countryenergy

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11 September 2006

Mr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box H166
AUSTRALIA SQUARE NSW 1215

Dear Mr Tamblyn

Draft Rule Determination – Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006

Country Energy would like to thank the Australian Energy Market Commission (AEMC) for the opportunity to comment on the Draft Rule Amendment (the Draft Rule) for the economic regulation of transmission services revenue, and the highly consultative process undertaken by the AEMC throughout this rule change process.

Overview

Country Energy believes that economic principles and processes for approval of regulatory revenues should be relatively common between transmission and distribution networks, however operational differences mean that some of the specific elements of the Draft Rule may not be applicable to a distribution network.

Country Energy is generally supportive of the approach taken in the Draft Rule as being appropriate for transmission economic regulation. Country Energy's response will therefore seek to address issues of importance from the Draft Rule and those that are considered in need of further consideration prior to the release of the final rule. These issues are set out in detail in the sections below.

National Regulatory Arrangements

Country Energy considers that the AEMC review of rules for the economic regulation of transmission services presents a great opportunity to streamline regulatory arrangements, particularly in relation to defining assets that form part of a transmission network.

Country Energy requests that the AEMC give special consideration to transmission assets owned by a distribution network service provider (DNSP), as defined in Chapter 10 of the National Electricity Rules (NER). Country Energy believes that transmission assets that are immaterial or incidental to the operation of the DNSP's distribution network could be deemed by the DNSP, after agreement with the Australian Energy Regulator (AER), to be subject to the economic regulatory arrangements for distribution services.

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Scope and Form of Regulation

Country Energy is generally supportive of the positions adopted by the AEMC in this section of the explanatory paper, which attempt to add certainty and transparency to the principles and processes to be followed by transmission network service providers and the AER.

Country Energy supports the inclusion of connection services from one network service provider (NSP) to another as a prescribed transmission service rather than being subject to commercial negotiation. This will alleviate concerns over the workability, potential cost and time impacts that such negotiations may impose on NSPs.

Country Energy fully supports the principle espoused by the AEMC that services subject to competition, or capable of competitive supply, should be outside the scope of regulation.

Finally, Country Energy agrees with the AEMC's adoption of a revenue cap and CPI-X incentive based regime that utilises the well established and understood building block approach as being most appropriate at this point in time for transmission network service providers (TNSP).

Decision Making Framework and Process

Country Energy is firmly of the view that more codification in the Rules will provide investment certainty and transparency in decision making for regulators and market participants. However, it is also acknowledged that some allowance needs to be made for the guided exercise of regulatory discretion, or the Rules would become too prescriptive and cumbersome.

Guidelines

In the explanatory paper to the Draft Rule the AEMC describes the new institutional and governance arrangements for access price regulation in the National Electricity Market (NEM)[1] that have been endorsed by the Council of Australian Governments (COAG). These arrangements comprise the Ministerial Council on Energy (MCE) as the national policy and governance body, the AEMC as the rule making body, and the AER responsible for administering and enforcing the rules. The central foundation of these arrangements is a distinct separation of rule making and rule enforcement functions.

Country Energy is concerned that the Draft Rule undermines the institutional and governance arrangements described above because it confers discretion to the AER to effectively make rules, by publishing mandatory regulatory guidelines that must be complied with in submitting revenue proposals.

Country Energy suggests that guidelines should only be used as an administrative instrument by the AER to provide information on how they intend to interpret the principles and criteria listed in the Draft Rule. This may involve describing the

[1] Australian Energy Market Commission, 'Draft Rule Determination', July 2006 pp.34-35

aspects and information it would expect to be included in a proposed methodology, consistent with the principles in the rules. However, TNSPs would not be excluded from including more or less information than the AER has indicated, provided their methodology satisfies the principles.

Country Energy believes that instead of including the requirement that the AER develop mandatory guidelines, the Draft Rule should specify specific provisions, principles or criteria against which the AER can assess relevant aspects of the revenue proposal. An example of this is the cost allocation framework where TNSPs would develop and submit their cost allocation methodology consistent with the cost allocation principles listed in clause 6A.19.2 of the Draft Rule. The AER would evaluate the methodology against these principles.

If the AEMC, in its final rule determination, maintains the current position of allowing the AER to develop mandatory guidelines that undermine the institutional and governance arrangements, then a mechanism for review of these guidelines, or an approval process conducted by the AEMC is essential. Country Energy suggests that the AEMC must have some oversight over the mandatory guidelines to ensure they are consistent with the intent and purpose of the rules they are designed to implement. This may take the form of the AEMC approving all guidelines, or an alternative measure may be that the AEMC only become involved when an objection to a guideline is raised by a TNSP.

Timeframes

Country Energy agrees with the provisions in the Draft Rule that impose a 13 month overall cap on a revenue proposal process, but allows flexibility within this cap to overcome differences in the circumstances of individual cases.

Country Energy believes that the 30 business day period that TNSPs are limited to after the draft decision in order to resubmit a revenue proposal needs to be reconsidered. Draft decisions are often lengthy, and these detailed documents can take a substantial amount of time for TNSPs to adequately digest, analyse and address. The response to the draft decision is the final opportunity in the regulatory review process that TNSPs have to put forward their respective positions on a revenue proposal, and it is therefore imperative that they have an appropriate amount of time in which to prepare comprehensive and fully detailed submissions. Country Energy notes that the Draft Rule allows for the same 30 business day period for submissions on guidelines. However, these submissions would only be dealing with a limited amount of detail on one aspect of a revenue proposal, as opposed to the significant number of issues required to be addressed in a response to a draft decision.

Country Energy would prefer the inclusion of provisions in the Draft Rule that clarify the actions that would be implemented in the event that the deadline for the final decision is missed, resulting in a delay of the start date of the new regulatory period. If a final decision is delayed by any party other than the TNSP, then Country Energy believes that the TNSP should be entitled to recover revenue foregone between the original projected commencement date of the new regulatory period and the actual later commencement date resulting from the delay.

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Expenditure Forecasts

Country Energy supports the use of a 'reasonable estimates' concept in assessing TNSP expenditure forecasts. The emphasis must be on the AER to evaluate if the approach taken by the TNSP to derive the forecasts was reasonable, rather than the AER determining their own 'reasonable estimate'. If the approach employed by a TNSP is consistent with the rules and the NEM objective then the AER should approve the forecasts as 'reasonable estimates'.

Country Energy fully supports the provisions in clause 6A.14 of the Draft Rule relating to the AER's obligation to be accountable for their decisions by providing reasons against each of the matters listed in clauses 6A.6.6(b)(2) and 6A.7(b)(3) when deciding whether a TNSP's forecast expenditures are 'reasonable estimates'.

However, Country Energy believes the extensive list of factors that the AER must take into account when assessing forecast operating and capital expenditures[2] will lead to uncertainty and increased regulatory risk. The large number of factors requiring consideration and evaluation may result in conflict between them. The Draft Rule gives no guidance on how this conflict should be reconciled or which factor or factors should be given the most weighting. Country Energy believes that the list of factors could also be trimmed by removing redundant provisions from clauses 6A.6.6(b)(2) and 6A.6.7(b)(3) as described below.

Necessary expenditure required to comply with applicable regulatory obligations must be accepted as reasonable in all circumstances and should never be subject to the AER's discretion. Country Energy suggests an additional provision be inserted in clause 6A.6.6(b) that states the AER must accept expenditure if it is necessary for the TNSP to comply with regulatory obligations, with the subsequent removal of clause 6A.6.6(b)(2)(ii) as a result. Similarly, in clause 6A.6.7(b)(2) the words 'subject to subparagraph (3)' should be removed, as necessary expenditure related to reliability augmentations, regulatory obligations or that has already passed the regulatory test should not be subject to the AER's discretion. Clause 6A.6.7(b)(3)(ii) would also be removed as a consequence.

Clauses 6A.6.6(b)(2)(iii) and 6A.6.7(b)(3)(iii) should be removed as considering submissions received does and would form a normal part of regulatory practice during a revenue review process. Therefore, listing it as a specific factor to take into account in assessing a TNSP's revenue proposal is redundant and unnecessary.

Similarly, clauses 6A.6.6(b)(2)(iv) and 6A.6.7(b)(3)(iv) may also be removed as one could conclude that any analysis undertaken by or for the AER is actually analysis conducted on the other listed factors and would form part of normal regulatory practice.

Cost of Capital

Country Energy supports the inclusion of the Weighted Average Cost of Capital (WACC) methodology and key parameters in the rules as it will provide greater certainty and transparency in regulatory decision making to TNSPs.

[2] Draft Rule, Clauses 6A.6.6(b)(2), 6A.6.7(b)(3)

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Country Energy also welcomes the insertion in the Draft Rule of guiding principles and criteria that must be taken into account when reviewing the WACC methodology and parameters every five years. Country Energy believes the guiding principles and criteria could be strengthened at clause 6A.6.2(j)(4)(ii) by adding that the evidence must be new or original evidence as well as persuasive.

Country Energy also believes that the five yearly ~~review~~reviews of WACC methodology and parameters should be subject to a rule change process carried out by the AEMC, regardless of whether or not a prior review is conducted by the AER. Country Energy believes that it is inappropriate for the AER to be completing the review outside of a rule change process without appropriate appraisal or oversight. At the very least, if the AER does conduct the five yearly reviews without a consequent rule change process being conducted, all decisions taken by the AER to amend the WACC methodology or parameters must be subject to a formal review mechanism, due to the substantial impact minor changes to the allowed rate of return can have on incentives to invest and maximum allowed revenues.

Incentive Framework

Initial Regulatory Asset Base

While Country Energy supports the lock in and roll forward approach to setting the regulatory asset base (RAB) during future regulatory periods adopted in the Draft Rule, it is important that the initial asset base reflects the complete and correct value of past investments before being locked in.

Country Energy suggests that the inclusion of a mechanism to allow for a once off initial valuation of an asset base prior to locking it in. This will ensure past capital expenditure and omitted asset values are recognised, and property rights are maintained and reflected in the RAB. If a genuine error has occurred in the calculation of the current RAB, TNSPs should not be penalised.

There are various options available that would allow implementation of such a mechanism including allowing each individual jurisdiction to determine and direct the asset value to the AER (which may be the current RAB rolled forward), allowing for a once off asset valuation utilising recognised valuation methodologies, or by inserting an extra provision in the savings and transitional rules that allows the AER to consider adjustments to the RAB for past capital expenditure and omitted assets where they can be demonstrated by the TNSP, similar to the provision currently contained in the Draft Rule for ElectraNet[3].

From Country Energy's reading of clause S6A.2.1(f) of the Draft Rule it is not clear that the methodology described for adjusting the value of the RAB at the beginning of a regulatory control period allows for an inflation adjustment in order to maintain the real value of the RAB. Country Energy requests that this be made explicit by the AEMC when the final rule is released.

[3] Draft Rule, clause 11.5.13

Capital Expenditure Incentives

Country Energy is satisfied with the AEMC's clarification in the Draft Rule that the option of an *ex post* review by the AER on the prudency of capital expenditure has been removed. However, Country Energy does not support the change to the capital expenditure incentive mechanism through the inclusion of depreciation in the reward and penalty element of the mechanism.

Country Energy believes that the confiscation of prudently incurred capital expenditure under the Draft Rule capital expenditure incentive mechanism may hinder a TNSP's ability to invest in necessary capital expenditure required to maintain the reliability and security of supply, and put at risk the long term interests of consumers. For these reasons, Country Energy is of the view that the Draft Rule would not satisfy the AEMC's obligation under the National Electricity Law (NEL) that they may only make a rule if satisfied it would contribute to the achievement of the NEM objective[4].

Performance Standards Incentives

Country Energy firmly believes that the Draft Rules should not impose a service standards incentive mechanism where there is already a comprehensive service standards regime established by jurisdictions. It would be inappropriate for the Draft Rule to allow for the introduction of a second service standards incentive mechanism that could potentially negate the benefits and intent of existing jurisdictionally set service standards. TNSPs would be effectively penalised twice for not meeting the same single target, making it even more difficult in upcoming years for the TNSP to achieve service standard targets. The flow on effect of such duplication is degradation in the security and reliability of supply, with long term negative impacts for consumers, undermining the NEM objective.

Pass Through Mechanism

Country Energy believes the 60 business day timeframe allowed for TNSPs to lodge a pass through application is inadequate. Country Energy has first hand recent experience with a pass through event application in NSW for the introduction of new planning and reliability licence conditions. The NSW electricity distribution network determination allowed 90 business days for the pass through application, and due to the complexity of the event and the amount of information required, this proved an extremely challenging deadline. Therefore, it is important that the AEMC reconsider this timeframe and consider extending it to a minimum of 90 business days.

We would be pleased to discuss the matters raised in this submission with the AEMC. If you require further information or clarification in relation to this submission please feel free to contact Jason Cooke on 02 6338 3685 or myself on 02 6589 8419.

Yours sincerely

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[4] Section 88, NEL

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