to come back and revisit the situation. I think we need to understand that when TNSP puts a revenue cap application together and puts the capex forecast together, we've actually got a forecast quite a long way out, up to seven or 10 years - and things can be a bit uncertain over that time frame. So it seems to make good sense that there needs to be some provision to be able to address issues if they arise.

I also noted that Liza mentioned that the provisions in the draft rules would basically allow you to come back as long as you couldn't fund that requirement from savings that had already been made in the period. My thought there is that that might be well and good in terms of when you aid the money, but you would think that the incentive - any savings you generate through the incentive, you should not be penalised if something then comes up that requires efficient investment. The idea here is to give us an incentive to try and be efficient. If then other things have to be dealt with, then that should not be traded off I would have thought.

If we are going to have reopening and not have the sort of contingent projects addition that Gordon spoke about earlier, then the level of the 5 per cent of RAB is actually very high; hundred million dollar projects in some cases. We would suggest that may be a little high if you don't have that contingent projects provision there as well.

The draft rule - and this has come up so far already in the course of this session - provides a long list of factors which the AER must take into account in accepting or rejecting the capex and opex forecasts. Just one observation that we would make is that there doesn't appear to be any guidance as to the weight that should be applied to those factors. Some of them seem more important than others. For example, having to meet regulatory obligations is something that you wouldn't think could be traded off against some other factors. So in summary, the rules should provide and should guide the use of reliable information in the regulatory decision-making process. I think there's perhaps a bit of tidy-up that could occur there.

In terms of the basis for decision-making, the draft rule, as we've heard, requires the TNSP - this is a new initiative - to provide a certification by an independent and appropriately qualified expert of the reasonableness of our capex and opex forecasts. Again there doesn't appear to be any guidance in the draft rule as to the weight that should be applied to that certification by the AER. Will they look at that, but then do all their own investigative work as usual? If so, we also note that there's a requirement, as I said, for qualified experts. We would think it would be helpful that any experts that the regulator applies to this task should also have a requirement to be suitably qualified, and we're keen that regulatory decisions are soundly based.

In terms of expenditure pass-through, we support the provision of expenditure pass-through in the draft rule which clarifies an uncertainty that exists at the moment. The regime should provide adjustment for all material unexpected events that are not taken into account in the revenue cap decision. So we think what's there could be enhanced, as we proposed in our submission on the issues paper, by allowing a supplementary pass-through events. If there's anything perhaps that's another category event that's specific to a company, that could be agreed in the revenue cap decision with the regulator. It allows a little more flexibility for both the regulator perhaps and the company.

Service performance incentives had quite a bit of discussion before. The draft rule proposes advice scheme, better targeted, as Alex said, on market impact. A question in our mind - and I think perhaps the way we read it is that the proposed incentive or the question here on the slide is is the proposed incentive intended to supersede or supplement the existing service incentive arrangements? The way I read it, what the draft rules are calling for is a refinement of the existing regime. I don't read it in the sense that we replace it with the market impact transparency measures for example that the AER is developing, and in any event, I think there's no chance at all of those turning into something that you can apply financial incentive to by the end of December. So some clarification on that would be good. What I'm seeing is let's better target the existing availability incentives so that we focus on critical elements and critical times.

Separation of prescribed negotiated services, we've had quite a bit of discussion on that earlier as well, and I think the big issue there which Gordon addressed is that there is a lot of service provision at the moment on a contestable basis, and we don't see that that should change where that is a genuine contestable works. The other issue that the working group has to struggle with - and I think the working group the AEMC has established which the transmission companies of course would input to, has a big task ahead of it, but the concept is we need to define a standards level of service for network service, above or below which - it's outside the revenue cap and will be dealt with under the negotiating framework.

So setting that benchmark of what is a standard level of service is a difficult challenge, and our view would be contrary to what's in the AEMC discussion on this; that schedule 5.1 perhaps does not give you that firm basis from which to start. So we're looking forward to some more discussions on that, but that would be our initial view.

I think the other thing here, too, is we don't want to be caught in a situation. We need to look carefully at the definitions here because we don't want to be caught in a situation where a transmission company actually has an obligation to make an investment, to provide a service. It's not included in the revenue cap, and there's no-one to actually pay for that services. So there's some risks there from a TNO point of view as well that need to be addressed.

Just another specific issue on generator access. I know certainly at Electronet we've had quite a bit of practical experience with us with generators seeking access, firm access to the network, and the current arrangements are very unclear in the rules. The draft rules suggest that generator access would be part of the negotiation framework. As I've said, we've previously pointed out, our submission on the issues paper dealt with this, some of the practical difficulties associated with that. If we're going to pursue the concept of generator access, then I think we need to recognise a need to develop a standard model capable of general application. We don't have that yet.

So we need to be careful as we move forward with these rules that we're not then entering into an arrangement where parties can come to us and seek generator access. It's unclear. We can't agree. It goes to arbitration, the arbitrator is deciding in something, and we don't yet have a clear model on how this should work. I think there's a risk there.

The final point I have is I think a number of people throughout this session have commented on how it's been a little hard going, working through the draft rule. There's a lot there, and we're still working through the details ourselves. I think one thing that we would encourage is that as we move forward and finalise the rule, as well as tackling the technical issues, that we try and make the drafting as clear and as simple as possible, because I think it's clear to all of us that if you have unclear rules that are difficult to interpret - and I would categorise the current rules we have in that way - that adds to the cost of regulation. So can we please and keep it simple. That's all I've got.

CHAIRMAN: Thank you, Rainer, very much. That last point we are very conscious of, and we will do some further work on the rules themselves. Liza, over to you.

MS CARVER: I just wanted to make some clarifying observations, and I meant to pick the point up this morning when Gordon spoke. There's no intention through these rules to compel the provision of negotiated services. If there is an obligation to provide negotiated services, it resides outside chapter 6. It is either in chapter 5 or it is in jurisdictional requirements or it does not exist. What we're seeking to do in chapter 6 is provide a framework for the negotiation and resolution of the question of price, not to compel the provision of negotiated services, particularly in circumstances where negotiated services may well be contestable. If we haven't achieved that through the draft rules, that's the intention - if we haven't actually achieved that, then we will refine the drafting of the rules.

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

My final comment is on the ex-post review. I'm glad you raised it, because it was and continues to be something that obviously weighs upon us as we think about what we've drafted. On the one hand, the intention of an ex-ante rate capex regime is to create high-powered incentives for efficiency in the delivery of capital programs. We have picked up the discretion of the AER to conduct ex-post reviews. It's not a new proposition. It's actually in the SRP. If you go and look at the fine language of the SRP - I mean, I think there's often a misunderstanding about what the SRP actually says on this - the AER has reserved under the SRP a discretion to conduct ex-post reviews if it wishes to, and we have picked that up whether that is appropriate or not.

So it means that our capex regime is not a high-powered incentive regime. It's a low-powered capex incentive regime, using the terms that consultants like to throw around. Whether that is the right outcome I think we've got a very open mind about, and whether that discretion to conduct ex-post reviews should be open ended or whether it should be subject to some precondition to be satisfied, such as there's a reason to believe a particular capital program wasn't carried out efficiently and therefore a review is justified, I think that these are all points that are eminently contestable going forward in how we take the draft rules and move them to a final form.

CHAIRMAN: Thanks, Liza. Ian, any comments?

MR WOODWARD: Just two questions really. One builds from the commentary that Liza has just made relating to our intention to have a more robust and appropriate commercial negotiating

environment where that's appropriate between the parties, the TNSPs and any of the users or generators. We have - and I've asked this question before to other participants. We have proposed a very specific commercial negotiation route that is defined to chapter 6, rather than using what has been the chapter 8. To the TNOs have a view about that, not just the negotiation, but actually the process that we've adopted in the draft rules?

MR KORTE: I think we haven't really talked about that so much, but I think as Gordon highlighted this morning, the key issue for us is not so much the processes that are there to address the non-contestable negotiated services that we provide, the key issue is to be clear that there are actually services that are contestable that we see are completely outside the realms of the framework that you've established.

MR WOODWARD: And as such, the working group on review in terms of the definition that we've drafted is going to be a critical element.

MR KORTE: That's right. We see that as a very important piece of work and a very challenging piece of work.

MR WOODWARD: You mentioned the issue around the reasonable estimates and the factors that need to be taken into consideration and the weightings. Clearly you've raised the reliability and security one. Are there any other factors there that you or the TNOs believe have a differential weighting?

MR KORTE: I think we do. I'm probably not prepared today to talk about that at a point-by-point basis. I think that's an area that we'll be discussing this afternoon as we look at a little bit more detail of the rules, and we'll certainly address that in our submission to you.

MR WOODWARD: Thank you.

CHAIRMAN: Thank you, Ian. Comments from the floor or questions about it. Yes.

MR NOUTSO: Con Noutso from TRUenergy. Just a little bit confused. I think Rainer was saying that the provision for shared transmission services provided above or below the standard service actually creates a regime for transmission rights whereas I think Liza was saying that it doesn't actually provide a regime for transmission rights. It provides firmer capacity, but it doesn't actually provide you with a firm transmission right. I'm just seeking some clarity on what it actually does do.

MS CARVER: As I said, there's no intention - and in fact I don't think under a chapter 6 review could the AEMC have jurisdiction to introduce copyrights for generators in transmission, and that is why I used the term "firmer access". We have had generators come to us and say that they have instances where they have been very willing to contribute to augmentation of network to deliver more reliable evacuation capability without conferring property rights, but had not been able to

negotiate an effective commercial agreement with a TNO to deliver that.

On the other side, we have had TNOs come to us and say that while generators may say that they're prepared to engage in that sort of commercial discussion, when the rubber hits the road, they're no longer in the room. We don't intend through chapter 6 review to try and resolve what seems to be fundamentally a commercial question between TNOs and generators by resolving it through some compulsory set of rules. What we want to do is set up a framework for commercial negotiation and a commercial dispute resolution so that generators and TNOs can see if they can work it out for themselves.

It's been put to us - and I think anyone who looks at chapter 5 and chapter 8 could readily draw the conclusion that the rules currently, while there may be provisions in chapter 5 that relate to funded augmentation, there is no mechanism to progress the negotiation and resolution of the question of how those funded augmentations may come about, and in particular, the provisions in chapter 8 in respect of dispute resolution under the rules as a whole are completely inappropriate for what is fundamentally a commercial negotiation. That's what we're seeking to achieve.

MR WOODWARD: And consequently there's not enough incentive on the parties to enter into genuine and timely commercial negotiations, and that was one of the criticisms that was put to us about the actual mechanism acting as a disincentive to the parties to reach conclusive commercial outcomes.

CHAIRMAN: Thank you. Gordon?

MR JARDINE: Can I just clarify that again. What Liza is talking about, when you talk about generator paying for an augmentation, you're talking about an augmentation to the shared grid. So if they want to pay for an augmentation to the shared grid, that gets picked up under negotiable services. If all they want to do is connect their 240 kilometres of line to the shared grid, right now that's out in contestable land, and those two are two separate things.

MS CARVER: I think this is a long conversation that can probably be had through the working group, but if you're talking about radial transmission lines, what may be part of the shared grid or a connection asset today is not necessarily shared or unshared in the future, and I think some of those uncertainties have got into the way of commercial negotiations about the example you've just given, for example, on a radial transmission line.

But in terms of augmentations of the shared network, you may have an augmentation of the shared network, that the cost of which a generator is prepared to contribute to without getting a property right in return, and we want to create an environment where TNOs and generators actually come together to try and work out whether there are opportunities for those sorts of arrangements and pursue them, because to date we think that the provisions in chapter 5, chapter 6 and chapter 8 get in the way of those sort of discussion.

CHAIRMAN: Thank you for that. Very good comment. Any other?

MR JARDINE: I guess what we're saying is we don't have a difficulty with the commercial framework picking up that augmentation of the shared grid. Where we have our difficulty is if you're trying to capture the radial lines, and we think the radial lines which are out there contestable today should not be captured in that regime.

MR WOODWARD: I don't think it's a policy intention of our proposal to include more elements that are currently regulated and in the commercial arena into the regulated bucket. That would be counter-intuitive to the philosophical direction that's been put there.

CHAIRMAN: Over here on the right.

MR MARTINSON: Mike Martinson from Energy Australia, the other electricity transmission company in attendance here. I guess I just wanted to pick up on a comment that Liza made before about the ex-post reviews. Clearly for a network business, the risk of asset stranding is a huge impact on business, and I was very encouraged when I read the report from AEMC saying there was no support for ex-post reviews and the content seemed to be suggesting that really the use of ex-post reviews is minimised. Unfortunately when I read the draft rule proposal, it really doesn't seem to suggest that at all, and it seems to, as Liza was suggesting, picking up aspects from the SRP that really allows the AER almost unfettered discretion really in looking at ex-post reviews.

I guess I would just - one of the subjects for Energy Australia's response will be that all the good work that's been done in trying to create investment certainty through the draft rule proposal could potentially be undone by not having a little bit tighter criteria for when ex-post reviews could be conducted.

Moving on I have I guess just a brief question for Rainer. The two presentations from ETNOF today, can you just clarify please, is the position of ETNOF that you are supporting a reopener and a contingent project regime or one or the other?

MR KORTE: My understanding is we are supporting both. So we're not talking about rolling back to the SRP arrangement for contingent projects. So we support, as I said earlier, the general principle that you need to have a - you know, if everything goes wrong, you need to have an opportunity to have that addressed, and the reopeners do that. But the contingent projects, as Gordon spoke about earlier, concept, if we had that to the reopener, it just allows a clearer path again to investment to deliver reliability for customers. If things do come up that have been pre-identified but are uncertain, you can deal with them in a more efficient manner than doing a revenue cap reopener which will be a much bigger exercise.

CHAIRMAN: Other comments from the floor?

MR SKELTON: Russell Skelton from Macquarie Generation again. Just an alternative view to

your concern, Rainer, about the deadline for getting the incentive regime in place, an alternative reaction might be that there's nothing that focuses the mind quite like a deadline, and maybe it will focus people's minds on what really needs to get happening, and rather than making it complicated and confusing, simple. So the deadline might actually clarify people's thoughts and drive us to an outcome, and I would subscribe to that view more rather than say that it's impossible to get it to happen by the end of the year.

MR KORTE: I guess my thought on that would be it may be possible to get some arrangement in place by the end of the year, but I suspect it wouldn't look like what the AER is currently proposing, because I think the measures that have been identified which we haven't yet seen the first report on those measures. I believe the report is imminent. There really is a need to have a look at whether those are sensible measures in terms of attaching a financial incentive to them. I can't see that happening in the next six months. There may be an opportunity to apply a financial incentive in a different way, but I have my doubts. It's taken us, what, two or three years to date.

CHAIRMAN: Okay. Further comments? Yes, over here.

MR STERLING: Ian Sterling from Electronet. I just want to re-emphasise the contestable projects approach again. I understand from what Ian just said that there was no intention of capturing within the framework those things that currently aren't. I'm pleased to hear that. Just in case that doesn't actually get up, I think it's important to clearly remember there are a number of people who are not TNSPs who provide network connection back to the networks from generators for example.

If that regime does capture the TNSPs and doesn't capture those others, that will be an interesting outcome where we have one hand tied behind our back and others don't.

CHAIRMAN: Thank you for that. Other comments or questions? Yes, one here.

MR ROBERTS: Sebastian Roberts from the AER. Just a comment on the ex-post discussion we've just had, just to clarify, the approach the ACCC and the AER have adopted in the SRP is very clearly a move to an ex-ante regime. That was the underlying driver and rationale for our process. I think the outcome and the intent should be pretty clear. We didn't establish an ex-post regime. We moved away from the implied arrangements in the code, the previous arrangements. So we don't support a move to ex-post. I should say that the general intent, our view is if you've got an appropriate set of incentives in place, you just don't need the provision. So again we wouldn't support that move.

CHAIRMAN: Thank you for that, Sebastian, and as Liza said, this is a matter that we will deliberate on further and we certainly do look forward to submissions on this point. Any other comments from the floor? If there are not, Rainer, thank you very much for that presentation. That brings us I think to the close of our proceedings today. So it remains for me simply to thank you all for coming along and participating. We've benefited very much from your comments and suggestions. I'd like to thank all of the presenters. I think the work you've put in, the ideas that

you've put forward have been very helpful. So we thank you all for that.

As we mentioned, submissions are due on the rule proposal by 20 March. We look forward to your submissions. We will ask you to focus very precisely on the nature of the concerns you have and solutions you might have to those concerns, and to focus on the proposal and the rule package itself, and we will look at your submissions very, very closely. We'll be then producing a draft determination for further comment towards the end of April, and you will see in that draft determination how we've responded to your comments and submissions in the process.

Finally if I could just thank to the AEMC staff who have put in an enormous amount of work in the preparation of the proposal and the rules. It's a very detailed piece of work, and our staff have worked extremely hard. They've also worked very hard on the preparation for presentation of this hearing today. The staff members - and I'd like to name them - are Brendan Crown who has been the project manager of this exercise, Liesel Baumgartner who is the senior director overseeing the work, Peter Brook, Nathan Martin, Prue Anderson, Nevis Martosin and Caitlyn Robson. All have worked extremely hard and we appreciate your effort. Thank you very much.

That concludes our proceedings. So thank you very much for your participation.

MATTER ADJOURNED AT 12.59 PM ACCORDINGLY