20 March 2006

Dr J. Tamblyn
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Level 16
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By email – submissions@aemc.gov.au

Dear John

ETSA Utilities' Comments on the AEMC Review of the Electricity Transmission Revenue and Pricing Rules – Draft Rule Proposal Report (February 2006)

ETSA Utilities wishes to provide the following comments on the Draft Transmission Revenue Rule proposal Report. Please contact me if you wish to discuss our submission.

4.3 Negotiated Transmission Services. ETSA Utilities notes the AEMC's endeavours to open up to competition activities where this is possible, by shifting such activities from Prescribed to Negotiated. ETSA Utilities and Electranet have had to arrange several of these exit upgrades and an occasional new exit point over recent years.

In situations where a single customer has dominated the need for such an exit, the negotiation arrangement would be an effective mechanism, particularly if the negotiated outcome can be placed on the single customer that may actually be embedded within the distribution network. That is, despite there being distribution network between a customer and the transmission asset, where a customer dominates the need for a new/upgraded transmission exit, then that customer should be interested in negotiating a good outcome, and be financially responsible for the outcomes.

However, the majority of transmission exit upgrades that ETSA Utilities require are for general customer growth. Transmission exit upgrades occur just as our sub-transmission lines, zone substations and the like also get upgraded. From a customer perspective, all of these assets are part of the 'shared network' that lies between them and the generators. Some assets are distribution, some shared transmission and some transmission exit. If these transmission exits are to become a negotiated service, where is the competition to deliver a competitive price going to come from and what mechanism is the distributor expected/encouraged to use to achieve a good outcome? It may be that the local distributor can source a transmission exit at a lower price (perhaps built, owned and operated in-house). Currently, transmission service (including prescribed and negotiated services) are pass-throughs for distributors, with transmission exits designed and built on the basis of good electricity industry practice and rolled into the prescribed asset base at actual cost. It is unclear how negotiated transmission services for general growth requirements at transmission exits will operate effectively under the proposed model.

5.3.3 Propose-Respond Model. ETSA Utilities agrees that the propose/respond model outlined by the AEMC is a step in the right direction for networks regulation. The shortened timeframe and the focus of the Regulatory Reset on the network provider's submission rather than another review of the regulatory framework is a good outcome. We expect to make further submissions on this matter for Distribution, to ensure that the issues faced by distributors in different jurisdictions with different cost and performance issues can be effectively accommodated within such a propose/respond model.

ETSA Utilities expects that the propose/respond arrangement will lead to a significant reduction in the time (and elapsed time) required to conduct a Price Review.

6.1.2.3 Weighted Average Cost of Capital. ETSA Utilities agrees with the AEMC proposal to lock in the WACC parameters now for a period of five years through to 2011. We also support the use of BBB as the appropriate credit rating for a network provider.

If the use of post-tax real WACC does flow through to distribution, we will have a transition issue as we currently operate on a pre-tax real WACC regime. We would like to comment on the details of how such transitions from one regime to the other will be treated, if and when such information becomes available.

Outcomes of the WACC regime proposed by the AEMC include greater certainty for the network provider (who has to procure long-term debt) and the customer (who receives greater stability of long-term prices). We also note that at the Forum held at Melbourne Airport on this matter, the Public Interest Advocacy Group valued price certainty highly.

6.1.1.3 Treatment of Capex in the RAB Roll Forward. ETSA Utilities appreciates the increased certainty that the AEMC has provided in the roll-forward values of the regulatory asset base. Capital investment requires certainty of return on and of investment. One aspect which we wish to raise is the allowance for the AER to consider the prudence and efficiency of actual expenditure prior to rolling these amounts into the RAB. We note that at the Forum, the AER spoke of their reluctance to undertake such ex-post reviews, and preferred to have an ex-ante arrangement with the correct incentive regime in place to render redundant the need for ex-post reviews.

If the AEMC is to leave the opportunity for ex-post reviews in the Rules, then we ask that careful guidance is provided on where such reviews can be used. If such reviews are conducted by the AER and a negative adjustment to the RAB roll-forward is made, the network provider must have the opportunity for merit appeals on this decision.

6.1.3.3 Depreciation. ETSA Utilities notes the AEMC's desire to allow the network providers some discretion with the depreciation schedules, to enable for example smoothing of revenue requirements between regulatory periods. We note the last dot point referring to assets dedicated to one transmission network user (or small group of users). This may be intended to cover assets at risk of commercial stranding (as discussed in section 7.4 by the AEMC). This may represent transmission exits dedicated to single (or dominant) customers, or it may represent all transmission exits. Given that ETSA Utilities is deemed to be a transmission network user, it could be argued that all of ElectraNet's assets are for the benefit of a single (or dominant) customer. ETSA Utilities recommends that the AEMC carefully consider the intent and wording of this obligation.

6.1.6.3 Cash Flow Revenue Requirements. ETSA Utilities notes that the AEMC has recommended that revenues should be determined by the use of the AER's Revenue proposal model, and ensuring that the NPV of revenues then matches the NPV of expenditures and asset values. Issues such as the part-depreciation of assets during the year of construction and the timing of revenues and expenditures are discussed in this rule proposal.

ETSA Utilities recognises that Regulators will endeavour to 'improve' the quality of regulation, and to move to what is perceived as the current 'best practice' for a matter. ETSA Utilities asks that where such changes in practice amend the effective asset value and revenue generation potential of an asset, the effective reduction in asset value is added to the existing RAB. In this way, regulatory procedures can be improved for the future without network providers suffering a loss of value for the sake of 'best practice'.

6.2.3 Reopening of Revenue Cap for Capital Expenditure. The transmission revenue proposals incorporate a fixed revenue cap but with variable operating and capital expenditures. The AEMC propose that revenue can be reopened if capital expenditure for a single project not included in the original revenue determination (reliability and Regulatory test projects only) exceeds 5% of the RAB. Any efficiency achieved by the network provider in the course of the regulatory period to date are to be allocated to the funding requirements of the new project first, and any residual funding required is considered for return on/of capital requirements. ETSA Utilities considers that this draft rule provides very limited benefit, covering only the largest of projects and eroding away what limited benefit any capital efficiency incentives that currently exist.

ETSA Utilities encourages the AEMC to review the project threshold to perhaps 2% of RAB, and to exclude the forecast capital expenditure review from the test.

If such a clause is to be considered for distribution, then different issues will arise, reflecting the effect of the economy on the level of customer growth initiated projects. Distribution does not have the same type of project-specific capital works lists that transmission can have.

<u>7.1.3 Level of Performance Incentives.</u> Performance incentives are capped at +/-1% of revenue per annum in a number of network jurisdictions. The AEMC draft report recommends that this cap continues. ETSA Utilities agrees with this level of incentive.

At first glance, +/-1% of revenue appears to be a modest incentive. However, the capital-intensive nature of network businesses needs to be considered. The majority of a network's costs are capital related (depreciation and return on capital) with operating expenditure making up perhaps 25% of allowed revenue. So, a 1% of revenue performance incentive has the same profit impact as a 4% change in total operating expenditure. Such a level of expenditure reduction is difficult to achieve, so the performance incentive is a real, significant factor for network businesses to consider.

ETSA Utilities' preference is for such incentives to be capped at +/-1% of revenue, with the rate of incentive linked to the value that customers see for that performance. Such an arrangement leads to changes in performance that maximise customer value, for example by improving performance where it is efficient to do so. Care must be taken in selecting the appropriate performance measure, as measures that are primarily weather related become more of a raffle than a management performance incentive and just increase the volatility of revenue allowed in a year.

<u>7.2.3 Capital Expenditure Efficiency Carry-over</u>. ETSA Utilities is disappointed to see the AEMC propose a low powered incentive on capital expenditure efficiency, removing depreciation from this incentive and proposing that savings may need to be applied to other projects that emerge during the period. We ask that the AEMC carefully review this matter which has challenged regulators across the world, and to balance the benefits of getting a better decision (leading to greater incentives) against the perceived risks of network providers gaining a benefit where the efficiency cannot be proven to every participant's satisfaction.

The issue of balance between operating, capital and performance efficiency seamlessly over the five year regulatory period, with equal incentives applying in each year and across all three areas, is a difficult one. It does not appear to ETSA Utilities that the low powered capital efficiency proposal has that necessary balance.

Lewis Owens
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