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First proposed guidelines
Australian Energy Regulator
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By email: AERinquiry@aer.gov.au

AER Electricity transmission Guidelines under the National Electricity Rules (NER)

Alinta is pleased to provide this submission on the drafts of the first proposed guidelines made by the AER in accordance with the AEMC's Rule for the Economic Regulation of Transmission Services of November 2006.

Alinta is the largest energy infrastructure company in Australia. Following the acquisition of gas and electricity assets from AGL, Alinta manages, operates or owns a diversified portfolio of energy assets worth $14 billion. Alinta serves energy supply to over 3 million electricity and gas customers. Although Alinta's interests in electricity lie primarily in distribution rather than transmission, Alinta is aware that the transmission framework has been the model for the draft distribution rules, but with significant modifications.

Alinta's perspective in this submission is therefore not simply on the role of AER guidelines proposed for transmission, but on their implications for electricity distribution and energy regulatory frameworks generally.

Some key messages in this submission are:

- A central issue for Alinta and others is that the AER guidelines must not impose new and substantive regulatory obligations on businesses (outside the Rules), thereby violating the MCE-agreed principle of separating rule making from rule administration;
- Alinta welcomes provisions in the Guidelines that regulated business, rather than the AER, will select the specific allocators for shared costs, and also the recognition that different allocators would apply to different regulated businesses;
- Alinta considers that the Guidelines should fully recognise the potential use of an avoided cost approach in cost allocation;
- Several of the Guideline proposals for carrying out information audits appear onerous and unnecessary;
- There are several instances where the Guidelines could express with greater clarity what information is required from regulated businesses.

Alinta would be pleased to clarify any aspect of this submission. I can be contacted on (02) 9270 4512 or sandra.gamble@alinta.net.au.

Yours sincerely,
Alinta Limited

Sandra Gamble
Group Manager Regulatory

ALINTA SUBMISSION ON AER ELECTRICITY TRANSMISSION GUIDELINES UNDER THE NATIONAL ELECTRICITY RULES (NER)

SECTION A – INTRODUCTORY ISSUES

1. BACKGROUND

The AEMC's 2006 review of Chapter 6 of the NER required the Australian Energy Regulator (AER) to produce (within certain timeframes) a number of "guidelines, schemes and models" (guidelines) dealing with revenue regulation.

While these guidelines were designed specifically for transmission, they have major significance for distribution businesses. The following sequence of events will assist in understanding why this is so:

- During the AEMC review (and after) there has been concern among regulated (particularly distribution) businesses that the guidelines specified by the AEMC Rule constituted (to varying degrees) a delegation of Rule making power to the AER. This concern arose from the binding nature of the required guidelines (on businesses) and their significant subject matter;

- Legal advice obtained by the distribution sector in September 2006[1] advised that the relevant guideline provisions of the NEL as it stood in 2006[2], although somewhat ambiguous, would not confer a power on the AER to require general compliance with guidelines. However, the draft NEL amendments of January 2007 contain a new s 34(3)(e) which appears to allow the AEMC to confer a general 'power of determination' on the AER with respect to distribution guidelines[3];

- In September 2006, the AER issued a 'Statement of Approach' to electricity distribution regulatory guidelines which outlined an intention to develop electricity distribution guidelines "as a separate process from gas distribution and electricity transmission". The AER proposed a similar range of guidelines to those in the Transmission Rule;

- The MCE/SCO Exposure Draft of the electricity distribution rules has positioned guidelines as a feature of the rules, covering similar matters to those required for the Transmission Rule;

- The AER's (transmission) Cost Allocation Guidelines *Issues Paper* indicates that the AER will adopt as far as possible common approaches for cost allocation between transmission and distribution[4]. It is not stated – but perhaps implied – that a similar approach will be adopted for all other guidelines, within the bounds of the relevant rules.

In summary, Alinta's major concerns with the transmission guidelines are that:

- They have been adopted as major influences on the distribution guidelines. This will raise a number of important questions during the course of the distribution rules

[1] Gilbert and Tobin, National Electricity Law: *Separation of rule–making and rule enforcement powers as between the Australian energy Market Commission and the Australian Energy Regulator*, 11 September 2006
[2] Particularly ss 34 (3)(c) (e) and (h)
[3] Rules made by the AEMC may 'confer a function on the AER, the AEMC, NEMMCO or a jurisdictional regulator to make, prepare, develop or issue guidelines, tests, standards, procedures or any other document (however defined) in accordance with the Rules, including guidelines, tests, standards, procedures or any other document (however defined) that leave any matter or thing to be determined by AER, the AEMC, NEMMCO or a jurisdictional regulator'.
[4] AER, First Proposed Cost Allocation Guidelines, *Explanatory statement and Issues Paper*, p 5

consultation as to the similarities and differences between the (established) transmission guidelines and the (proposed) distribution guidelines, and their intended roles in both frameworks;

- The guidelines should not intrude into rulemaking and go beyond the powers specified in the appropriate governing rule; and

- The guidelines should be appropriate for their purposes (given that similar provisions may carry over to distribution).

2. CURRENT CONSULTATION PROCESS

The AER anticipates that it will engage in the following process after publication of the draft guidelines:

- consider any written submissions received during consultation;
- if necessary, publish a further consultation draft and invite submissions and
- publish the final guidelines.

To the extent that the consultation uncovers substantive issues, Alinta urges that further consultation should be held. Alinta recognises that this may have implications for the for transitional guidelines already in place to cover the first round of revenue resets[5], but considers that there is adequate time to explore any additional concerns prior to finalising the current proposed guidelines in September 2007.

3. THE ROLE OF GUIDELINES

The background review in section 1 explored concerns over the mandated use of guidelines in the transmission and distribution regulatory frameworks, given the potential for guidelines to become quasi-rules. This concern is not alleviated even when consultation procedures required by the rules when developing “guidelines, models or schemes”. The central issue is that guidelines must not be permitted to impose new and substantive regulatory obligations on businesses, thereby violating the MCE-agreed principle of separating rule making from rule administration.

The guidelines required under the transmission and distribution rules deal with very substantive matters – namely, the specification of key inputs required for revenue determination, which is a central focus of the Law and Rules. On the other hand, the Transmission Rule is relatively prescriptive with regard to the form and content of the guidelines to be made, and to the extent that the AER guidelines faithfully reproduce the requirements of the Rule, their potential to become quasi-rules should be reduced.

Even so, Alinta considers that the proposed transmission guidelines need to be appraised for their consistency with the letter and intent of the Rule, as well as for general workability. These matters are addressed in section B. As noted, the AER must also be careful to ensure that its guidelines are not creating substantive new obligations and thereby crossing over into rulemaking.

Please note that this submission is not providing a detailed assessment of the content of all the proposed guidelines, schemes and models issued by the AER, but focusing only on selected items.

[5] Guidelines noted in Submissions Guidelines Issues Paper p4

SECTION B – DETAILED ISSUES

4. COST ALLOCATION GUIDELINES

Selection of allocators

Alinta welcomes the proposal that *inter alia*:

- The regulated businesses , rather than the AER, will select the specific allocators for shared costs, subject to the Cost Allocation Principles under the NER and the Cost Allocation Guidelines;

- The AER will assess and approve the allocators as part of its broader consideration of the Cost Allocation Methodology[6].

In addition, Alinta welcomes the recognition that different allocators will apply to different regulated businesses (albeit that they should all promote the Cost Allocation Principles)[7].

Given that the Rule does not require a 'universal cost allocation methodology' being developed and applied to all TNSPs, Alinta considers that the Guidelines should not mandate such an approach, but should positively affirm that it will not be contemplated. The Issues Paper cites adjustments and future consultations which could be canvassed in order to address the issue of comparability between businesses[8].

Supporting information

It appears to Alinta that the information required to be provided by the TNSPs to support their cost allocation methodologies and the procedures to be followed for approval has the potential be more than is necessary to meet the requirements of the Rule. The AER acknowledges that the Rule provides only high level guidance on the content of the guideline[9]. Further, as noted by the AER, the requirement on TNSPs to comply with the Cost Allocation Principles is achieved indirectly -

> *Clause 6A.19.4(b) provides that the Cost Allocation Methodology must give effect to, and be consistent with, the Cost Allocation Guidelines. As clause 6A.19.3(b)(1) requires the Guidelines to be consistent with, and give effect to, the Cost Allocation Principles, the Methodology must by implication also promote the Principles*[10]

In other words, TNSPs are presumed to comply with the Principles by complying with the Guidelines. This appears to Alinta to be a design weakness in the Transmission Rule, in that compliance could have been better achieved by requiring the TNSPs to comply with the Principles as the immediate priority, and secondly with the Guidelines which would have elucidated the Principles. As it stands, it appears that the Guidelines take priority, which means that compliance is filtered through any information, procedures or other requirements which the AER may include in the Guidelines, but which may or may not be compatible with the Principles.

Alinta suggests that two useful areas of clarification required in the Guidelines are the references to:

- *The business's detailed principles and policies of cost attribution and allocation---*

[6] Cost allocation Issues Paper section 5.2
[7] Ibid
[8] Ibid.
[9] Op cit section 5.1
[10] Op cit section 5.4

- *The nature of <u>each cost item</u>*[11] ----

Alinta comments as follows:

- Alinta acknowledges that the Cost Allocation Principles themselves do refer to "detailed principles and policies" used by a TNSP[12] for allocating costs, but this is used in the context of specifying sufficiency of information for the AER – ie the information must be sufficient to enable the AER to replicate reported outcomes. Alinta suggests that the Rule itself is not well phrased in specifying the level of detailed information required, since it appears repetitive in saying that "the detailed principles and policies-----must be sufficiently detailed" to enable replication[13].

  In summary, the repeated use of the word "detailed" in clause 2.2.1 of the Guidelines (four occasions) suggests a quantum of information which may not be warranted (or intended). Alinta has no issues with the actual information specified in clause 2.2.1.

- The reference to "each cost item" in 2.2.1 may also raise some concern, because it implies provision of a very high degree of specific information (which may not be intended). If this reference is simply a generic term to identify a particular cost category for allocation, then there is no issue as long as this is the AER's intention as expressed through the Guidelines. However, there would be a problem if the intention was to imply an unnecessarily detailed level of cost categorisation.

Avoided cost

The *Issues Paper* invites comment on (a) whether the avoidable cost method should be allowed under the guidelines and (b) whether it should it be restricted to immaterial costs. The proposed Guideline prohibits the use of an avoided cost basis of allocation[14] without the express permission of the AER. Alinta does not consider this appropriate.

The issues Paper argues that *the use of avoidable cost may be problematic where it can be a matter of considerable judgement as to the quantum of costs a business would save by no longer performing a particular activity*[15].

In Alinta's view, the above argument misses the real issue, which is that avoidable costs are an essential component of the efficient allocation of costs (ie a range between stand-alone and avoidable is efficient) and are in full accordance the NEL Objective. Uncertainty of estimation is not a valid reason to reject such an allocation; it is simply a reason to be cautious when using it. Further, an avoided cost approach is fully consistent with the requirements of the Rule for a causation basis of allocation[16] since it identifies the costs caused by a particular activity.

In Alinta's view, the suggestion that use of avoided cost be restricted to immaterial items has little value. If avoided cost is a legitimate basis of allocation, (as it is) then it is appropriate for material costs. If a cost is immaterial, then the choice of allocator is also likely to be immaterial.

Alinta therefore considers that the Guidelines should fully recognise the potential use of an avoided cost approach by the service provider, and should not require the express permission of the AER.

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[11] Op cit section 5.3 (Guidelines cl 2.2.1) – emphasis added
[12] AEMC Transmission Rule cl 6A.19.2(1)
[13] Ibid
[14] clause 2.2.4(e)
[15] Cost allocation Issues Paper section 5.2
[16] clause 6A.19.2.3 (ii) (A)

AER initiated changes

The proposed Guideline provides little guidance on the circumstances in which the AER may initiate changes to a Cost Allocation Methodology whereas the circumstances under which a TNSP may seek approval of a change to its methodology are closely prescribed [17].

Alinta considers that the Guidelines should adopt a symmetric approach, and more clearly specify the circumstances in which the AER may seek changes to a TNSPs Cost Allocation Methodology.

Audit of application of Cost Allocation Methodology

The Guidelines specify that where an audit is requested by the AER (under the *Information Guidelines* or the *Submission Guidelines*) of a TNSPs financial information used to prepare an approved Cost allocation Methodology, then

> *The scope of that audit or the form of independent assurance must include an assessment of whether a sample of allocations of shared costs accords with the TNSPs approved Cost Allocation Methodology*[18]

Alinta questions the imposition of an audit on information which has already been the subject of detailed investigation and approval by the AER. Moreover, it is not clear that the power to audit certified annual financial statements conferred on the AER by the Transmission Rule[19] extends to an audit of cost allocations by a TNSP.

The Guidelines require that an auditor have a duty of care to the AER and provide appropriate assurances to the AER [20]. Assuming that the AER does have a power to require an audit of cost allocations, the auditor's primary duty of care should be to the business itself, not the AER. This is especially so since the Guidelines make the business responsible for commissioning the auditor. The approach in the proposed Guidelines is not only problematic, but does not recognise that the business has the basic obligation to comply with the Cost Allocation Guidelines. Requiring an auditor to have a duty of care to the AER is both unreasonable and unnecessary.

5. SUBMISSION GUIDELINES

Alinta has not undertaken a detailed review of the Submission Guidelines, but makes a number of observations on the AER's general approach. The Guidelines are essentially about the information required to be provided by service providers in their initial Revenue Proposals – ie the prime focus of the Guidelines is on the upfront (starting) point of the review process.

Information requirements

The proposed Submission Guidelines go beyond their intended purpose by creating an obligation to provide the AER with ad hoc information in order to assess a TNSPs Revenue Proposal[21].

This requirement duplicates the regime contemplated by the Transmission Rule, which provides that:

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[17] clause 4.2
[18] Guidelines cl 5.3 (emphasis added)
[19] cl 6A.17.1 (e)
[20] cl 5.3(c)
[21] cl 2.6

- the information required in Revenue Proposal will be specified in the Submission Guidelines[22] and
- the AER will initially determine whether the information provided complies with the requirements of the Submission Guidelines and, if not, the additional information required and the reasons that information would be of assistance to the AER[23]

A requirement in the Submission Guidelines to provide information on an *ad hoc* basis is not appropriate or necessary. The purpose of the Submission Guidelines is to set out what must be included in the TNSP's proposal. It is intended to ensure that a TNSP's proposal is complete and give certainty about what is and is not required in a submission. Therefore the Guidelines must set out what is required as a minimum and not (in effect) be open ended.

Alinta notes that there is already a general power in the Transmission Rule which can require a TNSP to provide information to the AER that is required as an input to the AER's decision making in revenue determinations[24]. To seek to create (or appear to create) a power to gather information other than what is already provided for in the Rule is inappropriate. The AER should simply use the power under 6A.17.1.(d)(3) if and when required during a revenue determination.

Information on past capital expenditure

The Submission Guidelines propose the continued collection by the AER of detailed information about past capital expenditure, notwithstanding that the Rule simply requires actual capital expenditure to be included in a TNSP's regulatory asset base.

Alinta notes the draft electricity distribution Rules issued by the MCE contain a similar treatment of capital expenditure in relation to the capital base, and so a requirement to continue to supply information on past capital expenditure needs to be proportionate to the AER's genuine need for this information.

Lack of clarity of obligations created

The Submission Guidelines do not, on occasion, establish clearly when, how or why the AER intends to require TNSPs to supply new information or require audits of existing information. For example:

> *If so requested by the AER, a TNSP must give the AER full and detailed documentation of the financial and regulatory accounting principles and policies adopted in the preparation of the TNSPs Revenue Proposal. This must be provided in a way that ensures the AER understands the regulatory information and can make comparisons over time.*[25]

The above statement entails several uncertainties:

- There is no indication of the circumstances under which the AER would require this information; eg to supplement a Revenue Proposal or for some other purpose?
- There is no indication of what power would be used to obtain such information; eg either the ad hoc power proposed in the Guidelines (which as noted above may be disputable) or the general information collection power under cl. 6A.17.1 (d)(3) of the Transmission Rule;
- The specified information itself appears very broad. What for example would the AER regard as "full and detailed documentation"?
- The criteria in the second sentence that the provided information must *ensure the AER understands the regulatory information and can make comparisons over time* also appears very loosely defined.

[22] cl. 6A.10.1 (c)
[23] cl. 6A.11.1, 6A. 11.2
[24] cl. 6A.17.1(c) and (d)(3)
[25] Submission Guidelines cl 2.2(a)

Alinta suggests that such broad clauses in Guidelines are not of great assistance to regulated businesses. They should be replaced with a better specification of the information sought if the AER considers that it is essential to fulfil Rule requirements. If the latter, then the Guideline should specify what purpose is being fulfilled under the Rule.

Audit Assurance

The Transmission Rule provides that the Submission Guidelines may *specify the requirements for any information contained or accompanying the Revenue Proposal to be audited or otherwise verified*[26].

Based on this simple provision, the Guidelines have constructed an extensive audit regime in clause 2.8 which in Alinta's view contains elements which are onerous and unnecessary - eg the auditor's duty of care to the AER (see comments above under Cost Allocation Guideline).

Additionally, the Guidelines require the AER to be satisfied with the credentials and experience of the auditor (presumably also with a power of veto). In Alinta's view, the Guidelines should establish the minimum requirements for selection of the auditor that the AER will consider acceptable, and then leave the business to fulfil those requirements without AER intervention.

The Submission Guidelines repeat the provision in the Cost Allocation Guidelines that any audit of regulatory information must include at the same time an assessment of a TNSPs Cost Allocation Methodology. As noted above, Alinta questions the validity of, and need for, this requirement.

6. Post Tax Revenue Model (PTRM) (and Roll Forward Model)

Under the Rule, the AER is required to specify the timing assumptions and discount rates that are to apply in the PTRM in relation to the building blocks. The AER has asked several questions in relation to timing.[27]

Alinta considers that the currently used timing assumptions for capex and opex are workable and appropriate and reflect common industry practice. If a change to mid-year cash flows is contemplated, this must include a return on working capital.

The AER has also asked whether there should be a single PTRM on which all revenue proposals should be based, with adjustments for different regulatory control periods. Alinta endorses a flexible approach, with a capacity for the model to handle different review periods (ie there is no need for a suite of models to cover each control period from 5 to 10 years.

Alinta also observes the the Roll Forward is simply a subset of the PTRM and this needs to be pointed out in the relevant models (ie they are addressing virtually the same issues and inputs).

[26] cl 6A.10.2(b) (2)
[27] PTRM Issues Paper, s 3.4