



**Australian Energy Regulator**

**Further Comments in Response**

**to**

**First Proposed Transmission Guidelines**

**by**

**The Major Energy Users Inc**

**August 2007**

**Assistance in preparing this submission by the Major Energy Users Inc was provided by Headberry Partners Pty Ltd and Bob Lim & Co Pty Ltd.**

**Major Energy Users Inc acknowledges the financial support provided by the Advocacy panel in preparing this submission.**

**The content and conclusions reached are entirely the work of the Major Energy Users Inc and its consultants.**

## **Introduction**

The Major Energy Users (MEU) provides the following comments following yesterday's (22 August 2007) telephone conference with the AER and TNSPs.

This conference followed on from the observations we provided at the AER forum on 17 July 2007. At the forum there were a number of issues which were not resolved, and MEU recognised the need to pursue these matters further to ensure that the outcomes incorporated consumer views.

During the discussion on 22 August (and also at the 17 July Forum), the MEU noted, along with others, dissatisfaction with the AER process for determining these guidelines. Therefore MEU confirms, for the record, its strong disappointment with the AER's process to date on its draft guidelines on regulatory transmission revenues.

The AER has sought to explain away its failure to properly consult with stakeholders (by issuing a draft decision and then inviting stakeholder comment), by blaming timing constraints. The request by MEU (and others) at the AER's Forum on 17 July was ignored and the telephone conference (which was held on 22 August at the MEU's instigation) is not really sufficient. Indeed, key MEU concerns (expressed in its submission and at the Forum) were not even properly recognized.

The guidelines are very important. They will be applied to the various AER regulatory resets over the next few years, which will have very substantial impacts on consumers. It is important, therefore, that stakeholders have confidence in the integrity of the work undertaken by the AER and that proper, consultative processes form part of that work. The current review process has been a disappointment to the MEU.

## **MEU responses to AER draft letter provided as the basis for discussion on 22 August**

The following commentary on the issues by MEU uses the AER letter format. MEU comments are made in bold text.

### **1. Post Tax Revenue Model**

No matters were identified for further discussion.

**MEU:** It is not clear how the AER proposes to respond to the issues raised by the MEU in its earlier submission and in commentary provided at the AER Forum.

- On debt premium, what is the most appropriate method, as there are a number of approaches?
- On depreciation, how is the AER responding to the MEU's concerns about TNSP's ability to alter depreciation approaches between resets? These concerns were also detailed in commentary provided at the AER Forum. At yesterday's telephone conference we were assured that the AER expects that proposed depreciation will be equitable, and will require an explanation for a change from standard depreciation to be fully explained, and why there is a need for change.

**We will not have the opportunity to review the final text.**

## **2. Post Tax Revenue Model**

*Tax values roll forward sheet (ETNOF)*

The AER sent a revised Roll Forward Model to ETNOF and Energy Australia on 7 August 2007 for factual checking. No comments have been received to date. The AER would appreciate if any comments could be received by 24 August 2007.

**MEU:** The MEU has not been provided with the revised Roll Forward Model, which had been sent to ETNOF and Energy Australia.

## **3. Service Target Performance Incentive Scheme**

*Revenue at risk (ETNOF and MEU)*

The AER is retaining the revenue at risk under the scheme at one per cent. However, the AER will consider increasing it from this level in the future after it has undertaken a full review of the scheme to assess whether it is achieving its intended outcomes. In this regard, the AER considers it may be appropriate to place additional revenue at risk for any market impact of transmission congestion (MITC) parameters that may be incorporated into the scheme in the future. The MITC issue is currently under separate consideration.

**MEU:** The AER has not informed stakeholders its reasons for retaining the revenue at risk under the scheme at one per cent. At yesterday's telephone conference the excuse for not moving beyond 1%, as consumers had advocated, was the lack of time,

**but that there will be more exposition of AER reasons in the final decision.**

**In any case, the AER pointed to the Rules as specifying a maximum of 5%, so the 1% decision was within the Rules. The MEU considers the reasons given by the AER to be inadequate and poorly-advised. The MEU points to the debate on the 1% level, extending as long ago as March 2006 – some 18 months ago, when the 1% Vs 5% issue was debated at the AEMC’s public forum on its draft decision. The fact that the Rules specify a maximum of 5% is indicative that more weighting should be given than to maintain the historic level AER/ACCC of 1% used previously. The fact that the AER was aware that this increase was being sought should be sufficient to increase the allowance, and it is noted that TNSPs themselves have sought a higher level than the 1% that the AER will permit.**

**Statements that the AER will undertake a future review of the scheme do not allay the concerns that the AER’s current decision is inconsistent with the AEMC’s approach to incentive regulation.**

#### **4. Efficiency Benefit Sharing Scheme**

The AER has sought to develop an Efficiency Benefit Sharing Scheme (“EBSS”) which is simple to understand and apply, predictable, requires minimal adjustments and does not threaten the financial viability of a regulated firm.

#### *Clarification of Opex components to be included in the scheme (ETNOF and MEU)*

Whilst the focus of the EBSS should be on controllable costs, the AER notes that it is a difficult exercise to develop a comprehensive list of those uncontrollable cost elements that can properly be excluded. There is not universal agreement on the most appropriate treatment of this issue and views range from making no adjustments at all to development of a comprehensive list of all permissible exclusions. The AER considers a middle course is appropriate.

The AER considers that adjustments to forecast and actual operational expenditure arising from pass-through events, changes in capitalisation policy and growth should be applied in calculating carry-over amounts. Transmission Network Service Providers (“TNSPs”) will also be able to propose, for consideration by the AER, other adjustments in relation to uncontrollable events so that TNSPs are not unfairly penalised. The AER envisages that, over time, this approach will establish the appropriate range of

matters for exclusion. In addition, the AER is not proposing to incorporate potential efficiency improvements in setting benchmarks.

*Adjustments to carry forward calculation to ensure no 'double whammy' (ETNOF and MEU)*

As noted above, the AER considers some adjustments may be made to forecast and actual operating expenditure in calculating carry-over amounts.

*Carry forward of net negative amounts (ETNOF and MEU)*

The proposed EBSS is intended to provide ongoing incentives to TNSPs to achieve efficiency gains, when the opportunity arises. The AER considers, after carefully considering all submissions and views, that the symmetrical treatment of gains and losses is an essential design element of the EBSS. A major concern that can arise with the operation of this scheme is an under-estimation of efficient revenue in the next regulatory period to meet the opex needs of a business. This risk will be greatly diminished by planned adjustments to account for variations in major uncontrollable factors: new responsibilities; demand growth variance and pass-through events. TNSPs will also be able to propose additional categories of uncontrollable costs for consideration by the AER as part of their revenue proposals.

The application of both positive and negative carry-over amounts under the incremental rolling scheme design, which has previously been adopted by the ACCC as described in its Statement of Regulatory Principles, and the adjustments to forecast operating expenditure should mean that the magnitude of any negative carry-over amounts are likely to be small compared to the total allowed revenue.

The AER also proposes that the EBSS calculations be conducted in real, not nominal, terms to minimise errors arising across regulatory periods.

**MEU: see also comments below.**

**The MEU has a real concern that the carryover of negative amounts will reduce the amount of funds the TNSP will provide for operating the network. It is not in the interests of consumers that the AER reduce the funds needed to provide the service if the outcome will be that the TNSP intends for the reduced amount to be the maximum it will dedicate to providing the service. Consumers see that the outcome of such an approach will be to reduce the overall performance of the TNSP both in the short and medium terms.**

*Sharing basis to achieve fair sharing (ETNOF and MEU)*

The sharing ratio depends on the carry-over period and discount rate. The AER proposes a 5 year carry-over period in the EBSS which is consistent with the 5-year regulatory period. Therefore, assuming a real discount rate of approximately 6% and a 5 year carry-over period, the sharing ratio between TNSPs and customers is 30:70.

**MEU: From yesterday's discussions it seems that the EBSS will be based on:-**

- **Meeting the fundamental goal of encouraging the TNSP to achieve most efficient opex level. If it fails this test then AER will find another approach**
- **The actual opex used will be adjusted by exogenous impacts and will address opex which is controllable only by TNSP. The MEU considers that this is fair and reasonable, but TNSPs must provide a detailed basis for any adjustments**
- **The actual opex will be based on five years of history (yet stakeholders will not see this because AER refuses to give more than the current period actual opex and capex – see a later comment as this is a very contentious issue for the MEU) and not just on the current period performance.**
- **The EBSS must be symmetrical to achieve the goals of incentives and developing efficient opex**
- **The EBSS will carry over a negative amount into next period but the amount of any negative carryover will be assessed if the impact of the negative amount is considered to be detrimental to the interests of consumers. The AER notes that it will modify the amount carried over, but if this occurs then we expect that the amount not carried over will become a debt due for the next period**

**The MEU raises for discussion whether there should there be a Rule change to allow the AER to average actual opex over a longer term (eg average opex) rather than use just year 4 opex as the benchmark and so allow a better approach to the EBSS.**

**The MEU supports the sharing ratio between TNSP's and consumers at arriving at 30 : 70. As explained at yesterday's discussion, the funds arising are from consumers' contributions to the TNSP's, and as such, the sharing ratio is considered fair. It is also noted that the 30:70 is derived from a notional equal**

**sharing adjusted by a discount rate approach for addressing time impacts of payments.**

## **5. Submission Guidelines**

### *Relationship between Rules and Guidelines (ETNOF)*

The AER notes that the Submission Guidelines are consistent with the provisions of the National Electricity Rules and, as such, no distinction can be drawn between the two. Therefore, paraphrasing is not required.

### *Audit requirements (ETNOF)*

The AER will provide more detail and certainty regarding audit requirements to allow TNSPs sufficient time to arrange for suitable verification of their information. There will be no audit requirements for forecast capex and opex information and TNSPs will be able to choose from a number of options regarding the level of assurance provided. The AER also agrees that it is inappropriate for an auditor to explicitly provide a duty of care to the AER and this requirement will be removed.

**MEU: The MEU supports the principle of data being provided by TNSPs being demonstrably accurate – an audit approach is a cost effective method for providing confidence in the accuracy of the data provided**

### *Director's sign-off (ETNOF)*

The AER is proposing to amend the Directors' Statement from that provided in the January 2007 consultation documents. The AER considers the amendments to be reasonable regarding the assurances requested from Directors. This will entail redrafting to clarify that Directors are not expected to verify forecasts but merely that any estimates provided are the best available at the time.

### *Recognise change to ex-ante (ETNOF)*

The AER acknowledges that, under an *ex-ante* regime, historical capital expenditure will not be subject to the reviews undertaken for an *ex-poste* regime. However, the AER has an obligation to assess historical costs against the relevant original forecast costs when reviewing and assessing the forecasts

provided in a TNSP's Revenue Proposal. The AER considers that information on both historical and forecast capital expenditure are necessary components of a TNSP's Revenue Proposal to facilitate understanding of the firm's ability to implement the proposed capital works program.

**MEU: The MEU sees that the certainty provided by an ex post review of capex was always an essential element for providing control over TNSP spending habits. The MEU accepts that the Rules, as now drafted, prevent an ex post review of capex, and that actual capex will be automatically rolled into the RAB.**

**When these changes are taken into consideration with the acceptance that capex is based on a “probabilistic” approach (in that there is no requirement that any of the projects envisaged will proceed), the MEU considers that it is essential that there is not only the ability for the AER to investigate the historic performance (eg comparisons between forecasts and actual) of the TNSP, but that this should be an actual exercise undertaken, with the AER making a clear statement that their analysis has (or has not as the case may be) demonstrated confidence that the TNSP has exhibited the ability to make reasonable estimates for planned capex.**

**Based on this assessment we expect that the AER will make adjustments to allowed capex to reflect this performance of TNSPs.**

#### *Dealing with confidential information (ETNOF)*

The Guidelines have been amended to better reflect the intention of the National Electricity Rules (“NER”).

#### *Provision for safe harbours (ETNOF)*

The AER believes that TNSPs should have flexibility in preparing their Revenue Proposals. As such, ‘safe harbour’ provisions are not included in the Submission Guidelines. While TNSPs may find it useful to refer to Revenue Proposals previously accepted by the AER, they are also able to discuss specific matters with the AER in the course of the pre-lodgement discussions. Whilst not labelled as such, in particular respects, ‘default’ approaches are evident in the guidelines and the AER would regard submissions made consistent with the guidelines to *prima facie*, be compliant.

**MEU: The MEU agrees with the above AER proposals.**



## 6. Cost Allocation Guidelines

*Only higher level information relating to a methodology is required (ETNOF and MEU)*

The AER will provide further detail to clarify what level of detail should be provided to allow the AER to replicate the TNSP's reported outcomes as required by the NER.

**MEU: The MEU points out that this is a good example of the flawed process being used in regard to the development of these guidelines. That the AER is stating at this stage that there is additional clarity required at this stage of the guideline development is an indictment of the process.**

**If MEU had not insisted that further debate was essential in regard to the guidelines, then this issue would not have been addressed.**

*Audit requirements (ETNOF and MEU)*

The AER's proposals for audit requirements will be clarified. An important element of the AER's regulatory functions is to monitor and enforce compliance with the TNSP's Cost Allocation Methodology.

**MEU: see comment above**

*Clarify avoided cost is not prohibited (ETNOF and MEU)*

The AER proposes to allow application of the avoided cost methodology, subject to assessment of the circumstances.

**MEU: The application must provide support that the approved methodology has been used in the past and for the new period, especially that historic opex and capex has been allocated properly and that the forecasts use the same approach [ie no manipulation to get around the ring fencing guidelines]. The approach to using avoided costs as the basis might allow many costs to be added to prescribed revenue when in actuality they are used for other parts of the business. This potential loophole must be closed-off.**

## 7. Information Guidelines

The Information Guidelines share a number of important elements with the Submission Guidelines and, consequently, a consistent approach will be taken in relation to cost reporting and audit requirements, amongst other matters.

**MEU: Adequate and robust information provision is the basis for all efficient regulatory assessment and not providing an adequate amount to Interested Parties detracts from the regulatory process. The AER must not be permitted to undermine this principle because by doing so it places the regulator in the position of being prosecutor, judge and jury, rather than being able to judge an acceptable outcome based on the arguments put before it.**

**We need the TNSP's application to:-**

- **Provide explanation for any step change causing opex to increase**
- **Provide more than current period opex and capex. We have to respond to TNSP application based on the information provided with the application. Even if AER has more data than included in the application, this is not released by the AER until draft decision stage. This is totally inadequate. The AER commented that it doesn't have the power to require this additional information to be included in the application. This is very curious.**
- **Describe the performance of individual projects in the current period so that we can assess the ability of TNSPs to match forecast costs with actual – this is the only way we can get any confidence that ex ante approach to capex is being controlled. Just because a regulatory test has been done, doesn't protect consumers from over-runs. We would point to an outcome of the ex ante approach is that it provides an incentive to understate amounts in regulatory tests to have a network solution, as a TNSP can juggle other capex (because it was based on a probabilistic approach rather than a deterministic approach) to minimize the unfunded cost of over-running capex.**

**Unless at least 10 years of historical capex and opex data are required to be available for public scrutiny in relation to the new reset, Interested Parties will only be able to readily access 3 ¼ to 4 years' historical data (i.e. from the previous regulatory period), with the 5<sup>th</sup> year, at best, an estimate (which can be very wide off the mark).**

In response to the MEU concerns, the AER advised that it had access to the historical data, and therefore it could not require the application to include it. This may be the case, but there is no facility for the AER to provide this information to Interested Parties at the time an application is provided. We point to the recent ESCoV decision on electricity distribution in that it provided this data at the same time as applications were submitted. If the AER is concerned that it does not have the power to require the TNSP to provide the information in its application, then the AER must ensure that the information is provided in another way.

Yesterday's discussion with the AER was most unsatisfactory. Simply stating that the AER disagrees with the MEU is not sufficient reason for its position. The MEU has previously debated this issue and actively provided strong support for the AER to have adequate information disclosures and information collection powers during the development and reviews of the NEL, NER, NGL and NGR legislative packages. To have its interests in a longer historical series so lightly dismissed is not welcomed, and reflects a poor understanding of consumer interests in transparency and information disclosures in regulatory reviews.