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Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO Box H166
Australia Square NSW 1215

By email to: submissions@aemc.gov.au

Dear Dr Tamblyn

Review of the Electricity Transmission Revenue and Pricing Rules
Revenue Requirements: Issues Paper

AGL is pleased to provide further comment on the AEMC Issues Paper on Revenue Requirements for Electricity Transmission. As well as being a generator, retailer and distribution network service provider in the NEM, AGL has extensive experience with the Gas Access Regime and is therefore able to comment on this issue from many viewpoints.

AGL provided a brief submission on 18 November dealing with the review process and foreshadowed this submission dealing with some of the more detailed aspects of the Issues Paper. The main point of the initial submission was that any review of pricing regulation should consider the outcome of the review of the panel of experts appointed by the MCE to review pricing issues, and in turn the panel of experts should base their principally on the Productivity Commission's Review of the Gas Access Regime.

This paper builds on that theme and highlights some of issues that are raised in the Issues Paper, but which have already been extensively reviewed in other forums.

If you have any queries, please contact Alex Cruickshank, Manager NEM Development on (03) 9201 7694 or David Pringle, Manager Regulatory Affairs Gas Networks on (02) 9921 2405.

Yours sincerely,

Dr Robert Wiles
General Manager Regulation and Policy

AGL submission to the AEMC on its review of the Electricity Transmission Revenues and Pricing Rules – Revenue Requirements Issues Paper

Form of Regulation

The questions raised in this section of the Issues Paper should be answered with reference to outcome of the review of Expert Panel. This panel has been appointed by the Ministerial Council on Energy (MCE) to “provide advice on the model legislative provisions and the model contents of the statutory rules for a new, seamless national approach to energy access” and to “specifically consider whether there are alternative approaches to price regulation.”

The Gas Access Regime provides the service provider with the discretion to choose the applicable form of regulation. The new Rules for electricity transmission pricing should specify boundaries around which the form of regulation must fit, but the Rules should allow flexibility for the service provider to propose detailed methodologies that suit that service provider’s particular operating environment.

The National Gas Access Regime was established after extensive industry consultation, including the advantages and disadvantages of allowing pricing flexibility. The flexibility under the Gas Code was reaffirmed under the Productivity Commission’s (PC) Review of the Gas Access Regime.

The Rules for electricity transmission should be consistent with the Gas Code to the extent that the manner in which a reference tariff may vary within an access arrangement is within the discretion of the service provider, provided that it complies with various factors set out in the Code. The Rules should be flexible enough to allow service providers to propose forms of price control to suit their individual circumstances.

AGL notes that the Gas Code provides regulators with adequate powers to obtain relevant information and considers that these powers should form the basis of the Rules developed by the AEMC.

A specific concern to AGL is the need for electricity transmission to include a mechanism for including generator contributions to TUoS under Rule 5.5.

Performance Obligations and Incentives

Efficiency Incentives

AGL supports the use of incentives as part of revenue determination. The existence of incentives is a mandatory requirement of the National Gas Access Regime that requires an Access Arrangement to contain an incentive mechanism before it can be approved by a regulator. Under the propose-response model of the National Gas Access Regime the precise form of the incentive regime is proposed by the service provider and ratified by the regulator provided it meets the requirement of the Code.

AGL proposes that the National Gas Access Regime should be used as the basis for developing efficiency incentives for electricity transmission (and distribution).

Service Standard Incentives

In electricity there is a far greater inter-relationship between costs and performance standards than exists in the gas industry. This is one area where it may be appropriate for the access conditions for the two industries to vary.

Performance standards, in conjunction with the National Electricity Rules and the jurisdictional regulatory instruments, define the level of service that is to be provided for the payment of network charges. They are, therefore, an essential part of the access and pricing regime for networks.

It is also important to note that transmission assets in the NEM have a major influence on the setting of energy/ancillary service prices and new investments in generation and demand side. With continuing growth in customer demand this influence will undoubtedly grow creating increased intra-regional congestion. This congestion will need to be addressed by efficient investment in the market by generation, transmission, demand side or other initiatives. Hence

transmission investment and operation cannot be separated from the market but rather are part of the deregulated market for electricity. It is therefore essential that TNSP performance measures and incentives ultimately reflect the market impact of TNSP activities.

The standards should be:

- directed at market outcomes that benefit electricity users
- applied during periods of system stress when performance matters
- universally applied to all TNSPs both in scope and level
- focused on best practice in the industry
- subject to *force majeure* provisions that are consistent with general industry practice.

AGL accepts that the AEMC cannot yet include the specifics of a performance standards regime in the outcomes of this review since the AER has not concluded its work on the performance standard regime. We consider, however, that the potential to include a significant incentive for market impacts or other incentive mechanisms should be supported in the revenue mechanisms adopted. This may be as simple as including an 's' factor in the approach in the same way that is currently used in some distribution determinations.

It is worth noting that this area is one where gas and electricity differ markedly. The nature of the gas industry and the contract carriage model used means that this form of incentive is less applicable. The coverage regime and the commercial contracts for gas contain adequate incentives and therefore a separate regime is not required.

Approach to Determining Cost Components

The National Gas Access Regime has been the subject of extensive review in recent years. Firstly the PC reviewed the National Access Regime, following which the Government accepted many of its recommendations. The PC then carried out a review of the National Gas Access Regime that involved extensive further consultation. In its Report on the review of the National Gas Access Regime the PC recommended pricing principles whereby the Gas Code (ie Rules) set the principles which a regulator must use to determine whether tariffs proposed by service provider should be approved. These rules establish the building blocks but do not set out a detailed prescriptive set of procedures that must be followed in applying those building blocks. AGL supports the consistent adoption of this approach across the Electricity and Gas Access Regimes.

The following comments on specific cost components should be read in the context of this overall approach.

Asset Base

AGL considers that an asset base at the beginning of each regulatory period should be determined by the roll-forward method based on asset base at the beginning of the previous regulatory period, less depreciation plus inflation and actual capital expenditure. AGL considers that providing an option for the revaluation of assets provides no appropriate purpose and creates an additional level of regulatory uncertainty for all affected parties.

The discretion to make downward revisions to asset values due to asset stranding or redundancy should only be allowed if appropriate adjustments to the allowed rate of return and depreciation are mandatory. Any such provision should also be accompanied by provisions to re-instate stranded assets values should subsequent events increase the use of those stranded assets.

Criteria for Determining Efficient Investment

AGL supports an ex-ante approach to determining efficient capital investment. The Rules should establish the criteria that must be used by a regulator to determine whether the capital expenditure forecasts proposed by a service provider are appropriate for use in determining the forecast cost of service for each regulatory period.

AGL does not believe that the use of historic trends of either service provider or industry expenditure is appropriate for determining forecast capital expenditure. Capital expenditure by nature varies with specific requirements and does not closely follow historic trends.

Operating Expenditure

The Rules should establish the general criteria which must be used by a regulator to determine whether the operating expenditure forecasts proposed by a service provider are appropriate for use in determining the forecast cost of service for each regulatory period. The Rules however should not mandate the use of a particular tool. Tools such as benchmarking and TFP may have merits if applied appropriately but they are known to have significant practical weaknesses¹ and their use should not be mandated.

Depreciation

The key principle in determining the level of depreciation to be recovered through tariffs is that expenditure should be fully recovered through tariffs, but should only be recovered once. The method and timing for the recovery of that expenditure should be at the discretion of the service provider and should only be rejected by the regulator if it does not conform with the objects and principles in the Law and/or the Rules.

The discretion to make downward revisions to asset values due to regulatory or market stranding should only be allowed if appropriate adjustments to the allowed rate of return and depreciation are mandatory.

Rate of Return

It is accepted in financial markets and by finance academics that a firm's cost of capital can only ever be estimated within a reasonable range.

This was formally recognised by the PC in recommendation 7.9 of its Review of the Gas Access Regime where it proposed that if a rate of return is used to determine Reference Tariffs, then the method used to determine the rate of return and the values used in applying that method shall be in the first instance proposed by the service provider. In this instance:

The role of the Relevant Regulator is therefore to assess whether the Service Provider's:

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

The Relevant Regulator must approve the proposed method if (a) is satisfied. The Relevant Regulator must approve the values in applying a method if (b) is satisfied.

AGL considers that the AEMC should adopt similar provisions for the electricity transmission Rules.

The Rules should therefore avoid the prescription of detailed methodologies, formulas or parameters.

Tax

The flexibility for a service provider to propose a rate of return methodology should extend to whether that methodology is pre or post tax.

AGL also believes that a service provider should have the ability to retain the benefit of any tax concession that would result in the effective rate of tax being lower than the statutory rate. These concessions result from government policies to encourage investment, the effect of which will be lost if service providers do not have the ability to retain such benefit.

Procedural Requirements

Discretion

AGL supports procedural requirements which promote certainty and transparency for investors and access seekers and deliver timely, well-considered regulatory decisions.

Certainty and transparency can be achieved with procedures designed to constrain the level of discretion available to regulators and service providers, however, a substantial amount of discretion is inevitable. In the interest of providing investors with adequate certainty in their

¹ Farrier Swier Consulting for URF (2002) "Comparison of Building Blocks and Index-based Approaches" June 2002.

operating environment, the discretion to propose the form of regulation, incentive mechanisms, tariff structures objectives and other criteria relating to revenue should be left to the service provider. The role of the regulator should be constrained to assessing compliance of the proposal with the Code. If the proposal falls within a range of reasonable values, the regulator should accept the service provider's proposal and not require the business to use a different methodology or arrive at a 'best' estimate.

A limited degree of flexibility is necessary to reflect company and regional circumstances and ensure Rules accommodate evolution of regulatory practice over time. AGL proposes an appropriate level of discretion for regulators and service providers is exhibited in the Gas Code. While providing certainty to service providers and access seekers, the design of the Rules allows a practical degree of flexibility by allowing participants options and guidance.

Guidance on Regulatory Submissions

AGL supports the propose-respond model adopted in Gas Code. This model recognises that the service provider is best placed to establish services, prices, terms and conditions related to the needs of its business, including the market, its customers and the commercial and operating environment. It allows the service provider to develop access arrangements specific to their particular operating environment and deliver an appropriate outcome for investor, regulator and consumers. The model results in more streamlined and timely regulatory outcomes; the duration for recent decisions under the Gas Code has been approximately 12 months compared to 19 months under the Electricity Code's 'regulatory determination' model. The propose-respond model continues to provide regulators with the power to reject access arrangements or prices which do not meet requirements of the access regime laid out in the Rules, including pricing principles and object clause. Rather than releasing initial guidance on the information to be included in submissions, AGL proposes that Rules provide sufficient guidance to the service provider similar to the Gas Code.

Timeframes

AGL believes a balance between timeliness and the quality of decisions must be achieved when determining review timeframes. While lengthy delays in arriving at regulatory decisions may have adverse impacts on investment decisions, AGL recognises legitimate delays may arise, and prefers a regime which delivers sound decisions in a reasonable timeframe rather than swift decisions which are poorly-considered.

AGL believes 12 months is adequate to review and implement an access arrangement and should be the standard timeframe imposed. However, extensions should be available if a delay in delivering a decision is justifiable. A limit of one extension may constrain regulators and compromise the quality of decisions; AGL submits that the benefits of delivering a decision reflecting the true costs of the business must be balanced against the benefits of delivering an early, yet inferior, decision. While supporting a mechanism to extend the timeframe for review, AGL requests that regulators are required to take into account the consequences of delaying decisions when justifying extensions.

AGL supports the AER in proposing to engage with industry and considers that consultation is essential in making decisions appropriate for service providers and end users alike. AGL recommends that all consultations are focused on their issue of consultation and confined to an appropriate timeframe to ensure resources are available to deliver well-considered and timely decisions.

AGL supports stop-the-clock provisions in reasonable circumstances including judicial proceedings.

AGL supports the PC's position that backdating may increase uncertainty, increase investment risk and have significant practical difficulties. Furthermore, the event of an arrangement expiring without new terms yet finalised can be accommodated for in the outgoing arrangement with provisions such as prevailing conditions will continue until a new access arrangement is final.

AGL believes incentives or sanctions to meet timelines would create distortions as both regulators and service providers are inherently obligated to take a cooperative and consultative approach to finalise arrangements.

Simultaneous/Sequential Reviews

AGL does not support simultaneous regulatory reviews and is of the view that benefits derived are likely to be overstated.

There is potentially a significant downside to simultaneous reviews. AGL is concerned that simultaneous reviews will prove to be an unnecessary workload challenge for the AER.

Simultaneous reviews would result in unmanageable peaks and troughs in workloads which may compromise the quality of regulatory decisions. Different business and locational circumstances may be overlooked if the regulator takes an industry-wide perspective required for a simultaneous review. Reviewing determinations sequentially allows the incorporation of developing regulatory expertise in subsequent reviews and facilitates the development of best practice regulation.

Provision of Information

Transparency

AGL supports transparency in determinations as an important and necessary part of administrative decision-making. It is necessary to include in a statement of reasons all information relevant to decision-making either publicly or in confidence if information is of a sensitive nature.

AGL believes modelling underpinning price determinations is usually commercially sensitive and should be provided in confidence to the service provider. The business has a fiduciary duty to investors to verify the accuracy of the modelled outcome for assurance that returns on their assets are adequate and transparency is essential for verification. Moreover, a transparent regime delivers consistency in decisions, ensures regulatory accountability and facilitates the evolution of the regime, minimising regulatory risk to participants.

Information Requirements

AGL supports the attitude the AER has taken to regulation of adopting wherever possible a less intrusive approach². AGL contends that the standard regulatory concern over problems associated with asymmetry of information is overstated as service providers can only give best estimate forecasts to represent efficient costs which will be incurred for the duration of the regulatory period. To overcome this fundamental problem with provision of information, AGL suggests an approach be adopted which recognises actual historic operating costs to the business, with efficiency savings passed on to the service provider at the end of the regulatory period.

AGL is concerned with a requirement for regulatory accounting information on an annual basis, rather than at each review. This is contrary to the principles of incentive regulation under which access and pricing terms are reviewed every five years and service providers then seek to increase the efficiency of the business. Furthermore, AGL believes this unnecessarily diverts attention from safely and efficiently delivering services to customers.

Rules in relation to Information Requirements and/or accounting guidelines should not pre-empt the service provider's preferred method of cost allocation. The Gas Code approach of requiring approval of accounting guidelines, either generic or specific to individual businesses, is appropriate. However, consistent with the comment above, it is not appropriate that regulatory accounts be provided to the regulator between reviews, nor that the regulator, in approving the guidelines should determine specific cost allocations.

Reasonable Ranges

AGL supports the development of a regulatory regime allowing the service provider the discretion to arrive at estimates which lies within a reasonable range. The regulator's role should be to determine whether the service provider's estimate lies within a reasonable range. The approach where a regulator proposes a supposedly better estimate which is in that same reasonable range is clearly duplicative and unnecessary. AGL points to the WA Electricity Network Access Code as an exemplar of the extent of discretion a regulator should have to reject a proposal.

The risks to the long term interests of consumers associated with the regulator having full discretion in choosing a 'best' estimate are minimised through the approach of accepting the service providers estimate. Adopting the most likely estimate risks underestimating the service provider's actual costs, which will reduce incentives to invest.

Due to the significant imprecision involved in estimating the costs to the business, AGL proposes the use of a statistical approach to estimate the upper and lower bounds of the reasonable range, such as the Monte Carlo simulation approach to estimate a reasonable range for the cost of capital. Acknowledging each parameter's degree of uncertainty to obtain a reasonable range brings a level of rigour to the process. This approach ensures that the final result is within a

² Speech by Steve Edwell, Chairman, 'National Electricity Reform – Address to Power and Electricity Congress', 21 November 2005.

reasonable range and has an acceptable level of risk that costs to the business are understated. As well as simplifying the process for estimating the cost of capital, the Monte Carlo Simulation brings to the process perspective on the inherently uncertain nature of cost estimates and forecasts which in turn enhances transparency and certainty of the regime.

AGL has been concerned by recent application³ of the statistical approach that incorrectly uses a broad range of possible and indeed quite unlikely parameter values. AGL asserts that to derive a reasonable range of values at the WACC level, reasonable ranges must be estimated at the parameter level rather than constructing a range from the most unrealistic low and high estimations.

Accepting an outcome at the upper end of a reasonable range is consistent with the NEM objective. As identified by the PC in its reports on the National Access Regime⁴, if the regulatory WACC is set too low, this will act as a deterrent to efficient investment. In this report, the PC recommended that Part IIIA of the Trade Practices Act be amended to include pricing principles which would, among other things, state that regulated access prices should be:

- set so as to generate expected revenue across a facilities regulated services that is at least sufficient to meet the long-run costs of providing access to those services; and
- include a return on investment commensurate with the regulatory and commercial risks involved.

Substantially the same pricing principles (which have been endorsed by the Commonwealth Government) are repeated in the PC's report on the Gas Access Regime. The National Access Regime report explains the rationale behind these principles⁵ as being to "set a relatively clear floor to revenue allowed within the access regime to facilitate investment in the essential service". In addition, revenue should be related to costs, "but in a way which provided headroom for revenue and prices to be above costs provided that this did not significantly impede efficient use of the service."

AGL notes further recognition of this issue by policy makers such as Treasury Secretary, Ken Henry in relation to water, electricity and land transport reform⁶:

But without appropriate price signals, quality investment decisions will not be made. And present price signals are far from appropriate. The risks of taking large infrastructure investment decisions in such an information-poor environment are very great. Yet, if we undertake sensible reforms, delivering the right price signals and regulatory regimes that are not unnecessarily burdensome, the appropriate level of infrastructure spending will not be far behind. Indeed, with the right prices questions about infrastructure adequacy would be redundant

There is resounding recognition in the current policy environment there is much more to be lost by any under-estimate of costs than an over-estimate.

³ ACCC (2005) 'Assessment of Telstra's ULLS and LSS monthly charge undertakings – Draft Decision' August 2005.

⁴ Productivity Commission (2002) 'Review of the National Access Regime' September 2002, p 338.

⁵ Ibid, p 330.

⁶ Ken Henry (2005) 'The Task of Economic Policy – Address to the Sydney Institute', 20 June 2005 p. 12.