AUSTRALIAN ENERGY REGULATOR

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15 September 2006

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

Dear Dr Tamblyn

RE: Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 (Draft Rules)

Please find attached the AER's submission on the AEMC's review of the revenue requirements in chapter 6 of the National Electricity Rules - Draft Rules.

The AER will respond separately to Steven Graham's letter dated 11 September 2006 in relation to savings and transitional arrangements to support pending revenue determination processes.

Please contact me if you have any questions in relation to the matters raised in our submission.

Yours sincerely

Steve Edwell
Chairman

AER Submission

Australian Energy Market Commission

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

September 2006

Contents

1. Introduction

The Australian Energy Regulator (AER) is responsible for regulating the revenues of Transmission Network Service Providers (TNSPs) in the National Electricity Market (NEM). As the Australian Energy Market Commission's (AEMC) review of the revenue setting Rules of Chapter 6 of the National Electricity Rules (Rules) is directly relevant to the AER's role as transmission revenue regulator, the AER welcomes this opportunity to comment on the Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006[1] (Draft Rules).

The AER's submission on the initial draft of the Rules (Proposed Rules) argued that the framework outlined in the Proposed Rules was a significant departure from current regulatory practice. While acknowledging that there were opportunities to improve the regulatory framework, the AER questioned whether such wholesale change was warranted. In particular, the AER raised the following major concerns:

- incentives for efficiency are diluted by introducing a new "reopener" provision, re-introducing ex post capital expenditure (capex) prudency reviews, removing incentives on the depreciation component of capex forecasts, and by limiting service standards incentives to one per cent of revenues
- the regulatory framework outlined in the Proposed Rules is likely to alter the current balance of interests in favour of the regulated businesses
- the AER's capacity to flexibly respond to the individual circumstances of each business will be limited by the high level of prescription
- the restrictions on the AER's ability to publish information on the TNSPs' financial performance inappropriately limit transparency in the electricity market

The AER considers that the Draft Rules improve on the Proposed Rules in some areas. In particular, the incentives properties of the regulatory regime have been improved by re-introducing incentives on the depreciation component of capex and by increasing the service standards incentive to a maximum of five per cent of revenues. The decisions to adopt a credit rating of BBB+ in the Draft Rules and remove the requirement to undertake ex post prudency assessments are also improvements.

However, there are significant issues that remain with the Draft Rules, including a number of new provisions which are problematic. These are briefly outlined below and discussed in more detail in later sections of the submission.

[1] Australian Energy Market Commission (AEMC), *Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*

Guidelines

The Draft Rules require the AER to produce six guidelines by the end of 2006. The proposal raises legal and practical issues. The AER is prevented from commencing consultation on its guidelines until the Rules have commenced operation. This means that the AER's formal processes cannot begin until 1 January 2007 at the earliest. Even if this legal issue is addressed, the AER would not commence consultation until the Rules are finalised (in October). Either way it is not feasible to develop the guidelines by the end of the year.

The AER appreciates that the end 2006 deadline appears to be driven by upcoming revenue resets in Victoria and South Australia. However, appropriate transitional arrangements can be put in place for these impending revenue resets. The AER has developed proposals for transitional arrangements and informally consulted with affected TNSPs. The TNSPs have indicated their support for the proposed Rule amendment as outlined in the submission.

Including transitional arrangements will allow time for the AER to properly develop and consult on the guidelines. The AER considers 12 months an appropriate time frame for undertaking this task. Accordingly the AER recommends a revised time frame for completion of the guidelines of 31 December 2007.

Publication

The Draft Rules introduce further restrictions on publication of information on the TNSPs' financial performance and their revenue proposals. If implemented the changes will prevent the AER from publishing, without the consent of service providers, most of the data now released in its annual regulatory reports and some of the data currently made available for comment during its revenue reset consultation processes. This data is routinely published by jurisdictional regulators.

Limiting publication in the way proposed will reduce transparency about the TNSPs' performance and compromise the AER's ability to meaningfully consult with interested parties on the TNSPs' revenue proposals.

The AER recommends a number of changes to ensure appropriate transparency.

Revenue reset process

The AER supports the reduction in prescription in relation to time frames through the revenue reset process. However, the Draft Rules introduce new process issues and fail to address some of the issues previously raised by the AER.

The Draft Rules require the TNSPs to resubmit a proposal if the AER identifies elements which are not compliant with the relevant requirements. In the Proposed Rules the TNSPs were required to resubmit within a period specified by the AER, being no longer than one month. The Draft Rules remove this provision, instead requiring only that the TNSP resubmits "as soon as practicable".

The term "as soon as practicable" is open to interpretation giving rise to the possibility of significant delays. Given the Draft Rules include a six month time

frame for the AER to make its draft decision, the absence of a resubmission deadline may reduce the time available to the AER to consult and deliberate on a TNSP's pricing methodology proposal and compromise the ability of the AER to provide a timely well considered draft decision.

The AER recommends re-insertion of the former clause 6.13(c) of the Proposed Rules.

The Draft Rules allow the TNSPs to submit a revised proposal after the draft decision. There are no limitations on the extent of these revisions. The TNSP could submit a completely new proposal. This has the potential to make the previous considerations and consultation redundant and to leave insufficient time for any genuine consultation on, or consideration of, the revised proposal. The AER recommends limiting revisions to matters raised in the AER's draft decision, if not removing the ability of TNSPs to submit a revised proposal entirely.

Clause 6A.15 (revocation and substitution of the revenue cap) continues to allow the challenge of the AER's decision at any point during the five year regulatory control period. This means that a revenue cap would never truly be final, introducing a high degree of risk and uncertainty into the NEM. The AER recommends amendments to address this risk and uncertainty.

Incentive properties

While there are some improvements in the incentive properties of the regulatory framework, the AER continues to hold serious concerns relating to the revenue reopener provision and the contingent projects mechanism.

This submission makes two points about the reopener provision. First, the reopener provision is unnecessary given the inclusion of pass-through provisions and the contingent projects mechanism. The AEMC still has not articulated the problem it is trying to address by continuing to include a reopener. The AER encourages the AEMC to explain its reasoning in the event that it retains the provision.

Second, the AER considers that the reopener provision as currently drafted undermines the incentive properties established by the CPI-X incentive regime. The CPI-X framework is based on setting efficiency targets at the start of the regulatory period and rewarding TNSPs for beating these targets. The proposed reopener does not provide these incentives for efficiency. The reopener provides a relatively open ended opportunity for the TNSPs to receive more revenue if they spend more than the capex target set by the AER, or are "reasonably likely" to exceed the target. For example, the provision recognises that a reopener event could be a "series of events or a state of affairs, which may include a greater than anticipated increase in demand". The scope of events covered by this provision is very broad. It also allows the TNSPs to aggregate events, potentially rendering the materiality provision redundant. Further, sound planning processes will address demand volatility except in extreme circumstances.

The AER recommends removing the reopener provision. In the event that the AEMC retains a reopener provision the AER recommends the following:

- remove the clause stating that events can include a "series of events or a state of affairs, which may include a greater than expected increase in demand"

- retain the proposed materiality threshold of five per cent of the regulated asset base (RAB).

In relation to contingent projects, the proposed threshold is set at five per cent of the RAB. In practice this is a high threshold for contingent projects. None of ten projects Powerlink has asked to be considered as contingent projects in its current regulatory reset would meet the threshold. The AER supports inclusion of a threshold, but recommends giving the regulator discretion to approve contingent project proposals submitted by the TNSPs where the threshold has not been reached.

Other issues

The AER also notes that there are a number of other areas in the Draft Rules where issues of concern remain:

- the retention of an approach whereby weighted average cost of capital (WACC) parameters are locked in the Rules for an initial five year period, with five yearly review thereafter by the AER

- the retention of a 'propose-respond' decision making process based on 'reasonable estimates' of capex and operating expenditure (opex)

These areas of concern will be outlined in the remainder of the submission.

The AER maintains its view that the AEMC is adopting an overly prescriptive regulatory approach and is altering the balance of interests in favour of the regulated businesses. It is still not clear why the AEMC has adopted this approach and what problems it is attempting to address. The approach adopted appears to reflect concerns raised by interested parties, but does not rigorously analyse the validity of these concerns.

Finally, the AER notes that its previous submissions have raised detailed issues, for example:

- the lack of flexibility to take into account the individual circumstances of each TNSP, created by detailed specification of pass through events

- practical issues with the proposed negotiated services framework

- the proposed method of setting the RAB where a market network service provider converts to regulated status.

The AER would encourage the AEMC to reconsider the AER's arguments in relation to the issues.

2. Guidelines

In the Proposed Rules, the AEMC directed the AER to issue the following guidelines and models within six months of the Rules taking force:

- Post Tax Revenue Model
- Roll-Forward of Regulatory Asset Base Model
- Efficiency Benefit Sharing Scheme
- Service Performance Target Incentive Scheme
- Information Guideline
- Cost Allocation Guideline

Given that the Rules were proposed to take effect on 1 July 2006, the guidelines were due to be completed by 31 December 2006.

The AER's submission on the Proposed Rules noted that given the extensive consultation required under the transmission consultation procedures, it would be a significant challenge for the AER to produce the six guidelines required by 31 December 2006. The AER therefore recommended that the AEMC provide flexibility in the Rules to extend this deadline if it became necessary.

The Draft Rules now set out eight guidelines that must be issued by the AER. These are outlined in Table 2.1. Notwithstanding the delay in finalising the Rules, the AEMC has retained the 31 December 2006 deadline for all of the guidelines required in its Proposed Rules, with the exception of the Information Guideline which is required by 1 July 2007. Of the new guidelines, the Submissions Guideline is due by 31 December 2006, while the Ring Fencing Guideline has no due date.

Table 2.1: Guidelines required by Draft Rules

Clause	Guideline	Due date
6A.5.2	Post-Tax Revenue Model	31/12/2006
6A.6.1	Roll Forward Model	31/12/2006
6A.6.5	Efficiency Benefits Sharing Scheme	31/12/2006
6A.7.4	Service Target Performance Incentive Scheme	31/12/2006
6A.10.2	Submission Guidelines	31/12/2006
6A.17.2	Information Guidelines	1/7/2007
6A.19.3	Cost Allocation Guidelines	31/12/2006
6A.21	Ring Fencing	-

While the due dates largely remain unchanged, the timeframe provided for the completion of the guidelines has significantly changed, as guidelines which were to be issued within six months of the Rules taking force under the Proposed Rules, are

now to be issued before the Rules take effect. This creates both legal and practical difficulties.

Transmission guidelines – legal issues

Most of the transmission guidelines must be made (and can be amended) in accordance with the transmission consultation procedures. These transmission consultation procedures are set out in clause 6A.20. The steps required by these procedures include the following:

a) the AER must publish the proposed instrument, an explanatory statement, and an invitation for written submissions (clause 6A.20(b)). The invitation must be published in a national newspaper;

b) the invitation must allow a period of no less than 30 business days for submissions (clause 6A.20(c)). The AER must consider all submissions received (clause 6A.20(f));

c) within 80 business days of publishing the material required by clause 6A.20(b), the AER must publish its final decision, including the instrument and its reasons (clause 6A.20(e)).

The transmission consultation procedure formally begins with the publication of the material required by clause 6A.20(b).

Ordinarily, the AER could publish the material required by clause 6A.20(b) on the date that the amendments to the Rules are formally made, even if they do not commence operation until a later date. This is because of section 27 of Schedule 2 to the National Electricity Law (NEL) (exercise of powers between enactment and commencement). However, section 27 does not apply to the Rules (clause 1.7.1).

This means that the AER cannot formally begin the transmission consultation procedures until the amendments actually come into operation on 1 January 2007.

Transmission guidelines – practical issues

While it is possible that this legal issue could be addressed in the Final Rules (so as to allow the consultation procedure to commence from promulgation of the amendments) the practical issues associated with the development of the guidelines mean that it is not possible for the guidelines to be completed by 31 December 2006.

As noted above, the transmission consultation procedures contemplate an 80 business day period for the development of guidelines, with this period commencing following the publication of draft guidelines. The process outlined in the Draft Rules however contemplates a far shorter period of time for the development of guidelines, with this period of time including the development of draft guidelines.

The AEMC's Draft Determination notes that the Final Rules will be released in October or November 2006.[2]

If the Rules are released at the end of October, the AER will have 41 business days to develop six guidelines. Given that the AER must allow at least a 30 business day period for parties to comment on each of the draft guidelines (clause 6A.20(c)), the AER would have 11 business days (at most) to analyse the AEMC's Final Rules, finalise the six draft guidelines, consider all arguments raised in submissions on the draft guidelines (which includes a requirement to summarise and respond to each material issue raised in submissions), and develop the final guidelines.

If the Rules are released at the end of November, the AER will have 19 business days to develop six guidelines. It is not possible to develop six guidelines in 19 business days, given the 30 business day consultation period noted above.

Proposed transitional arrangements and new transitional rules

The AER appreciates that the 31 December 2006 deadline for the guidelines may be driven by the impending revenue resets for SP AusNet and VENCorp in Victoria and ElectraNet in South Australia. Given that the guidelines can not be completed by 31 December 2006, appropriate transitional arrangements will need to be developed for these three businesses.

The transitional guidelines to facilitate the submission and assessment of the transmission revenue proposal for these businesses can be developed in consultation with the businesses. These transitional guidelines and models would be based on the current versions as issued by the AER, but incorporating essential elements of the framework outlined in the AEMC's Draft Rules. These guidelines could be developed in draft form by the end of November 2006. Following further consultation with businesses that are required to lodge revenue resets in 2007, the AER anticipates the transitional guidelines being finalised by the end of January 2007 for the purposes of facilitating these revenue proposals. The transitional guidelines will also form the basis or starting point for consultation on the more enduring guidelines during 2007.

The AER has informally consulted with each of the three businesses on this approach and all have indicated their support the suggested form of the Rule amendment that is proposed below.

As the TNSP's application and its subsequent evaluation will be subject to compliance with guidelines which must be in a prescribed form, it will be necessary to develop a transitional Rule or derogation which allows the AER to make the transitional guidelines that are to apply to the revenue proposals of SP AusNet, VENCorp and ElectraNet. The AER envisages that chapter 11 would need to be amended to incorporate a new transitional provision for each business. A suggested form of wording for this provision is outlined in the recommendation below.

[2] Page iii of the AEMC's, *Draft Determination - Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006* cites a November release date for the Final Determination, whilst page 133 sets out a timeline which cites October as a release date.

If appropriate transitional arrangements can be put in place for all of the revenue resets which will commence in 2007, there is then no particular urgency to complete the formal guidelines early next year. A twelve month period is needed to allow for proper development, consultation and finalisation of all the guidelines required by the Rules. The AER recommends that in the Final Rules the AEMC amend the date for the completion of the guidelines to 31 December 2007.

It is recommended that the following amendments be made:

1. Substitute the date "31 December 2007" for the dates currently set out in clauses 6A.5.2(c), 6A.6.1(d), 6A.6.5(e), 6A.7.4(e), 6A.10.2(d), 6A.17.2(c) and 6A.19.3(e).

2. Amend the final paragraph of clause 1.7.1 of the Rules by deleting "26" and substituting "27".

3. Insert the following provision in Chapter 11:

"Transitional guidelines for SP AusNet, VENCorp and ElectraNet

(a) In this clause:

"**guideline** means an instrument made by the AER under clause 6A.5.2, 6A.6.1, 6A.6.5, 6A.7.4, 6A.10.2 or 6A.19.3.

"**2008 determination** means a *transmission determination* to be made in 2008 for SP AusNet, VENCorp or ElectraNet.

"**transitional guideline** means a *guideline* that will have effect only for the purposes of making a *2008 determination* and adjusting the *maximum allowed revenue* during the *regulatory control period* covered by a *2008 determination*.

(b) Notwithstanding any other provision of these *Rules*, the *AER* must develop and *publish* each *transitional guideline* by 31 January 2007.

(c) In developing the *transitional guidelines*, the AER must consult with SP AusNet, VENCorp and ElectraNet.

(d) The *transmission consultation procedures* do not apply to the making of a *transitional guideline*.

(e) The *AER* may revoke or amend a *transitional guideline* in the same manner, and subject to the same conditions, as the corresponding *guideline*.

(f) For the purposes of making a *2008 determination* and adjusting the *maximum allowed revenue* during the *regulatory control period* covered by a *2008 determination*, anything that must be done in accordance with a *guideline* must instead be done in accordance with the corresponding *transitional guideline*.

(g) Unless revoked earlier, a *transitional guideline* ceases to have effect at the end of the *regulatory control period* covered by a *2008 determination*. For the avoidance of doubt, a *transitional guideline* does not apply to the making of any subsequent *transmission determination*."

3. Publication of information

The Draft Rules introduce a number of changes to confidentiality provisions which significantly impact on the AER's ability to consult on the TNSP's revenue proposal and to publish the information that is currently contained in the AER's annual electricity regulatory reports. These changes create significant issues for the AER, as they greatly affect the accountability and transparency of the regulatory process.

3.1. Disclosure of protected information generally

Clause 6A.18 creates a category of confidential information called "protected information". Clause 6A.18.1(a) defines protected information as all information provided by a TNSP to the AER under clause 6A.17 (i.e. in an annual statement or otherwise) except:

- information referred to clauses 6A.17.1(d)(4) and (5); and
- information required to be provided in accordance with submission guidelines in clause 6A.10.2 where those guidelines permit the information to be disclosed.

Where a TNSP has withheld its consent, 'protected information' may only be disclosed by the AER where:

- the disclosure is reasonably necessary for one of the purposes set out at 6A.17.1(d); ***and***
- the information is published in an aggregated and 'reprocessed' form; ***and***
- the AER is of the view that the disclosure would not cause detriment to the TNSP (or other person) or that the public benefit of the disclosure outweighs the detriment to the TNSP (or other person).

All of the requirements in the above procedure must be met to allow disclosure of protected information. The practical effect of this is that very little protected information will be able to be disclosed without a TNSP's consent – and only then in an aggregated form.

Clause 6A.18 is based on the presumption that this information must, in almost all cases, be protected from disclosure. The AER does not believe that this will always be the case. While it is important that claims of confidentiality can be made and accommodated, the question of disclosure should be dealt with on a case by case basis. In most regulatory regimes in Australia, this is achieved by allowing claims of confidentiality to be made and by allowing the regulator to determine:

(a) whether disclosure of the information would harm the provider; and

(b) whether the public benefit in disclosure outweighs the harm this would cause.

The AER believes a similar mechanism must apply with respect to protected information under clause 6A.18. Clause 6A.18.3 purports to allow disclosure of protected information, but in circumstances that are so limited as to render this a virtual impossibility. It is doubtful that the AER could even disclose such information for the purposes of enforcing a breach of the Rules.

The AER submits that clause 6A.18.3(a)(2) should be amended by replacing the word "*and*" with the word "*or*". This would allow protected information to be publicly disclosed under each of the limbs in clause 6A.18.3(a).

Further, the AER submits there is a need to clarify clause 6A.18.3(a)(2). The term "aggregated" form needs to be clarified to make it explicit that aggregation is to occur for the individual TNSP and not the electricity transmission sector as a whole. It is understood the AEMC is concerned about the disclosure of information relating to individual connection agreements. In relation to this, the AER would like to clarify that all the information published in its annual regulatory reports is based on each TNSP and reveals nothing about individual customers. If the AEMC wishes for information to be published in aggregate across the electricity transmission sector, then this decision should be explained given the extensive ramifications of such a decision.

Finally, the AER believes the reference to a "reprocessed" form should be deleted. It is not clear what degree of "reprocessing" would be sufficient to satisfy this requirement, and the AER considers it to be unnecessary and confusing.

It is recommended that clause 6A.18.3(a)(2) be amended as follows:

1. delete the word "and" and substitute "or";
2. delete the words "aggregated or otherwise reprocessed form" and substitute "a form that aggregates the information in so far as it relates to a *Transmission Network Service Provider*".

3.2. Publication of annual regulatory reports

The AER has previously noted that the Proposed Rules contained confidentiality provisions which would not allow the AER to publish information on TNSPs' capex and opex outcomes, their performance against the targets set by the AER, the profit performance of their transmission operations, or any other information currently published by the AER in its annual regulatory accounts. In its submission on the

Proposed Rule the AER recommended that the AEMC remove the confidentiality clause in the information collection provisions and explicitly allow the AER to report on TNSP performance against expenditure targets, service standard targets, financial performance and other information that is in the public interest.

Following the AEMC's request for further information on this issue, the AER provided a supplementary submission to the review, which included a detailed discussion of the relevant clauses. Draft substitute clauses were included in this supplementary submission.[3]

Notwithstanding these submissions, the Draft Rules continue to significantly limit the information that the AER will be able to collect and publish in its annual regulatory reports without the consent of TNSPs. The AER is extremely concerned about this outcome because it weakens the transparency of the regulatory regime. The AEMC's reasons for such a limitation are also unclear.

The problem lies in the fact that disclosure of this information is limited by the requirements of both clauses 6A.17.1(d) and 6A.18.

The purposes set out in clause 6A.17.1(d) will permit the collection and disclosure of only a fraction of the information currently contained in the AER's regulatory reports. Most of the information currently used for these reports relates to the financial, economic and operational performance of TNSPs. Yet clause 6A.17.1(d)(3) only permits the AER to *collate* such information for the purposes of future decision making. In contrast to the rest of clause 6A.17.1(d), paragraph (3) does not allow the AER to use information gathered under clause 6A.17.1 for the purpose of monitoring and reporting on the financial, economic and operational performance of TNSPs.

The AER considers that its annual regulatory reports are central to the integrity of the regulatory regime. Information on the performance of network service providers is already published by jurisdictional regulators as well as the AER (eg. ESCOSA publishes *Annual Performance Report - Performance of South Australian Energy Distributors* and the ESC publishes *Electricity Distribution Businesses - Comparative Performance Report)*. Providing for the publication of such information is a critical step in fulfilling the objective of creating a clear and transparent revenue regulation framework. Regulatory reports allow all stakeholders, including the AEMC and governments, to be informed about the performance of network service providers and on going developments in the electricity industry. The future existence of these reports should not be conditional on the consent of TNSPs. If even one TNSP withholds consent (which was the case for several years) the regulatory reports will provide an incomplete picture of the Australian electricity industry.

The AER recommends that clause 6A.17.1(d)(3) be amended to allow collection and disclosure of, rather than just collation of, the relevant information. The amendments to clause 6A.18.3(a) recommended above are also essential. If clause 6A.18.3(a) remains in its current form, publication of the regulatory reports will not be possible without the consent of TNSPs.

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[3] AER, *Supplementary Submission to the AEMC Draft National Electricity Amendment (Economic Regulation of Transmission Service) Rule 2006 - Information Collection*, 3 May 2006.

It is recommended that clause 6A.17(1)(d)(3) be amended as follows:

- "to ~~collate data regarding~~ monitor and report on the financial, economic and operational performance of the provider ~~to be used as input to the AER's decision making regarding the making of revenue cap determinations or other regulatory controls to apply in future regulatory control periods~~;"

3.3. Publication of the TNSP's revenue proposal

Clause 6A.11.3(a)(1) provides that the AER must publish the TNSP's revenue proposal, except to the extent the submission guidelines provide that it will not be disclosed. Clause 6A.10.2(b)(3) requires the submission guidelines to specify those parts of the revenue proposal that will not be published without the TNSP's consent. This clause establishes a presumption that certain parts of the revenue proposal will be published.

However, clause 6A.10.2(c)(2) requires the submission guidelines to provide that the completed post tax revenue model (PTRM), roll forward model, and the information in these models, will not be disclosed except to the extent that this information is provided or otherwise available apart from being in the model. This means, in effect, that the AER will be prohibited from publishing parts of the completed PTRM and roll forward model without the consent of the TNSP.

The precise scope of this limitation is unclear as it was not contained in the Proposed Rules and its inclusion in the Draft Rules is not discussed in the Draft Rule Determination. The AER is opposed to this limitation on the consultation process.

The completed PTRM will set out the TNSP's proposed maximum allowed revenue (MAR) for each regulatory year together with the details of the amounts, values and other inputs used by the TNSP to arrive at these proposals (see clause 6A.5). The completed roll forward model shows how the TNSP proposes that the RAB will be adjusted from year to year. Clause 6A.10.2(c)(2) creates a presumption that none of this information will be subject to public consultation unless it is provided or otherwise available apart from the models.

Clause 6A.10.2(b)(3)(iii) suggests that the AER would be able to publish:

- the estimates of the total revenue cap and the MAR for each year;
- forecasts of required opex and capex (but not the RAB in each year (see below));
- X factors.

However, the clause appears to prevent the AER from seeking comments from stakeholders on other amounts, values and inputs used to complete the PTRM and roll forward model, including such matters as:

- the proposed annual building block revenue requirement for each regulatory year;
- forecasts of inflation;
- estimated cost of corporate income tax;
- the proposed return on capital;
- depreciation schedules.

The contents of the PTRM and roll forward model are essential elements in the determination of a revenue cap. Denying interested parties the opportunity to comment on any of the amounts, values and other inputs into these models is an extreme measure that could only be justified if it is demonstrated that this is a class of information so inherently sensitive that the public interest in disclosure is always outweighed by the risk of harm to the TNSP. There is nothing that suggests this information has such a quality. The inputs into the PTRM have been routinely published by the AER and ACCC without objection on the basis of commercial sensitivity. State regulators, such as the ESC in Victoria, similarly publish price service proposals, including inputs into the PTRM and roll forward model, without limitation.

Further, there is a tension between clause 6A.10.2(c)(2) and section 16(1)(b) of the NEL. This provision states that, in making a transmission determination, the AER must ensure:

> that the regulated transmission system operator to whom the determination will apply, and any affected Registered participant, are, in accordance with the Rules-
>
> (i)informed of material issues under consideration by the AER; and
>
> (ii)given a reasonable opportunity to make submissions in respect of that determination before it is made.

Clearly the phrase "in accordance with the Rules" empowers the AEMC to make Rules about the consultation process, but it does not authorise the AEMC to negate the basic obligation to consult imposed on the AER under this section of the NEL.

If the completed PTRM or roll forward model contains specific information that is commercially sensitive, there should be scope for the AER to consider and accommodate a request to keep the information confidential on a case by case basis. This is the approach usually taken in regulatory regimes around Australia. The Draft Rules already allow such a mechanism to be inserted into the submission guidelines pursuant to clause 6A.10.2(b)(3) (ie. the submission guidelines can provide that specific information will not be disclosed where the AER agrees to a request for confidentiality from the TNSP).

It is recommended that the AEMC delete clause 6A.10.2(c)(2)

3.4. Publication of submissions

Clauses 6A.11.3(c) and 6A.12.2(c) allow interested parties to make submissions to the AER following publication of the Revenue Proposal and the AER's draft decision. Clauses 6A.12.1(a) and 6A.13.1(a) require the AER to consider these submissions.

Clause 6A.16(c) requires the AER to publish a submission received under clauses 6A.11.3(c) and 6A.12.2(c) unless it contains information identified as confidential by the person making the submission. Clause 6A.16(d) prohibits the AER from publishing the submission to that extent.

This means that the AER must consider confidential submissions even though it cannot reveal the contents of the submissions.

This creates issues of procedural fairness.[4] The AER risks denying procedural fairness to a TNSP if, for example, it has regard to a submission that is critical of a TNSP without giving the TNSP a reasonable opportunity to be heard in relation to the matters raised by that submission. The AER is unable to comply with such a Rule to the extent that it would contravene section 16(1)(b) of the NEL.

There is obviously a need for the AER to be able to accept confidential submissions where appropriate, while at the same time balancing the requirements of procedural fairness. The AER does not seek the power to disclose a confidential submission over the objection of an interested party. In the past these issues have been successfully managed through negotiation with the affected parties. However, if procedural fairness prevents the AER from having regard to a submission without informing another party of its contents, the Rules need to provide that the AER can discount or disregard that submission.

It is recommended that a new clause 6A.16(f) be added in the following terms:

> "Notwithstanding clause 6A.12.1(a) and 6A.13.1(a) the *AER* may, but is not required to, consider a submission if the *AER* is prevented from *publishing* that submission by clause 6A.16(d)."

4. Revenue reset process

The AEMC's Draft Rules reduce the prescription in relation to some time frames through the revenue reset process. However, the Draft Rules introduce a significant process issue relating to the timing of a resubmitted revenue proposal. The Draft Rules also fail to address issues raised previously, in particular the apparent ability of the TNSP to submit a completely revised proposal following the draft determination; and the revocation and substitution provisions which introduce significant uncertainty surrounding the status of a revenue determination. The AER believes that these provisions will undermine the effectiveness of regulatory processes.

[4] such as those considered by the High Court in *Applicant VEAL of 2002 v Minister for Immigration and Multicultural and Indigenous Affairs* [2005] HCA 72 (6 December 2005).

4.1. Resubmission of compliant revenue proposal

In the Draft Rules, the AEMC has removed some of the timeframes for each step of the regulatory process, while maintaining the overall 11 month process for a regulatory decision. The AEMC argues that specific timeframes for some steps of the regulatory process "should be left to the discretion of the AER, bearing in mind the overall timeframe".[5] The removal of some of the detailed timeframes is supported.

However, one of the amendments gives the TNSP the ability to significantly reduce the overall time available for AER decision making. Clause 6A.11.2 of the Draft Rules requires a TNSP to resubmit a revenue proposal where the AER has issued a notice under clause 6A.11.1 finding that the revenue proposal is not compliant with the relevant requirements.

The Proposed Rules included a timeframe for the resubmission of revenue proposals and required a TNSP to resubmit a compliant revenue proposal:

> .. within such period as required by the AER for that purpose, being a period that is no more than one month after the AER so notifies the TNSP of its determination.

The Draft Rules simply require that a proposal be resubmitted "as soon as practicable".

This is a significant change. Given that the timeframes for completing various steps of the regulatory process commence from the moment an initial revenue proposal is submitted, the absence of a resubmission deadline may significantly impact on the AER's ability to provide a well considered draft decision.

According to the process prescribed in the Draft Rules, consultation cannot begin until the regulator publishes a revenue proposal that has been found to be compliant with the relevant requirements. Given the prescribed timeframes provided for consultation on the revenue proposal and the six month deadline for the making of a draft decision, the longer the consultation process is delayed, the less time there will be for the regulator to make its draft decision. This creates the risk that the quality of the draft decision will be compromised. It is also inconsistent with the "stop the clock" approach adopted by the Council of Australian Governments[6] in its February 2006 communique.

While the provision in the Draft Rules suggests that the TNSP must act expeditiously, what sort of timeframe is "practicable" is unclear. There is no practical method of enforcing such a requirement in the context of a revenue cap reset. Further, the TNSPs will have access to the AER's guidelines well ahead of submitting their applications, so they will be in a position to understand and act on the guideline requirements before the revenue reset process commences. The AER therefore recommends that the time limit from the Proposed Rules be reinstated.

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[5] AEMC, *Draft Determination - Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, p 113.
[6] Council of Australian Governments, *Council of Australian Governments' Meeting 10 February 2006 Communique*.

The AER also reiterates its concerns in regards to restricting the scope of changes that a TNSP may make to its revenue proposal following a notice to resubmit to changes necessary to make the proposal compliant with the relevant requirements. This issue was not addressed in the AEMC's Draft Determination and remains a weakness in the Draft Rules.

The AER therefore recommends that clause 6A.11.2 of the Draft Rules limit any amendment to the resubmitted revenue proposals to changes necessary to address the AER's concerns in relation to the proposal's compliance with the relevant requirements.

It is recommended that the clause 6A.11.2 be amended to read as follows:

> "If the *AER* notifies a *Transmission Network Service Provider* of a determination under clause 6A.11.1, the provider must~~, as soon as practicable thereafter,~~ resubmit its *Revenue Proposal*, proposed *negotiating framework* or the required information (as the case may be) in a form that complies with the ~~relevant~~ requirements set out by the AER in the determination referred to in clause 6A.11.1(a), within such period as is required by the *AER* for that purpose, being a period that is not more than one month after the *AER* notifies the *Transmission Network Service Provider* of its determination."

4.2. Revised revenue proposal following draft decision

In its submission on the Proposed Rules, the AER raised concerns over the ability of TNSPs to submit a revised revenue proposal following the AER's draft decision. The Draft Rules retain the provision as well as allowing TNSPs an open ended ability to submit revised revenue proposals.

Allowing TNSPs the ability to resubmit in this fashion has the potential to create an opportunity for regulatory gaming. These concerns were highlighted by the Expert Panel Report which noted that:

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

> the regulator's estimate of a reasonable range. The final offer will not of course be less than that proposed by the regulator.[7]

In relation to these concerns, the AEMC's Draft Determination notes that:

> Turning to the Expert Panel's concern about incentives for strategic behaviour, such incentives are a reality in a regulatory process the purpose of which is to determine the future revenue and prices of regulated businesses and thus their future profitability and shareholder value. In this situation, regulated businesses will have an incentive to 'talk up' the forecasts of expenditure required to provide the service under any decision criterion.[8]

While it may be true that there is an incentive to 'talk up' revenue proposals under any decision making framework, the issue that the Expert Panel highlights is that these incentives for strategic behaviour are far greater under an approach where the TNSP can be rewarded for seeking out the regulator's view on outcomes likely to be deemed reasonable through its ability to submit a revised revenue proposal.

The AER is concerned that under the Draft Rules a TNSP might, following the Draft decision, be able to submit what is, in effect, a new Revenue Proposal. There appears to be nothing in clause 6A.12.3 that would prevent a TNSP from revising any aspect of its original Revenue Proposal, including matters that had been accepted by the AER in the Draft decision or matters not previously considered.

An open ended right to submit a new revenue proposal may render much of the analysis in the draft decision redundant. Similarly it may render redundant much of the consultation process conducted to develop the draft decision. This is a particular concern because a revised proposal will be lodged relatively late in the determination process. Given that the AER has up to six months to develop a Draft decision and the revised proposal can be lodged at any time up to 30 business days after the Draft decision, in excess of seven months' work could be wasted in determining the TNSP's revenue allowance.

The AER therefore recommends that the ability for the TNSP to submit a revised revenue proposal should be removed or, if is to be retained, appropriately limited.

The AER's previous submission on this issue argued that if the AEMC finds it necessary to provide service providers the right to submit a revised revenue proposal, new or changed matters included in the revised proposal should be limited only to responding to concerns set out in the AER's draft decision. In response, the AEMC has stated that:

> The opportunity for the TNSP to resubmit a revised proposal following the draft determination, which would be subject to the same reasonable estimates assessment by the regulator, simply provides for due process on a consistent basis in the draft and final

[7] Expert Panel on Energy Access Pricing, *Report to the Ministerial Council on Energy*, April 2006, pp 86-87

[8] AEMC, *Draft Determination - Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, p 52

> decision-making processes and would be subject to the same regulatory checks and balances as those applying to the initial proposal.[9]

There are a number of problems with this argument. First, the AER considers that it is difficult to justify this provision as a simple matter of due process. Due process in this context would be the service provider's right to be adequately notified of decisions, and be given the opportunity to respond to any decision and have its response considered in making the final decision. This is already provided in the ability to provide a submission on the draft decision, as has always been the case in the regulatory process. What the AEMC actually proposes is the creation of a new basis for the final decision.

Second, the AER does not accept that the checks and balances which apply to the initial revenue proposal would apply to the revised proposal. This is because any new matters or figures included in the revised proposal would not be subject to the same consultation process or level of consideration afforded to the original revenue proposal, given that the revised proposal is lodged relatively late in the decision making process. This creates a substantial risk that users and other stakeholders will be disadvantaged in their ability to effectively and meaningfully comment on the revised proposal.

In light of this, the AER again recommends that the right to submit a revised proposal should be deleted, or in the event that it is retained, be expressly limited to responding to matters raised by the AER in its draft decision. This accords with the current rights of service providers under the Gas Code where section 2.15A limits the right of resubmission as follows:

> The Service Provider may, after the date of the draft decision, resubmit the Access Arrangement, revised so as to incorporate or substantially incorporate the amendments specified by the relevant Regulator in its draft decision or otherwise address the matters the Relevant Regulator identified in its draft decision as being the reasons for requiring the amendments specified in its draft decision.

It is recommended that:

1. the right to submit a revised proposal should be deleted; or

2. in the event that it is retained, a new clause should be inserted after clause 6A.12.3(a) in the following terms:

   "A *Transmission Network Service Provider* may revise its *Revenue Proposal* or *negotiating framework* only so as to incorporate or substantially incorporate the changes required or to address the matters included in the draft decision."

[9] AEMC, *Draft Determination - Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, p 53

4.3. Revocation for material error

Clause 6A.15 of the Draft Rules deals with revocation and substitution of the revenue cap.

The only substantive change from the Proposed Rules is that the requirement for the TNSP's consent has been removed. While supporting this amendment, the AER considers it to be of little consequence. It is the AER's experience that revocation is only ever sought by a TNSP. This means that the TNSP's consent can usually be taken for granted.

The AEMC summarised the AER's submission on this provision in the following terms:

> .. the AER believes that the terminology may be too broad and could extend to errors that would be reviewable under law.[10]

In fact, the AER's submission went further, pointing out that this would mean, in effect, that a revenue cap will be subject to challenge at any time during the regulatory control period. This means that a revenue cap would never truly be final, introducing an unacceptable degree of uncertainty and risk into the NEM. These consequences do not appear to have been considered by the AEMC.

Instead, the AER proposed a rule that would provide for revocation and substitution in cases of 'slips'. This is based on section 22 of the *Gas Pipelines Access Law*. When combined with existing rights of judicial review and proposals for merits review, the AER believes this would establish a sensible and balanced regime for revocation and substitution of a revenue cap. Again, the merits of this proposal do not appear to have been considered by the AEMC.

The AEMC states that, in its opinion:

> .. the use of 'material error' is well established in law and constitutes a material error of fact rather than judgment.

The AER agrees that this term does not refer to mere differences of opinion or disagreements on questions of judgment. However, material error is not limited to errors of fact. There are many cases in which a "material error" has included errors of law as well as errors of fact.[11]

This means a TNSP would be entitled to seek revocation and substitution of a revenue cap at any time during the five year regulatory control period based on an error of fact or an error of law, including grounds that would be available under judicial review. In the face of such grounds, a refusal by the AER to revoke the revenue cap would itself be a reviewable error.

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[10] AEMC, *Draft Determination - Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, p 121

[11] eg: *BHP Billiton v Schultz* (2002) 221 CLR 400; *R v Allpass* (1993) 72 ACrimR 561

This would, for example, allow a TNSP to demand revocation and substitution of a revenue cap at any time where it is alleged that the AER had:

- failed to have due regard to a matter put before it during the decision making process;
- made a decision that is unreasonable, illogical[12] or inconsistent with other decisions[13];
- made an error in its process, for example by not giving the TNSP adequate opportunity to respond to an unfavourable submission;
- misunderstood or misapplied a provision of the NEL or the Rules.

The AER has no concerns with any of these issues being agitated within the time usually allowed for judicial review. However, the effect of the AEMC's proposal will be to allow these issues to be raised at any time during the five year regulatory control period. This creates considerable uncertainty surrounding a revenue cap determination. The AER urges the AEMC to reconsider these issues and adopt the AER's proposal.

If the Draft Rule is adopted in its current form, the AER will administer clause 6A.15 on the basis that a material error refers to both an error of fact and an error of law. If the AEMC believes that a 'material error' should be confined to errors of fact (an outcome that the AER would support in the alternative) then this will need to be expressly stated in the Rules.

It is recommended that the AEMC amend clause 6A.15(a)(2):

1. to provide for a revenue cap to be re-opened where it contains:
   (a) a clerical mistake;
   (b) an error arising from an accidental slip or omission;
   (c) a material miscalculation of figures or a material mistake in the description of any person, thing or matter referred to in the transmission determination; or
   (d) a defect in form;

or, *in the alternative*;

2. by inserting the words "of fact" after the word "error".

5. Incentive properties

In comparison to the Proposed Rules, the Draft Rules improve the incentive properties of the regulatory framework. In particular the AER supports the re-introduction of the contingent projects mechanism, the re-introduction of incentives on the depreciation component of capex, and the increase in service standards incentives to a maximum of five per cent of revenues. However, the AER continues to hold serious concerns

[12] *Australian Broadcasting Authority Tribunal v Bond* (1990) 170 CLR 321 at 366; MIMA v Eshetu (1999) 197 CLR 611 at 656
[13] *Sunshine Coast Broadcasters v Duncan* (1088) 83 ALR 121

relating to the revenue reopener provision and the contingent projects mechanism. Changes in these areas would maintain the incentive framework.

5.1. Revenue cap reopeners

While the AEMC has introduced a contingent projects mechanism in the Draft Rules, it has also retained the reopener provision. The AER is concerned at the retention of a reopener provision in these circumstances. This provision is targeted at material unforeseeable events. However, the existing pass through provisions already cover unforeseeable events. A revenue cap reopener was originally conceived in the SRP as an alternative to pass through provisions. Given that pass through provisions have been retained by the AEMC in the Draft Rules, the AER considers that these are an adequate mechanism to address unforeseeable events and that the reopener provision is not necessary. If the AEMC believes that there are problems with the pass-through arrangements, the AER would encourage the AEMC to modify them rather than creating a separate reopener provision.

Adding a reopener provision limits the incentives on a TNSP to implement projects efficiently. By way of example, consider two TNSPs that have a capex allowance of $100 million and both have a requirement to spend $100 million to meet their statutory reliability obligations. TNSP 1 undertakes its capital expenditure program and fully expends the ex-ante cap. TNSP 2 undertakes the same program, but does so more efficiently, only spending $80 million. If then, a $20 million project is required prior to the end of this regulatory control period, under the current drafting of clause 6A.7.1, only TNSP 1 would be entitled to a reopener. This is the case as TNSP 2 could fit the project under the ex-ante cap as a result of efficiently undertaking its capital expenditure program. The AER raised concerns with the incentive effects of this provision in its submission on the Proposed Rules, but these concerns do not appear to have been considered by the AEMC.

The AER understands that the reopener provision is intended to target material unanticipated events beyond the TNSP's control, such as a natural disaster. This intent is reflected in clause 6A.7.1(a)(1) which allows a TNSP to apply for a reopener for "an event that is beyond the reasonable control" of the TNSP which "could not reasonably have been foreseen" by the TNSP.

However the intent of limiting the reopener provision to material events beyond the TNSP's control is not reflected in the drafting of the final paragraph in clause 6A.7.1(a). This paragraph recognises that a reopener event could include "a series of events or a state of affairs". This will enable a TNSP to seek to re-open a revenue cap by combining a number of events, none of which would qualify as a reopener in their own right under clause 6A.7.1(a)(4). This defeats the purpose of the materiality threshold proposed by the AEMC in the Draft Rules. Further, the reference that an event may include a "state of affairs" implies a focus on outcomes rather than a focus on an event beyond the control of the TNSP that could not reasonably have been foreseen.

The AER also notes that clause 6A.7.1(a) specifically recognises that the state of affairs that may lead to a re-opening "may include a greater than anticipated increase in demand". It is highly unlikely that an increase in demand would fail to be

anticipated. TNSPs are obliged to consider a range of demand forecasts and be able to build a range of demand growth scenarios into their capex projections. This is very much an entrenched process in transmission planning in the NEM. The rigour with which a TNSP undertakes its demand forecasting when preparing its transmission plans goes a long way to supporting its integrity.

Given the concerns highlighted above, the AER recommends that the reopener provision be deleted. In making this recommendation, the AER appreciates that there may be a case to protect TNSPs against extreme demand growth that they could not have reasonably foreseen, as the consequences of this extreme demand growth could be significant for the TNSP. However, the AER believes that there are existing mechanisms, such as the dynamically adjusting revenue cap (as outlined in the Statement of Regulatory Principles (SRP)) or load growth specific contingent projects, that could deal with higher than anticipated demand growth.

If the AEMC decides to retain the reopener provision, the AER recommends that it is amended so that it only covers a material unanticipated event beyond the control of the TNSP. The AER considers that this would be achieved by deleting the final paragraph in clause 6A.7.1(a).

Finally, the AER notes that the threshold for invoking the reopener provision has been set at a high level (five per cent of the RAB). The concerns expressed above about the operation of the reopener provision would be heightened if the threshold was relaxed in any way.

It is recommended that the AEMC delete clause 6A.7.1

In the event the AEMC decides to retain the re opener provision, **it is recommended that** the AEMC delete the final paragraph in clause 6A.7.1(a).

5.2. Contingent projects

In the submission on the Proposed Rules, the AER raised concern at the replacement of the contingent project regime established in the SRP with a new reopening provision for capital expenditure. In the Draft Rules, the AEMC has reintroduced a form of the contingent projects regime, a move which is supported. However, the AER has some concerns with the contingent projects provision as drafted.

The threshold for invoking the contingent projects regime is set at a very high level (five per cent of the RAB). The AER notes that none of the ten projects Powerlink has asked to be considered as contingent projects in the 2007-2012 regulatory reset currently being considered by the AER would come close to meeting this threshold – the highest value project sought by Powerlink amounts to sixty one per cent of the contingent projects threshold. This threshold will limit the role that the contingent projects mechanism can play. This will become more of an issue in the future as the RABs for each of the TNSPs grow in line with current capex programs.

In the SRP, the AER argued for a contingent projects threshold of ten per cent of the total capex allowance for the regulatory period, but with the discretion for the

regulator to use the contingent projects mechanism even where projects had not reached this threshold. The AER still considers that an approach where the regulator has the discretion to consider a project under the contingent projects mechanism where the threshold has not been reached is appropriate.

It is recommended that a new clause 6A.8.1(ba) be inserted after clause 6A.8.1(b) in the following terms:

> "If the criterion in clause 6A.8.1(b)(2)(iii) is not satisfied, the *AER* may determine that a *proposed contingent project* is a *contingent project* if it is satisfied that, in all the circumstances, such a determination should be made."

6. Other outstanding issues

6.1. Propose respond decision making process based on reasonable estimates of capex and opex

In its submission in response to the Proposed Rules, the AER expressed concern that the introduction of a "reasonable estimate" test could create uncertainty that has the potential to undermine consistency and predictability in regulatory outcomes. The AER continues to hold this concern and believes that the proposed Rules would be improved if the "reasonable estimate" component was removed from clauses 6A.6.6, 6A.6.7 and 6A.14. However, the AER notes the statements made by the AEMC in relation to the object of these provisions,[14] in particular:

- responsibility for deciding whether forecasts are reasonable estimates rests with the AER;
- the decision making process and criteria are intended to provide the AER with sufficient powers and safeguards to be able to achieve regulatory outcomes that are not overly distorted by strategic behaviour on the part of TNSPs;
- the AER should be able to deal with exaggerated proposals and TNSPs are likely to see the benefits of well supported forecasts, as opposed to ambit claims and poorly supported forecasts;
- the criteria specified in the Draft Rules are relevant and appropriate and the weight to be given to each criterion is to be determined by the AER depending on the relevance of each factor in each particular case.

The forecasts of opex and capex are very significant components of the final revenue cap. Given their significance, it is essential that the regulator has the ability to properly scrutinise and assess these forecasts. Further review by the AEMC may be required if the final Rules are interpreted so as to fail to achieve the objectives noted above.

[14] AEMC, *Draft Determination - Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, pp 52-53, 55.

The discussion above also highlights the importance of the list of criteria in assessing the 'reasonableness' of TNSPs' proposals. Any decision to narrow the list of criteria in the Draft Rules runs the risk of fundamentally undermining the ability of the AER to properly assess the expenditure forecasts.

6.2. Prescription of WACC parameters and the timing of reviews

The Draft Rules retain the specification of WACC methodology and parameters for an initial five year period, with five yearly reviews thereafter by the AER. The AEMC argues that:

> The provision of stability in the short term regarding the determination of the WACC reduces an important source of potential variability in regulatory decision-making providing a more certain and predictable environment for investment and finance-decision making.[15]

However there is a trade-off between promoting certainty and the need to flexibly respond to changes in financial market conditions. In trying to strike the right balance in the tradeoff between predictability and flexibility, it does not appear that the AEMC has clearly articulated how a greater level of prescription fulfills the NEM objective. The AER considers that if the optimal set of Rules are to be designed (optimal in the sense of achieving the right balance between predictability and flexibility), then an attempt needs to be made to develop a deeper understanding of information uncertainty, administrative costs and financing transaction costs.

The AER therefore reiterates its concerns with regard to the prescription of WACC parameters. There is no economic argument to justify a five-yearly review of WACC parameters. The more appropriate approach is to adjust WACC parameters as new data becomes available, rather than having arbitrary five yearly reviews. The AEMC's quest for greater certainty is best addressed by requiring the AER to undertake reviews in accordance with specified consultation processes. Service providers could also be given advance warning through a requirement to give notice (eg 12 months) before implementing the outcomes of a review. If the AEMC believes that there is value in "locking in" WACC parameter values for an initial period, the AER suggests a one-off five year moratorium on amending WACC parameter values, with the proposed review procedures applying thereafter. The AER's recommendation reflects this approach.

A clear implication of the AEMC's approach is that it will not necessarily remove uncertainty but rather concentrate it in the period leading up to and during the five yearly WACC reviews. Rather than potentially making a series of smaller adjustments under a more regular review process, any required adjustment would be larger, risking "revenue shock", where a number of incremental adjustments taken together have a significant impact every five years. This would ultimately create the potential for more uncertainty rather then less.

To the extent that there is a gap emerging between the true WACC and the prescribed WACC, then certain businesses will be treated differently depending on the timing of

[15] AEMC, *Draft Determination - Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, p 57

their revenue reset. For example, a business whose regulatory determination is completed shortly after the WACC review is less likely to be out of line with the prescribed WACC parameter values, but a business whose determination is completed in the year before the WACC review would be subject to WACC parameter values based on outdated conditions. This would appear to be a suboptimal outcome.

Further, clause 6A.6.2(j) sets out matters to which the AER must have regard in reviewing the WACC parameters. Clause 6A.6.2(j)(4)(i) requires the AER to have regard to the need to achieve an outcome consistent with the NEM objective. This provision is unnecessary. Section 16(1)(a) of the NEL already requires the AER to do this in performing its economic regulatory functions.

Finally, clause 6A.6.2(j)(4)(ii) refers to the "…need for persuasive evidence before adopting a value for that parameter that differs from the value that has previously been adopted for it". The AER does not consider this requirement to be appropriate. The WACC parameters to be determined through this review are forward looking estimates of the factors that establish the rate of return provided to TNSPs. Values adopted in the past, and the effect of changing those values, are certainly relevant in deciding what the values should be in the future. However, this provision, as currently drafted, gives undue weight to the existing values, at the expense of a reasoned assessment of the appropriate values into the future (whether they are high or lower).

It is recommended that clause 6A.6.2 be amended as follows:

1. Delete paragraphs (f) to (i) and substituting the following:

"(f) the *AER* may, in accordance with the *transmission consultation procedures* and paragraphs (g)-(j), review one or more of:

(1) the values of and methodologies used to calculate:

(i) the nominal risk free rate;

(ii) the equity beta;

(iii) the market risk premium;

(iv) the maturity period and bond rates referred to in paragraph (d);

(v) the ratio of the market value of debt to the market value of equity and debt;

as set out in this clause 6A.6.2 or as subsequently revised under paragraph (g);

(2) the credit rating level as referred to in paragraph (e) or as subsequently revised under paragraph (g).

(g) The *AER* may, as a consequence of a review, adopt revised values, methodologies or credit rating levels and, if it does so it must, subject to paragraphs (h) and (i), use those revised values, methodologies or levels for the purposes of a *Revenue Proposal*.

(h) The *AER* must only use revised values, methodologies or levels for the purposes of a *Revenue Proposal* if there has been a period of at least 12 months between the date the *AER published* a notice under clause 6A.20(e)(2) of the making of its final decision on a review of a matter referred to in paragraph (f) and the date the *Revenue Proposal* is submitted to the AER under clause 6A.10.1.

(i) The AER must not use any revised values, methodologies or levels for the purposes of a *Revenue Proposal* that is submitted to the AER under clause 6A.10.1 before 1 January 2012."

2. Delete clause 6A.6.2(j)(4).

7. Summary of recommendations

The AER's recommendations are as follows:

Guidelines

It is recommended that the following amendments be made:

1. Substitute the date "31 December 2007" for the dates currently set out in clauses 6A.5.2(c), 6A.6.1(d), 6A.6.5(e), 6A.7.4(e), 6A.10.2(d), 6A.17.2(c) and 6A.19.3(e).

2. Amend the final paragraph of clause 1.7.1 of the Rules by deleting "26" and substituting "27".

3. Insert the following provision in Chapter 11:

"Transitional guidelines for SP AusNet, VENCorp and ElectraNet

(a) In this clause:

"**guideline** means an instrument made by the AER under clause 6A.5.2, 6A.6.1, 6A.6.5, 6A.7.4, 6A.10.2 or 6A.19.3.

"**2008 determination** means a *transmission determination* to be made in 2008 for SP AusNet, VENCorp or ElectraNet.

"**transitional guideline** means a *guideline* that will have effect only for the purposes of making a *2008 determination* and adjusting the *maximum allowed revenue* during the *regulatory control period* covered by a *2008 determination*.

(b) Notwithstanding any other provision of these *Rules*, the *AER* must develop and *publish* each *transitional guideline* by 31 January 2007.

(c) In developing the *transitional guidelines*, the AER must consult with SP AusNet, VENCorp and ElectraNet.

(d) The *transmission consultation procedures* do not apply to the making of a *transitional guideline*.

(e) The *AER* may revoke or amend a *transitional guideline* in the same manner, and subject to the same conditions, as the corresponding *guideline*.

(f) For the purposes of making a *2008 determination* and adjusting the *maximum allowed revenue* during the *regulatory control period* covered by a *2008 determination*, anything that must be done in accordance with a *guideline* must instead be done in accordance with the corresponding *transitional guideline*.

(g) Unless revoked earlier, a *transitional guideline* ceases to have effect at the end of the *regulatory control period* covered by a *2008 determination*. For the avoidance of doubt, a *transitional guideline* does not apply to the making of any subsequent *transmission determination*."

Publication of information

It is recommended that clause 6A.18.3(a)(2) be amended as follows:

1. delete the word "and" and substitute "or";
2. delete the words "aggregated or otherwise reprocessed form" and substitute "a form that aggregates the information in so far as it relates to a *Transmission Network Service Provider*".

It is recommended that clause 6A.17(1)(d)(3) be amended as follows:

- "to ~~collate data regarding~~ monitor and report on the financial, economic and operational performance of the provider ~~to be used as input to the AER's decision making regarding the making of revenue cap determinations or other regulatory controls to apply in future regulatory control periods~~;"

It is recommended that the AEMC delete clause 6A.10.2(c)(2)

It is recommended that a new clause 6A.16(f) be added in the following terms:

"Notwithstanding clause 6A.12.1(a) and 6A.13.1(a) the *AER* may, but is not required to, consider a submission if the *AER* is prevented from *publishing* that submission by clause 6A.16(d)."

Revenue reset process

It is recommended that the clause 6A.11.2 be amended to read as follows:

"If the *AER* notifies a *Transmission Network Service Provider* of a determination under clause 6A.11.1, the provider must~~, as soon as practicable thereafter,~~ resubmit its *Revenue Proposal*, proposed *negotiating framework* or the required information (as the case may be) in a form that complies with the ~~relevant~~ requirements set out by the AER in the determination referred to in clause 6A.11.1(a), within such period as is required by the *AER* for that purpose, being a period that is not more than one month after the *AER* notifies the *Transmission Network Service Provider* of its determination."

It is recommended that:

1. the right to submit a revised proposal should be deleted; or

2. in the event that it is retained, a new clause should be inserted after clause 6A.12.3(a) in the following terms:

"A *Transmission Network Service Provider* may revise its *Revenue Proposal* or *negotiating framework* only so as to incorporate or substantially incorporate the changes required or to address the matters included in the draft decision."

It is recommended that the AEMC amend clause 6A.15(a)(2):

1. to provide for a revenue cap to be re-opened where it contains:
   (a) a clerical mistake;
   (b) an error arising from an accidental slip or omission;
   (c) a material miscalculation of figures or a material mistake in the description of any person, thing or matter referred to in the transmission determination; or
   (d) a defect in form;

or, *in the alternative*;

2. by inserting the words "of fact" after the word "error".

Incentive properties

It is recommended that the AEMC delete clause 6A.7.1

In the event the AEMC decides to retain the re opener provision, **it is recommended that** the AEMC delete the final paragraph in clause 6A.7.1(a).

It is recommended that new clause 6A.8.1(ba) be inserted after clause 6A.8.1(b) in the following terms:

"If the criterion in clause 6A.8.1(b)(2)(iii) is not satisfied, the *AER* may determine that a *proposed contingent project* is a *contingent project* if it is satisfied that, in all the circumstances, such a determination should be made."

Other outstanding issues

It is recommended that clause 6A.6.2 be amended as follows:

1. Delete paragraphs (f) to (i) and substituting the following:

"(f) the *AER* may, in accordance with the *transmission consultation procedures* and paragraphs (g)-(j), review one or more of:

(1) the values of and methodologies used to calculate:

(i) the nominal risk free rate;

(ii) the equity beta;

(iii) the market risk premium;

(iv) the maturity period and bond rates referred to in paragraph (d);

(v) the ratio of the market value of debt to the market value of equity and debt;

as set out in this clause 6A.6.2 or as subsequently revised under paragraph (g);

(2) the credit rating level as referred to in paragraph (e) or as subsequently revised under paragraph (g).

(j) The *AER* may, as a consequence of a review, adopt revised values, methodologies or credit rating levels and, if it does so it must, subject to paragraphs (h) and (i), use those revised values, methodologies or levels for the purposes of a *Revenue Proposal*.

(k) The *AER* must only use revised values, methodologies or levels for the purposes of a *Revenue Proposal* if there has been a period of at least 12 months between the date the *AER published* a notice under clause 6A.20(e)(2) of the making of its final decision on a review of a matter referred to in paragraph (f) and the date the *Revenue Proposal* is submitted to the AER under clause 6A.10.1.

(l) The AER must not use any revised values, methodologies or levels for the purposes of a *Revenue Proposal* that is submitted to the AER under clause 6A.10.1 before 1 January 2012."

2. Delete clause 6A.6.2(j)(4).