EnergyAustralia's submission to

Australian Competition &
Consumer Commission

ACCC Draft Statement of Principles for the Regulation of Electricity Transmission Revenue

29 October, 2004

Energy

EXECUTIVE SUMMARY

EnergyAustralia welcomes the opportunity to participate in the ACCC's review of the Statement of Principles for the Regulation of Electricity Transmission Revenues. EnergyAustralia considers the Statement of Regulatory Principles (SRP) as a living document and agrees that it should be subject to periodic review. Such a review ensures the regulatory framework remains relevant and responsive to the needs of customers and the industry alike. However, there is a risk that constant review will create unnecessary levels of regulatory risk that could undermine the purpose of the SRP itself.

EnergyAustralia has long held the view that the concurrent assessment of EnergyAustralia's revenue cap for the 2004-2009 period and the review and redesign of the capital investment framework has introduced significant risks to EnergyAustralia. Yet despite raising these issues from the outset, the ACCC has continued to redraft the Statement of Regulatory Principles and redesign the framework attempting to concurrently apply it in practice. EnergyAustralia maintains that it is inappropriate to apply a framework while it is still being developed.

We are disappointed that consideration of forms of economic regulation other than a revenue cap has not been undertaken as part of the review by the ACCC of its regulatory principles. This would have been an opportunity to canvass public response on this important matter and allow some initial assessment of the appropriateness of a Code change to facilitate alternative approaches. While the Code prescribes a revenue cap for TNSP's, EnergyAustralia notes that the Code does provide for a price cap for distribution networks. The ACCC has suggested that certain Code changes may be required to fully implement its SRP, and in this light we are disappointed that the issue of price caps has not been contemplated.

EnergyAustralia is fundamentally opposed to the introduction of an *ex-ante* firm cap on capital expenditure. We have concerns that elements of the proposed *ex-ante* framework are inconsistent with the requirements outlined in the National Electricity Code (the "Code"). EnergyAustralia believes that there is no support in the Code for a regulatory regime that fails to recognise prudent investment on an ongoing basis, regardless of whether it is above or below a capped amount.

EnergyAustralia is also concerned that the firm cap would threaten service levels whenever expenditures exceed the firm cap. Should investment above the level of the firm cap be required to maintain service levels, a business is faced with the choice of not investing – thereby reducing service outcomes – or investing to maintain service outcomes and having its investment "written off". Neither of these options is acceptable.

The recognition of actual investment could be achieved either through a continuation of the existing *ex-post* framework, with only minor modifications to the current investment criteria, or through explicit acknowledgment within the *ex-ante* framework that expenditure above the cap will be recognised at the subsequent reset if it can be demonstrated to be prudent and efficient.

EnergyAustralia recognises that the ACCC is required by the Code to ensure transparency in decisions, certainty in investment, and incentives to promote efficiency in expenditure. The ACCC has introduced sweeping changes to the current framework under the guise of meeting these obligations. EnergyAustralia believes the new framework has been developed in haste and ignores the merits of the current framework that already delivers these outcomes.

We believe that balanced, desirable outcomes can be achieved without requiring wholesale changes to the underlying incentive mechanisms implicit in the current regulatory framework. Neither the ACCC's review process nor EnergyAustralia's experience demonstrates wholesale regulatory failure, imprudent investment or declines in service standards.

EnergyAustralia welcomes any attempt by a regulator to explain their approach to carrying out its functions. However it must be borne in mind that a document such as the SRP cannot expand the powers of the ACCC under the Code nor can it fetter the discretion of the ACCC when exercising power and making decisions. The most that the SRP can do is to provide a guide to the manner in which the ACCC will carry out its functions. The SRP cannot be used to justify the ACCC exercising its functions in a manner which is inconsistent with its obligations under the Code, nor can it inappropriately bind the ACCC so that it does not properly exercise its discretion under the Code.

EnergyAustralia has some concerns that some matters contemplated by the ACCC in the SRP are inconsistent with the requirements of the Code and we have indicated this in relevant parts of the submission. However, there may be other areas where the SRP is not appropriate which are not currently apparent and consequently EnergyAustralia is not commenting on whether the SRP is proper in all respects.

ACCC DRAFT DETERMINATION ON THE STATEMENT OF REGULATORY PRINCIPLES

1. REGULATORY FRAMEWORK

1.1. The Role of the Statement of Regulatory Principles

EnergyAustralia welcomes any attempt by a regulator to explain their approach to carrying out its functions. However it must be borne in mind that a document such as the SRP cannot expand the powers of the ACCC under the Code nor can it fetter the discretion of the ACCC when exercising power and making decisions. The most that the SRP can do is to provide a guide to the manner in which the ACCC will carry out its functions. The SRP cannot be used to justify the ACCC exercising its functions in a manner which is inconsistent with its obligations under the Code, nor can it inappropriately bind the ACCC so that it does not properly exercise its discretion under the Code.

EnergyAustralia has some concerns that some matters contemplated by the ACCC in the SRP are inconsistent with the requirements of the Code and we have indicated this in relevant parts of the submission. However, there may be other areas where the SRP is not appropriate which are not currently apparent and consequently EnergyAustralia is not commenting on whether the SRP is proper in all respects.

1.2. Form of regulation

EnergyAustralia is a strong advocate of price caps to be adopted as the preferred form of regulation for network businesses. This stance is consistent with:

- providing incentives for efficient pricing (as discussed below);
- providing price stability to customers and retailers;
- the form of regulation applied to the NSW electricity distributors, and in particular the form of regulation applying to approximately 90% of EnergyAustralia's electricity network;
- the form of regulation applying to the Victorian electricity DB's;
- the form of regulation underpinning the National Gas Access Code; and
- the findings of the Parer Report on the national energy market review that recommended price caps for distribution businesses.

We are disappointed that consideration of forms of economic regulation other than a revenue cap has not been undertaken as part of the review by the ACCC of its regulatory principles. This would have been an opportunity to canvass public response on this important matter and allow some initial assessment of the appropriateness of a Code change to facilitate alternative approaches. While the Code prescribes a revenue cap for TNSP's, EnergyAustralia notes that the Code does provide for a price cap for distribution networks. The ACCC has suggested that

certain Code changes may be required to fully implement its SRP, and in this light we are disappointed that the issue of price caps has not been contemplated. EnergyAustralia raised this issue in its original submission to the ACCC on the SRP, and maintains that separate consultation on this issue is warranted – we request that such consultation takes place before any changes to the existing SRP are finalised.

1.2.1. Pure revenue cap

EnergyAustralia has a strong preference for a price cap over a revenue cap as a price cap overcomes many of the conceptual and practical deficiencies of a revenue cap[1]. A revenue cap:

- distorts investment signals in situations where forecasts of demand patterns or quantities are unpredictable;
- weakens price signals to customers and masks demand side participation in the market;
- is inflexible and ill-aligned with transmission providers responsibilities to the market and society to provide a reliable electricity supply;
- provides the TNSP with no incentive to encourage any use of the network that would result in higher costs, irrespective of whether the benefit to the consumer is greater than the cost to society of that use. This is clearly inefficient, as the business has a financial incentive to minimise the use of the service to the extent that it lowers costs – even if the marginal benefit to customers is greater than the marginal cost to the business of providing the service;
- means marginal revenues are set by the regulator (in this case to zero) and are completely independent of prices. As a result, the best this form of regulation can hope for is indifference on the part of the business with regards to its prices. However, if the marginal revenue is set above (or below) marginal cost, then this creates an automatic incentive for the business to price below (above) marginal cost;
- provides, at best, a neutral incentive for efficient pricing and, at worst, an incentive to price inefficiently. This creates strong incentives for inefficiently high prices;
- has no mechanism to manage forecast volume risk; and
- requires the use of an adjustment mechanism to account for any differences between actual and forecast revenues. This can not only be complex to administer but can also result in significant year-on-year price shocks as the account balance is resolved.

1.2.2. Price cap

EnergyAustralia considers that a price cap (in the form of a Weighted Average Price Cap, "WAPC") is a far superior alternative to the revenue cap. Under a price cap:

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[1] Adapted from previous EnergyAustralia submissions during the leadup to the IPART's July 2002 "Notice under clause 6.10.3 of the National Electricity Code - Economic Regulatory Arrangements". Also adapted from the September 2001 paper from NERA paper titled "Efficiency Properties of the Form of Price Control – A report for Integral Energy, EnergyAustralia and Country Energy" which formed part of our submissions.

- the marginal revenue received for each additional unit varies according to the marginal price charged for that unit, rather than being set to zero (as set by the regulator) for the revenue cap;
- if marginal prices equal marginal costs, then the business has effectively hedged its output. That is, output prices for expected levels and changes in costs are matched by changes in revenues. Importantly, the incentive to match marginal prices to marginal costs is, by definition, an incentive to price efficiently. This incentive exists with the WAPC, but clearly does not exist with the revenue cap;
- a network business can manage the demand for network capacity through efficient (ie., marginal cost) pricing. This gives customers the appropriate incentive to:
  - reduce total demand for network capacity;
  - shift demand for network capacity to off peak periods; or
  - change the nature of demand for service quality and type (ie., move to interruptible tariffs);
- the business has an incentive to reflect all of the marginal cost drivers in marginal prices and the flexibility to adapt them over time as appropriate;
- the business can manage volume risk more effectively, and employ demand side management tools;
- customers experience greater price stability; and
- administration is considerably more streamlined than under a revenue cap.

TNSP's regulated under the Code (including EnergyAustralia, due to the nature of our network[2]) are subject to revenue cap regulation. We note that IPART, in its 2004 Electricity Distribution Price Review, given the choice, decided to move away from a revenue cap to a price cap (WAPC) after an extensive consultation process. EnergyAustralia was a key advocate of the move to a WAPC and applauds IPART in acknowledging the benefits of such a move. We encourage the ACCC to also examine the potential for a move to a price cap as part of its SRP review.

1.3. Building block approach

EnergyAustralia accepts that most regulators throughout Australia have adopted the building block approach to the setting of allowed (or targeted) revenues and that such an approach represents a reasonable method for determining notional revenue requirements for regulated businesses. The building block approach, however, is not the only potential approach to economic regulation. In fact, there are many more "light handed" approaches, including price regulation, price monitoring, and TFP-based price escalation that have merit and should be reviewed periodically to assess their viability. At the current time, however, EnergyAustralia believes that the building block approach is the most developed and understood approach to economic regulation, and therefore we believe that it should be maintained for revenue setting purposes in the short to medium term. While the "lighter-handed" approaches may be preferred

[2] Transmission assets represent approximately 12% of EnergyAustralia's Network. Although the network is operated as a single network, for the purposes of regulation it is considered separately as transmission and distribution.

in the longer term, we believe it appropriate for the ACCC to continue to adopt the building block approach for at least the next five years.

In this context, it is important that there is clarity on how each of the individual building blocks is calculated. In addition, it is essential to assess how the resulting "package" of calculated revenues is impacted by the various incentives that the ACCC is contemplating introducing into the regulatory framework. It is in this regard that EnergyAustralia wishes to focus its critique.

1.4. Incentive regulation

1.4.1. The need for balanced incentives

The ACCC acknowledges the inter-relationships between incentive schemes and how they operate within the context of a regulatory regime. The objective, it argues, is to deliver a balanced regulatory regime: one where the incentive to reduce opex must be balanced with the incentive to reduce capex; and the incentive to improve service standards should be balanced with the incentive to reduce all expenditures.

Despite going through great lengths to articulate the interdependent nature of the incentives for capex, opex and service standards, the ACCC fails to demonstrate beyond the most rudimentary of reviews any balance in the overall framework put forward. EnergyAustralia expected that where wholesale changes were proposed to virtually all elements of the regulatory regime, a greater focus would have been placed on ensuring that the incentives work together as part of an integrated regulatory framework. The ACCC appears to have addressed this issue with cursory attention only.

The ACCC recognises the need for balanced incentives but dedicates the vast majority of the draft SRP to explaining how each incentive mechanism works independently rather than how each works in conjunction with other aspects of its proposed framework. The best the ACCC appears to offer is to "monitor and keep under review" the potential to substitute capex for opex and vice versa, or that "care will be taken to ensure that capex incentives do not threaten to erode service quality". EnergyAustralia believes that these limited comments prove that the ACCC has not thoroughly analysed and reviewed the wider ramifications of the introduction of their incentive mechanisms for capex, opex and service standards. EnergyAustralia is therefore concerned about unanticipated impacts that the framework may have on its ability to meet its supply obligations and in particular, how a regime under development could be applied to EnergyAustralia's current regulatory review.

1.4.2. Incentives in the current framework

EnergyAustralia believes that the ACCC has not adequately recognised the incentives created within the CPI-X incentive framework that underpins the National Electricity Code. In fact, the ACCC has implicitly disregarded the current incentives within the existing framework altogether without establishing the "need for change". EnergyAustralia believes that the ACCC should not move away from the current framework without a detailed assessment of the costs, benefits and incentives created. As noted previously, EnergyAustralia is concerned that the SRP is characterised by a set of individual proposals that have been prepared in isolation, with little

attention to the incentives created in the overall "package". EnergyAustralia suggests that caution be applied before any such moves are contemplated.

In the pursuit of delivering a highly-incentivised regulatory regime, the ACCC has suggested the following:

- an asymmetric, *ex-ante* firm cap on capital expenditure;
- a symmetric efficiency carry-forward mechanism for operating and maintenance expenditure; and
- a service standard incentive mechanism.

The ACCC has decided that the incentive properties of the existing framework are not sufficient to drive optimal investment outcomes and has therefore proposed an overhaul of its framework.

EnergyAustralia believes that the current *ex-post* framework, with some relative minor refinements, would deliver the outcomes the ACCC, and all other stakeholders, are seeking. The following sections outline the incentive properties inherent in CPI-X regulation in general, and for capital investment and operating and maintenance expenditure more specifically.

CPI-X regulation

Under the CPI-X revenue cap framework (for transmission) a revenue path is established for five years on the basis of the cost building blocks – based on return on capital, return of capital (depreciation), required operating and maintenance costs, and an allowance for taxation. Once set, the revenue cap by definition provides both a cap and a floor on the revenues a TNSP will receive in each year of the determination. Therefore, as incremental revenues are always equal to zero under a revenue cap, a profit maximising firm has the strong incentive to reduce its costs in order to maximise profits. In fact, a dollar of efficiency gain (loss) relative to the assumptions underpinning the revenue cap, *a priori* results in a one dollar increase (decrease) in earnings before interest and taxes (EBIT) that the firm retains for the remainder of the regulatory period. If the efficiency gain is recurring in nature, the firm will receive the benefit (face the cost) of the efficiency gain (loss) for each remaining year of the regulatory period. This is a very strong incentive for businesses to pursue efficiency gains.

It must be noted, however, that for every dollar of efficiency gain achieved by a TNSP, it is customers that receive the vast majority of the benefits of that efficiency gain through lower prices than would otherwise have been the case had the efficiency gain not been achieved[3].

EnergyAustralia notes that the ACCC (and other regulators) have spent considerable time contemplating whether an "efficiency carryover" mechanism (see Section 5.4) is needed in order to provide a stronger incentive for a business to pursue efficiency gains. In particular, whether an additional incentive is required to ensure the business has the same incentive to pursue efficiency gains irrespective of the timing within any given regulatory period. We caution that "tinkering" with the framework in this regard to provide what could only be considered marginal benefits are likely to be outweighed by the costs of introducing additional complexity.

[3] This sharing of benefits between customers and the business is well founded in regulatory literature. See, for example, ACCC, *Final Decision: GasNet Access Arrangement 2002*, Nov 13, 2002, p. 271-2.

We note that the ACCC has not outlined the need for change beyond anecdotal evidence and noting that businesses should have a strong incentive to pursue efficiency gains regardless of which year in the regulatory control period the business is in.

As noted previously, the revenue cap by its very nature (as distinct from CPI-X regulation more generally) creates incentives that are not efficient.

It is not appropriate to contemplate a vast array of changes to the incentive mechanisms without establishing the need for change. We believe the introduction of a price cap and the strengthening of the criteria used to determine prudence and efficiency within the *ex-post* framework would deliver the desired results.

Capital investment under an* ex-post *framework

Under the existing *ex-post* framework a revenue path is established for five years on the basis of the building blocks. Approximately 75% of the revenue path for a TNSP relates to the return on and return of capital associated with the capital base. Due to the capital-intensive nature of a TNSP, the treatment of the capital base is paramount to facilitating the ongoing efficient investment in the network. Under the *ex-post* framework, a TNSP invests in its network in response to various investment drivers and at the end of the five year period demonstrates to the regulator the prudence and efficiency of its investments over the period. Once prudence and efficiency has been demonstrated, the regulator includes the spent capital in the regulated asset base which forms the majority of the revenue for the following five years.

If a TNSP is unable to demonstrate the prudence of its investment, the regulator may not recognise the asset in the regulatory asset base, which means that the TNSP has effectively "written-off" or "stranded" its investment. This *ex-post* assessment of prudence and efficiency is a very powerful driver to ensure that the business invests appropriately. Ideally, investment criteria would be established by the regulator to guide investment decisions and to assist the TNSP in the provision of appropriate information to demonstrate prudence at the review.

If a TNSP invests less capital than it has been allowed by the regulator, it is able to keep the higher returns associated with the dollars that were not spent for the remainder of the regulatory control period only. At the time of the review, the TNSP must demonstrate prudence of its investments and only the prudent spend will be recognised in the asset base moving forward. Customers will receive the majority of the benefits of any lower capex than assumed in the revenue cap, through lower prices indefinitely compared to the case had the efficiency "gain" not occurred.

If a TNSP invests an amount that is higher than that allowed in the revenue cap, it does not receive a return on that investment during the period. Not only does investing more than the capital allowance result in reduced returns for the TNSP and compromise its cash-flow position during the regulatory control period, a higher level of spending is likely to draw a higher level of scrutiny to the non-forecast investment when reviewed by the regulator. A critical aspect of the *ex-post* framework is that the business has the opportunity to demonstrate why investment over forecast levels was prudent and efficient. If it is able to do so, the investment will be added to the asset base and reflected in full in regulatory revenues in subsequent regulatory periods.

As noted above, if prudence and efficiency cannot be demonstrated, the investment becomes stranded. EnergyAustralia is strongly of the view that the TNSP has no incentive to spend more

than the amount allowed under the revenue cap under the *ex-post* framework. It is not reasonable to conclude that expenditure above regulatory forecasts is inefficient. If more capital is invested than the level that underpins the regulatory revenues, despite powerful incentives not to do so, it clearly suggests a strong need for the investment to ensure (among other things) the security and reliability of the network.

The recognition of past spending at the time of the subsequent review is key to establishing whether the framework provides an incentive to invest. If the regulator recognises past spending and the holding costs (if any) of those investments, the business is NPV neutral. However, the TNSP bears significant risk that the regulator may not accept all projects as prudent. The risk is even higher when the investment criteria has not been made explicit. The business, therefore, has the incentive to ensure that all its spending can be demonstrated to be prudent and efficient. If the regulator does not recognise the foregone return on the higher capital expenditure, even if it recognises the actual investment that was not included in the allowance, the TNSP still faces a negative NPV on that investment.

Fundamentally, capital investment is required to operate a safe and reliable network. EnergyAustralia believes that too much emphasis on comparisons with forecasts with no ability to review the merits of the particular investment, regardless of whether it is in all cases higher or lower than the initial regulatory forecast (as is the case with the ACCC's *ex-ante* cap) results in a poor regulatory outcome that provides a disincentive to invest efficiently.

Operating and maintenance expenditure under an* ex-post *framework

Under the revenue cap, a TNSP's revenue line incorporates an allowance for opex which is ratified by the regulator on an *ex-ante* basis. The business may keep any higher returns resulting from lower than forecast operating expenditure for the remainder of the regulatory period. Therefore, there is a direct incentive for the TNSP to spend less than the opex allowance. This incentive is made even greater as any spending over the opex allowance is likely not to be recognised at all by the regulator in any regulatory control period given a regulatory disposition to treat higher than forecast expenditure as "inefficient". The TNSP has no incentive within the period to spend any more than the minimal level of opex required to maintain its service obligations.

EnergyAustralia would argue that TNSPs will limit opex spending in all years as there is no financial benefit in having higher than necessary operating expenditures. Furthermore, EnergyAustralia believes that the notion that "strategically" higher spending in the final year to attain a higher base for future years, while plausible in theory, would be a very risky strategy as the business would be trading off guaranteed lower returns in year five of the existing regulatory control period for the remote chance of receiving a higher opex allowance in the future. This is particularly the case given the detailed review of forecast expenditures generally undertaken as part of regulatory reviews, including EnergyAustralia's current revenue-reset. EnergyAustralia considers this would be a highly questionable strategy. If the regulator did not review the past year's spending as prudent, there would be no benefit in future years resulting in a "lose-lose" situation for the business.

1.4.3. Adequacy of the current incentives

As previously noted, EnergyAustralia believes that the incentives embedded in the current regulatory framework are adequate and have resulted in major initiatives designed to achieve ongoing efficiency gains.

EnergyAustralia has recently introduced its revised capital governance framework to drive greater transparency and accountability of decision making and capital delivery. The framework has been driven by internal needs, resulting from a significantly increased capex program for its network, and recognition that demonstrating prudence and efficiency to external parties is a necessary requirement for a regulated business.

EnergyAustralia has also undertaken a major revision of its operating program to better target maintenance activity. The move from a time- to condition-based program will deliver long term efficiencies in the maintenance program and improve condition monitoring and ensure strategic analysis of replacement programs.

In short, EnergyAustralia can demonstrate that it has responded to the existing incentives in the regulatory framework and that they are sufficiently strong to drive major operational reforms to pursue efficiency gains. They do not require wholesale change as suggested by the ACCC.

2. REVENUE CAP DECISION-MAKING PROCESS

2.1. Regulatory review time-lines

EnergyAustralia supports the extension of the regulatory review period, and suggests that the mooted increase to 12 months represents the minimum timeframe within which to develop a final decision. EnergyAustralia notes the inadequacy of the ACCC's timeframe for conducting the current review of NSW TNSPs, resulting in a one-year delay to the finalisation of that decision. It is EnergyAustralia's view that the SRP does not meet the ACCC's obligations under 6.2.4(b) of the Code to publish a description of the process and timetable for re-setting the revenue cap and that this would need to be undertaken prior to the commencement of the revenue cap review for each regulatory control period.

2.1.1. Requirement for the Submission of an application

EnergyAustralia has no objection in principle to the requirement to lodge an "application" in relation to its revenue cap re-set, notwithstanding that such applications are not contemplated by the Code. In fact, EnergyAustralia is strongly of the view that the appropriate approach to revenue regulation is one where the TNSP puts forward a proposal to the regulator which fully sets out a proposal from the TNSP of the service and price offering for the upcoming regulatory period which in the view of the TNSP is consistent with the requirements of the Code.

The role of the regulator should be to respond to this application by treating it as the appropriate basis for a determination unless it can be demonstrated that it is not consistent with the Code. The approach put forward by the ACCC appears to be limited to the TNSP putting forward its proposal, including rules such as the pass through rules which presumably will be reflected in each TNSP individual determination. EnergyAustralia urges the ACCC to take a more symmetrical approach to TNSP 'applications' and treat them as a complete package forming the basis of the TNSP revenue cap if accepted by the ACCC when consistent with the Code

2.2. Late submissions

EnergyAustralia believes that the method proposed for dealing with late submissions in the draft SRP, including reasons for the delay and an explanation of the detriment if the ACCC does not consider the submission, is appropriate.

2.3. Information requirements

EnergyAustralia welcomes the inclusion of more thoroughly and clearly defined information requirements detailed in Appendix A of the draft SRP. However, we note that it does not amend the *Information Requirement Guidelines* or impose any obligations under clause 6.2.5 of the Code. EnergyAustralia believes that further articulation of the necessary detailed information that we will be required to supply in advance of the next review will reduce the uncertainty that has characterised the current review process.

EnergyAustralia believes that adopting a “template” approach, similar to that used by IPART in its 2004 Electricity Distribution Price Review and the ESC in its 2006 Electricity Distribution Price Review, is an appropriate way to set out the information required well in advance of receiving initial submissions from TNSPs. In particular, the ESC process provides a high degree of clarity to the information requirements for the price review with considerable accompanying commentary as to how this information will be used. We believe the ACCC should adopt this approach as it provides more certainty to the business and transparency to the process, while at the same time minimising the need for a proliferation of ad-hoc requests.

2.4. Confidentiality

The requirements set out in the SRP regarding confidentiality do not appear unreasonable but do not properly reflect the requirements of the Code. The ACCC should note that all information provided to the ACCC as part of a revenue cap application is effectively provided under clause 6.2.5(c) of the Code as it has been requested by the ACCC to enable it to perform its regulatory functions. The fact that the ACCC has not formally referred to these provisions in its SRP does not change the fact that it is requested information from TNSPs to enable it to carry out its regulatory functions. Consequently all information provided to the ACCC by a TNSP in its “application” should be treated as confidential and subject to 6.2.5(e) of the Code and the procedures set out in clause 6.2.6(b)-(e). However, is not inappropriate for the ACCC to request in the SRP that TNSP’s indicate in its application which information it consents to being released by the ACCC as contemplated by clause 3.5 of the SRP.

2.5. Provision of information by the ACCC

EnergyAustralia concurs that provision of the financial model to be used in determining a TNSPs revenue cap is a necessary and welcomed requirement of the review process.

3. ASSET BASE

Regardless of the detailed methodology adopted, the asset base framework should promote the achievement of Financial Capital Maintenance (FCM) within the regulatory control period, such that the forecast closing balance is equivalent to the opening RAB less the net cash movements for the regulatory period. Any framework that does not have this as a core policy creates a regulatory environment that is unstable and subject to significant regulatory risk, with the asset investors needing to be compensated accordingly.

3.1. Roll forward versus revaluation

In principle, EnergyAustralia prefers the use of a roll-forward approach to determining the RAB. This approach significantly reduces the subjectivity associated with other forms of valuation and provides more certainty that prudent and efficient investment will earn a regulatory return over the lives of the assets. EnergyAustralia concurs in principle with the ACCC's decision to 'lock-in' the RAB. However, this is clearly contingent upon the clear articulation of a robust methodology that is internally consistent with the building block approach and the incentive elements of the regulatory framework adopted by the ACCC. In the absence of such detail surrounding the ACCC's roll forward methodology, when EnergyAustralia was required to submit its revenue submission to the ACCC in September 2003, EnergyAustralia was compelled to endorse an DORC valuation for its 2004 reset.

3.2. Value to be locked-in

The ACCC notes that in its discussion paper on the DRP it listed three main options for future reviews of the RAB. These are listed below:

- Option One: Revalue assets on a period basis using a valuation method such as DORC.
- Option Two: Set the RAB using the jurisdictional value plus an adjustment for new investment.
- Option Three: Conduct a one-off revaluation using DORC and then roll in new investment.

The ACCC states that it prefers Option Two, citing support from a number of TNSPs including EnergyAustralia. This was not EnergyAustralia's preferred approach and in fact we supported adopting Option Three. EnergyAustralia has spent considerable time in both its initial submission on the Transmission Revenue Determination[4] and subsequent submission on the Discussion Paper on the DRP[5] arguing that a one-off revaluation using DORC is necessary for the 2004-09 Revenue-Reset in light of the material errors and inconsistencies in the 1999 jurisdictional valuation for EnergyAustralia's transmission network. EnergyAustralia continues to hold this position.

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[4] EnergyAustralia, *EnergyAustralia's submission to the ACCC : Transmission Revenue Determination 2004-2009,* Sep 23, 2003, p. 35-8.

[5] EnergyAustralia, *EnergyAustralia's submission to the ACCC : Review of Draft Statement of Regulatory Principles,* Nov 28, 2003, p. 7-8.

Further EnergyAustralia believes that assets that change regulatory jurisdiction from distribution regulation to transmission regulation should be initially valued at ODRC. While this may be an issue unique to EnergyAustralia, the initial valuation of these assets using ODRC would ensure that there is value parity between all elements of the transmission network, and that the remaining value is neither too high nor too low. The valuation parity will also ensure pricing parity for CRNP direct connect customers.

3.3. More details required on roll forward approach

While the ACCC discusses its general approach to the asset valuation issue and indeed covers some areas in detail, there is still much of the technical detail of how to actually conduct a roll forward that is left undefined in the SRP.

EnergyAustralia notes that there is no one universally agreed approach to calculating a roll forward, and in fact there are a number of variations in the manner in which one could be conducted. In the TransGrid 2004-2009 draft Determination, the ACCC recognised that:

> *"(p)arameters that affect the roll-forward calculation include the choice of pre-tax or post-tax WACC, the treatment of inflation, the calculation of depreciation and remaining asset lives. There are a variety of ways to specify each of these and each affects the determination of the closing RAB."*[6]

Given that the ACCC recognised the potential variability in roll forward outcomes contingent on the view taken on the individual parameters, EnergyAustralia is surprised that it has not endeavoured to provide more specific details in the SRP as to how it intends to roll forward the asset base. The lock-in approach is intended to provide greater certainty, yet this certainty will be dampened as the ACCC fails to provide clarity over positions on key parameters.

EnergyAustralia also notes that a number of key concerns it raised with the ACCC in its initial submission on the Revenue-Reset for 2004-2009 and the response to EnergyAustralia's draft Decision, have yet to be addressed. As part of the review of the SRP, EnergyAustralia requests that the ACCC address these issues in detail.

3.4. Treatment of individual RAB components

As part of the roll forward methodology, the ACCC has gone to some lengths to outline at a high level how the RAB will be treated based on the second round re-sets. EnergyAustralia provides comments on each of these individual elements below:

Capital expenditure

EnergyAustralia believes that any efficient overspend should be rolled into the asset base. The TNSP should be compensated for any investment above regulatory forecasts with an allowance for the foregone return on capital or 'holding costs' associated with that expenditure to be included in the asset base. The incentives of such an approach are to facilitate

[6] ACCC, *NSW and ACT Transmission Network Revenue Cap – TransGrid: Draft Decision,* Apr 28, 2004. p. 42.

investment at any point, regardless of whether the prudent and efficient costs exceed the regulatory forecasts.

However, the ACCC's proposal to roll in the lower of the present value of the total actual investment and the present value of annual expenditures specified by the firm cap, under the *ex-ante* capex framework, concerns EnergyAustralia. We believe this approach is inconsistent with the Code and assert that any framework that attempts to exclude efficient investment is not in the long term interests of customers and shareholders.

The recognition of actual investment could be achieved either through a continuation of the existing *ex post* framework, with only minor modifications to the current investment criteria, or through explicit acknowledgment within the *ex-ante* framework that expenditure above the cap will be recognised at the subsequent reset if it can be demonstrated to be prudent and efficient.

Depreciation

EnergyAustralia concurs with the use of the straight line method for determining depreciation and that forecast depreciation should be used in determining the opening asset base.

However, key in this matter is the need to ensure that the remaining life of the asset is defined by its economic remaining life, not simply a physical remaining life. This serves two purposes. Firstly, it serves as input into the decisions of when to replace existing assets based on commercial analysis (ie., the annualised costs of replacing an asset are lower than the annual costs of continuing to use that asset). Secondly, some assets will have a limited commercial and operating life due to the nature of the load that is served (ie., mines) and therefore a reduced economic life is appropriate to ensure that the TNSP is able to recover its initial investment from the causal customer.

EnergyAustralia recommends that the TNSP should be provided with the discretion to recommend alternative depreciation profiles in certain circumstances. This may arise where the price impact is too high in the short-term, and so an alternate price path with a steeper gradient over the latter part of the assets life may be appropriate. It is critical however, that such alternate profiles are at the initiation of the TNSPs. We note that such an approach would need to be designed to ensure NPV neutrality over a reasonable time-frame.

Finally, the return of capital deducted from the RAB during the period must be the forecast return of capital allowed in the revenue cap. Anything more or less than this amount in real terms will result in windfall gains or losses and breach the principles of FCM.

Inflation

EnergyAustralia agrees that the TNSP should not bear inflation-risk and so accepts the position of the ACCC to base the roll forward calculation on outturn inflation.

Opening RAB

The ACCC states that the closing asset base should equal the opening asset base for the following regulatory control period[7]. The ACCC does not, however, factor in EnergyAustralia's unique position where inter-period adjustments to the RAB are necessary to take account of assets that change in classification between distribution and transmission. As previously mentioned, when assets move into the transmission RAB from another regulatory jurisdiction they should be valued at DORC to ensure that there is value parity between elements of the network.

[7] Having adjusted the RAB for the difference between forecast and outturn (efficient) capex including the foregone return on capital of the difference. Again, EnergyAustralia insists that failure to adjust for all prudent and efficient capex, as suggested under the ACCC's *ex-ante* capex framework, is not consistent with Code requirements.

4. INCENTIVE FRAMEWORK FOR CAPITAL EXPENDITURE

One of the most significant changes introduced in the draft SRP is a move from an *ex-post* review of capital expenditure for prudence and efficiency, to an *ex-ante* review of projects and the establishment of a firm cap for capital spending. The capex framework is essentially asymmetric with the lower of actual spend or the cap itself being included in the RAB. Any capital expenditure over the firm cap will not be recognised by the regulator as prudent and therefore will not receive a return in the future. This is a fundamental change in regulatory risk to the investor.

There are four aspects to the changes to the capital framework that cause concern:

1. The roll-forward of the lower of the cap or actual expenditure;
2. Code compliance;
3. The mechanics of the *ex-ante* framework, including excluded projects and off-ramps; and
4. Impacts of a relatively small portfolio.

4.1. Capital expenditure roll forward

EnergyAustralia submits that, under either *ex-post* or *ex-ante* regimes, the roll-forward of the regulatory asset base should include all prudent and efficient capital investment. EnergyAustralia is not convinced that the approach proposed by the ACCC of not allowing expenditure over the cap is consistent with the Code. In particular, EnergyAustralia believes that a framework that has at its core the proposition that prudent and efficient investment may not be recognised in future regulatory decisions if it exceeds the firm cap is inconsistent with the Code.

EnergyAustralia believes that the criteria for changing the capital investment framework should refer to the certainty of investment, and the flexibility of allowing a business to innovate and choose the most efficient projects. It should not be based on wishes to minimise infrastructure investment overall or minimise resources required to regulate it.

4.1.1. Code compliance considerations

EnergyAustralia is concerned that the ACCC's *ex-ante* framework may not be consistent with the Code. EnergyAustralia has sought legal advice and has been advised that there are a number of aspects of the ACCC's framework that appear inconsistent with the Code's objectives. In particular, we believe that because the framework contemplates the exclusion of actual efficient investment (above the *ex-ante* cap) from the asset base, it cannot be said that the framework has as one of its objectives the provision of a fair and reasonable return on efficient investment. Therefore EnergyAustralia would argue that the capex incentive mechanism cannot be consistent with the Code.

Furthermore, we would argue that the regulator at the next reset should determine on a prospective basis the required revenues given actual efficient investment in the previous and prior periods and anticipated or forecast efficient investment for the next period. On this basis, the exclusion of efficient investment above the *ex-ante* cap would not provide a fair and

reasonable rate of return on efficient investment on a prospective basis and would be directly contrary to what is provided for in clause 6.2.2(b)(2) of the Code. In fact, EnergyAustralia's advice suggests there is nothing in clause 6.2.2(b) that would justify the exclusion of actual efficient investment in the RAB for the next control period and there is no other provision in the Code which would support such an outcome.

EnergyAustralia acknowledges that the Code also requires the ACCC to use incentive-based regulation. However, we believe that the objective of incentive-based regulation under the Code is to promote efficient investment not inefficient low cost under-investment as could arguably become the case under the *ex-ante* framework. EnergyAustralia believes that the exclusion of actual costs above the estimated level appears to actually undermine efficient investment incentives rather than promote an environment where businesses reveal their efficient costs.

EnergyAustralia reiterates its belief that the ACCC should consider a reinstatement of the *ex-post* review should spending above the cap eventuate in order to ensure that the framework remains consistent with the Code and its objectives. EnergyAustralia would clearly not support any Code change that would attempt to exclude efficient investment, as we believe this is not in the long term interests of customers and shareholders.

4.2. Ex-ante firm cap

4.2.1. Impacts of a relatively small portfolio

EnergyAustralia has a small portfolio of projects relative to most TNSPs and particularly when compared to TransGrid. Capping spending in the context of a large portfolio of projects allows unforeseen cost increases on one project to be recovered through underspending on other projects in the portfolio. However, the smaller the portfolio, the less likely it is that cost increases on a particular project can be recovered within the cap.

This situation is made worse when there are large and uncertain projects within the small portfolio, and further compounded by the difficult construction environment (ie., a dense urban / CBD setting) faced by EnergyAustralia. The ACCC itself has realised the ramifications of this fact and has adjusted its framework to allow specific projects to be excluded to take account of their uncertainty.

The use of the excluded projects mechanism however, leads to an even smaller portfolio of projects to be included under the cap, therefore again, reducing the ability of EnergyAustralia to compensate for any unforeseen cost increase on any project.

The ACCC has indicated that it will set an *ex-ante* cap in a conservative manner. The ACCC's recent paper "*Incentivisation of excluded projects"* (Attachment 1) says that where an asymmetric incentive mechanism is applied the ACCC must "(set) the allowed expenditure above expected efficient expenditure level(s)".[8]

[8] *Incentivisation of excluded projects*, ACCC document received by EnergyAustralia on Oct 1, 2004, p5.

EnergyAustralia is pleased that the ACCC has acknowledged the relative disadvantage that could result from the *ex-ante* framework, but is concerned that no detail has been provided as to how this might be done in practice.

EnergyAustralia's proposal

EnergyAustralia expects the ACCC to set its cap conservatively at the level at which the business has a high degree of confidence that spending will not increase over the cap. This must, by definition, be higher than the mid-point estimate provided by EnergyAustralia for its capital program in 2003.

4.2.2. Probabilistic analysis

The ACCC has indicated it expects TNSPs to develop their capex proposals using both scenario modelling and probability analysis. EnergyAustralia is concerned that there has been insufficient time to adequately undertake either of these processes in its recent revision of its capital program for the 2004-2009 review.

Furthermore, EnergyAustralia is at a loss as to how it might develop scenario modelling or probabilistic analysis when a significant proportion of its program has the potential to be impacted by the investments made by TransGrid. Given that TransGrid is undertaking a similar process concurrently with EnergyAustralia, and in fact may submit its revised capex program after EnergyAustralia's submission, it is difficult to see how EnergyAustralia could take account of TransGrid's analysis when it becomes available.

EnergyAustralia's proposal

EnergyAustralia does not intend to undertake formal scenario modelling in the development of its capital program. This is because it intends to exclude projects that are the subject of joint planning or that are likely to be significantly impacted by joint planning with TransGrid. EnergyAustralia intends to exclude all jointly planned projects regardless of the projects' size. This is because any requirement to reach a threshold for excluding the project is uncertain in terms of planning a project in a way to ensure that EnergyAustralia's portion of expenditure was sufficient to trigger an excluded project, regardless of whether the project plan that eventuated was the optimal project design.

EnergyAustralia therefore proposes that all projects subject to joint planning be excluded from the cap regardless of the project's impact on the revenue cap. In early discussions, the ACCC has indicated its agreement with this position.

4.3. Excluded projects

4.3.1. Approval process for excluded projects

EnergyAustralia believes it to be crucial that the process for approval of excluded projects be as simple and streamlined as possible. The relative ease / complexity of the process will heavily influence the success or otherwise of this part of the framework, and therefore the inherent risks of the framework overall. If the process outlined for excluded projects is

cumbersome, time consuming, characterised by long delays to decisions and costly, EnergyAustralia believes that the benefits of this mechanism being contained in the framework will be lost. EnergyAustralia believes that maintaining this feature within the framework is a critical tool to balance the risks inherent in the new capex framework. EnergyAustralia has an incentive to ensure that the approval mechanism is streamlined, easy to comply with and minimises regulatory cost imposts and micro-management.

EnergyAustralia's proposal

The process set out by the ACCC appears to be a reasonable starting point. However, EnergyAustralia believes some further clarification needs to be provided, especially with regard to the ACCC's stated intention to "closely monitor key assumptions and the analytical approach adopted".

EnergyAustralia believes that its governance procedure should deliver the majority of information that is likely to be sought by the ACCC in its approval process for excluded projects. The governance procedure (Attachment 2) has been developed in response not only to requirements for significantly increased investment programs, but also in response to the need for greater transparency of decision-making both internally and to external stakeholders. EnergyAustralia intends to utilise the milestones that are delivered by the governance procedure as an appropriate starting point for the approval process for excluded projects. The alignment of the regulatory approval process for excluded projects with EnergyAustralia's internal governance regime will limit the administrative complexities and costs faced by EnergyAustralia in gaining approval for excluded projects, and would match the information generated for internal decision-makers with that available to external regulators.

The governance procedure outlines a 5-step process by which projects (and investment programs) will be developed. By following the step-by-step process, EnergyAustralia can ensure that appropriate assessment of options has taken place, including demand side analysis. The procedure ensures that projects do not pass through the "Approval Gates" to the next stage of development until all documentation, consultation and authorisation requirements are met.

4.3.2. Further general concerns about the approval process

EnergyAustralia is somewhat concerned that the development timeframe for excluded projects is not likely to be as short as perhaps the ACCC's process outline assumes. Step 1 of the arrangement for implementing excluded projects[9], is effectively a multi-stage process with the first stage being to identify the need for the project and to notify the ACCC. The next stage is the development of the project, which could take several months or years depending on the project. It is within this second stage that options are developed, a specific option is chosen, demand side analysis is conducted, specific designs developed, EIS conducted, planning authorities received, etc.

Throughout this phase, decisions are made that allow the project to be progressed. By the time the Regulatory Test is completed, the project is ready for construction and in fact, it is often too late from a system security perspective to reconsider an alternate project, particularly if the investment is being driven by demand. EnergyAustralia believes that it will be critical that the

[9] Ibid, p. 7

ACCC is involved in some of these key investment decisions leading up to the application of the Regulatory Test to ensure that the final option is not required to be re-engineered at too late a stage in the process. Clearly the challenge will be balancing the level of comfort sought by the ACCC through direct involvement in the process with the increased regulatory intervention that will necessarily increase compliance costs and project development times.

EnergyAustralia proposes that the ACCC's close monitoring of projects should involve a process of incremental approval of planning decisions. The incremental approval process will require regulatory commitment to participate in the planning and development of projects. It will provide hands-on experience of transmission planning and demonstrate the lengths TNSPs take to optioneer solutions and address performance risk. It will also demonstrate the level of information available to businesses when they make investment decisions. Most importantly, an incremental approval process will require the regulator to act consistently with decisions it has made in the past and will effectively remove the regulator's ability to look at investments with clear hindsight and discount the prudence of investments. This has clearly been the case in the Mountain & Associates report regarding TransGrid's CBD augmentation. Perfect hindsight is not a luxury afforded to transmission planners when making *ex-ante* investment decisions. It is therefore not appropriate that it be afforded the regulator.

EnergyAustralia believes that the ACCC should provide incremental approval for planning decisions. However, it should be such that it ensures the ACCC will not renege on previous decisions at the next reset. EnergyAustralia believes it is up to the ACCC itself to determine the appropriate governance arrangements to grant such approvals. It is critical that the approval mechanism minimises delays to ensure that customers are not negatively impacted.

The final element of EnergyAustralia's proposed approval mechanism for excluded projects is for a streamlined process whereby the regulator has a defined time period, 30 days, within which it must raise issues regarding the planning and development of the particular project. If no issues are raised within that timeframe, approval of the relevant decision would be deemed to be given.

Ideally, any concerns would be highlighted by the ACCC prior to the request for approval being lodged. However, there is significant risk of project delays should the regulator not be subject to approval time limits.

With regard to the ACCC's proposal for excluded projects, EnergyAustralia believes that a four month process is appropriate to allow the ACCC to provide its final assessment following the application of the Regulatory Test.

4.3.3. Provisions for excluded projects

EnergyAustralia sought clarification from the ACCC as to how provisions for excluded projects will be incorporated in the revenue line at the time of the revenue reset. The ACCC indicated that it did not expect to make a provision in the revenue line for all excluded projects, particularly those projects that are highly uncertain as to whether they would in fact be constructed within the period. The ACCC indicated that where the likelihood of the project proceeding was high, it might be appropriate to include some provision for the project in the revenue line.

EnergyAustralia believes that provisions in the revenue line are crucial to ensure that the business can continue to operate without a compromised cash-flow position. EnergyAustralia also believes that the cash-flow position of the business needs to be considered in isolation of other non-prescribed activities that the business may conduct.

However, EnergyAustralia recognises that customers should not pay for projects that are not being constructed. Therefore, there is a fine balance to be struck between supporting the commercial needs of the TNSP and ensuring that customers do not face higher than necessary prices for transmission services.

EnergyAustralia's proposal

EnergyAustralia believes that where projects are highly certain to proceed within the period, provisions must be included in the calculation of the revenue requirement. Where cost / scope of the project is uncertain, it is appropriate that a provision based on a mid-point estimate be included. EnergyAustralia believes that accepting a mid-point estimate rather than a high estimate balances the needs of both the business and the consumer. Consumers do not pay for the highest cost option, but TNSPs have the majority of their costs met within the period.

In cases where projects are very uncertain as to whether they will in fact go ahead (this is likely to be in cases where projects are scheduled towards the end of the period), EnergyAustralia accepts that it would be difficult to justify a provision in the revenue line. However, where the project does go ahead towards the end of the period, the next revenue reset must include a provision for the project. It should be noted that the provision in the revenue line is not necessarily the same as the estimate agreed to by ACCC during the excluded project's approval process. It is against this latter estimate that the incentive mechanism is measured.

4.3.4. Inclusion of excluded projects in the asset base

EnergyAustralia sought clarification from the ACCC on how it intends to include the expenditure associated with excluded projects into the asset base. ACCC indicated that it intends to roll-in actual spend on excluded projects at the revenue reset that follows the end of the 5 year incentive mechanism applied to the project. Thus, where an excluded project begins in one period and continues through to the next period, the expenditure on that project would not be incorporated in to the asset base until the end of the second regulatory period. If a project began early in the regulatory period and ended early in the following period, 8 to 9 years would pass before the expenditure would be included in the asset base. Figures 1 & 2 demonstrate the ACCC's proposed treatment of excluded projects.

EnergyAustralia does not believe it is reasonable for TNSPs to be required to wait such a long time for expenditure on excluded projects to be included in the asset base. The carrying costs of some excluded projects may be extremely high, particularly where the project is large and where no provision has been made in the revenue line for the project. EnergyAustralia believes that it is not a reasonable allocation of risk between the TNSP and its customers in this regard, nor is it sustainable from a cash-flow perspective for TNSPs to carry the costs of non-provisioned investments for two regulatory periods. Furthermore, the difficult cash-flow position may be compounded if several non-provisioned excluded projects are being constructed at the same time.

Figure 1 – ACCC's proposed framework for an excluded project

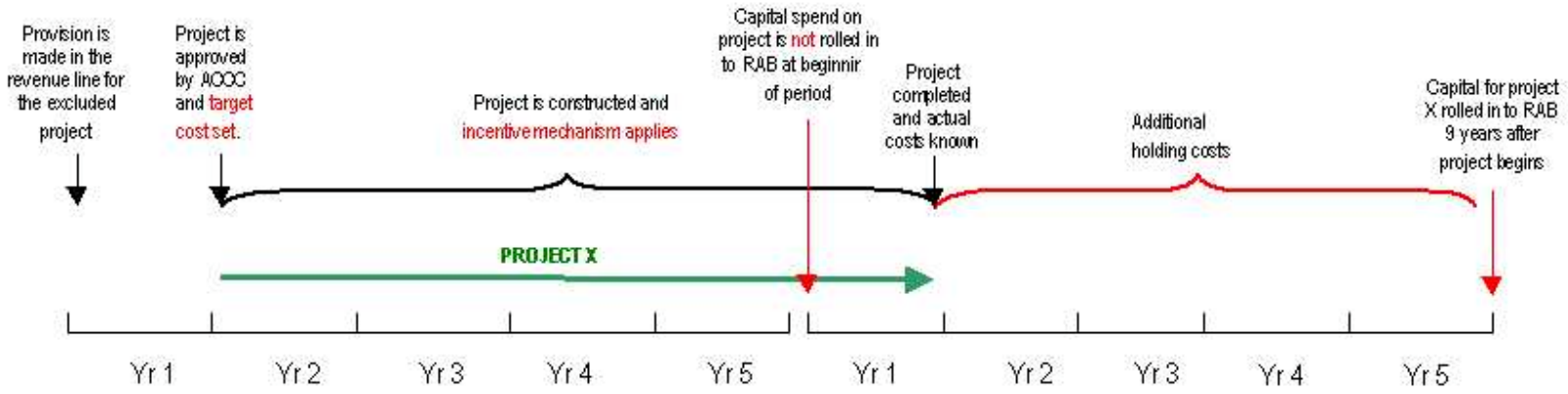
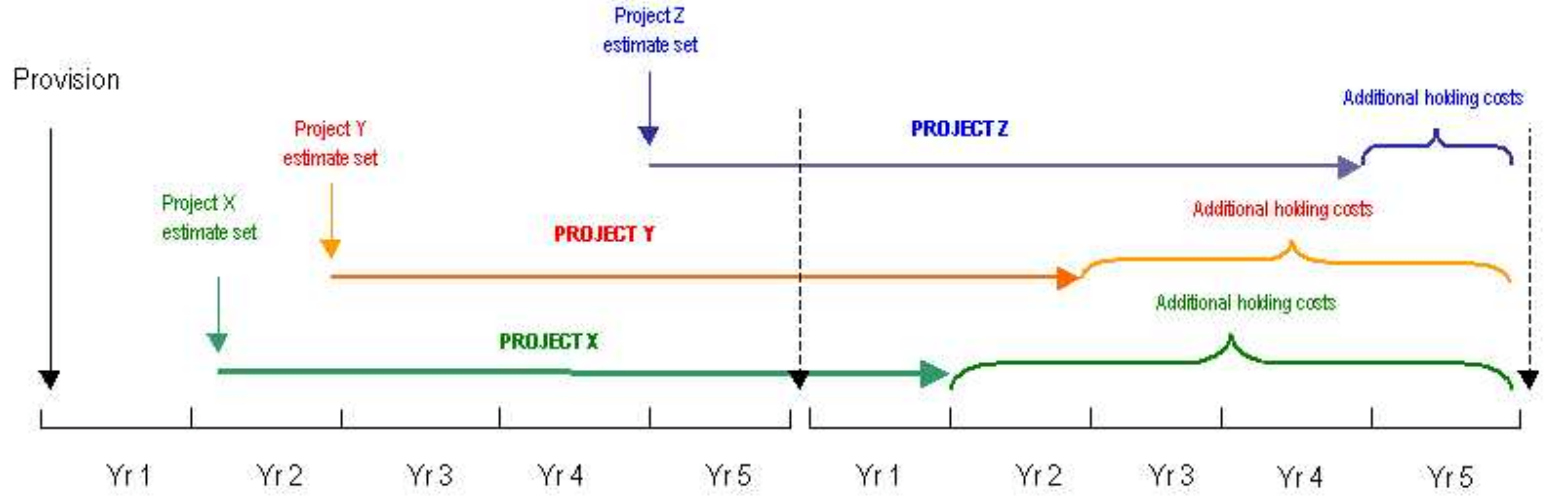


Figure 2 – Framework with more than one excluded project



EnergyAustralia believes that the requirement to wait until the end of the 5 year incentive mechanism for excluded projects before adding actual spend to the asset base is not appropriate. Under the current *ex-post* framework, capital investment on projects regardless of whether the project is completed or not, is reviewed for prudence and rolled in to the asset base. EnergyAustralia believes that the new framework should provide a similar outcome. It is not appropriate for businesses to wait up to twice as long before the costs of investments are recognised simply because of the operation of a construct (the notion of an excluded project) which is of the ACCC's making. EnergyAustralia strongly believes that the ACCC's new framework should meet the needs of the business and of other key stakeholders as a priority and mechanisms that compromise the business's ability to operate in a commercial fashion should not be considered in the framework.

EnergyAustralia's proposal

EnergyAustralia believes that all spending on excluded projects should be recognised at the time of the next regulatory-reset regardless of whether the 5 year incentive mechanism for the individual excluded project has ended. EnergyAustralia can see no reason as to why the incentive mechanism cannot continue to apply to spending in the following period, and that at the end of the period any remaining expenditure be recognised.

4.4. Off-ramps

The off-ramps mechanism outlined by the ACCC in its draft SRP is still somewhat unclear. It is understood that the mechanism allows for unforeseen circumstances that cause a material change in required capital expenditure to be taken into account through a reconsideration of the capital program, including the firm cap. It is understood that such circumstances should be agreed to up front and that a materiality threshold of five percent is to be used to trigger an off-ramp.

The ACCC in its "*Incentivisation of excluded projects*" paper includes the ACCC's latest thinking regarding off-ramps which is contrary to what is contained in the draft SRP.

> *"(T)he DRP provides for an "excess" for the recovery of expenditure related to off-ramp events equivalent to 5% of the total capex allowance for the regulatory period. This means that the TNSP is required to cover the first 5% of any investment following an "off-ramp" event. It also provided that off-ramp events" could be invoked by TNSPs, the ACCC or third parties."*[10]

The ACCC now propose the following:

- The "threshold" should be reduced from 5% of the total capex allowance during the 5 year regulatory control period, to an annual "threshold" equivalent to 5% of the average annual capex expenditure (in other words one percent of the total capex target). The threshold will apply annually. This means that although investment following an off-ramp may exceed the target in any one year, it will need to be reset for all subsequent years;

[10] Ibid, p 10.

- If the present value of the investment following an off-ramp event exceeds the "threshold", then the full cost will be recoverable from consumers;
- "Off-ramp events" can be invoked by TNSPs – in other words, TNSPs will be covered (subject to the excess) against cost increases resulting from off-ramp events. However, the off-ramp mechanism will not be used to reduce the *ex-ante* cap should forecast events not occur.

EnergyAustralia welcomes the ACCC's view that a threshold based on an annual spend should be used to trigger an off-ramp rather than a 5% trigger over a 5 year period.

The ACCC states in its paper "*Incentivisation of excluded projects*" that it does not intend to apply an incentive mechanism to projects triggered by off-ramps. EnergyAustralia agrees that events that trigger off-ramps are not appropriate to have an incentive mechanism applied. However, EnergyAustralia is not clear as to how the ACCC would treat off-ramps. It appears that ACCC intends to provide a target for expenditure, but that if circumstances drive costs above that target level, the TNSP is free to come back to ACCC to review the target. Once completed, the actual spend will be rolled in to the asset base.

EnergyAustralia's proposal

In its paper *"Incentivisation of excluded projects"*, the ACCC states that it would only review the agreed off-ramp target in extreme circumstances. EnergyAustralia proposes that the wording be changed to reflect "justified" rather than "extreme" circumstances.

EnergyAustralia proposes that off-ramps be rolled in at their actual cost including holding costs. This is consistent with the ACCC's position that no incentive mechanism be applied to off-ramps.

4.4.1. Suggested off-ramps for EnergyAustralia

The ACCC has suggested that off-ramps be agreed to up front with the TNSP. EnergyAustralia suggests that this is an ideal scenario but that it is likely to be impossible to identify all possible events that could trigger an off-ramp. While some events are clearly imaginable, there is also a possibility that completely unforeseen events could take place which must also be considered within the off-ramp category.

EnergyAustralia's proposal

EnergyAustralia suggests that an non-exhaustive list of events that could be considered in the off-ramp category be identified. EnergyAustralia suggests that the following non-exhaustive list of events should be considered as off-ramps:

- Changes in demand that drive material changes to the capital program;
- Material exchange rate variations;
- Unforeseen customer connection;
- Change to planning standards that drives changes to the capital program; and
- Response to a terrorism event.

4.5. Change to the framework for capex

4.5.1. The case for change

The ACCC has stated in various forums that the over-spend in NSW on transmission capex during the 1999-2004 period prompted it to rethink the capital investment framework. EnergyAustralia does not believe that spending capex over the amount allowed in the initial determination signals a failure of the framework. Instead, EnergyAustralia believes that such over spend is likely to be the result of a range of factors including the robustness of the initial forecasts, whether forecasts for demand growth were accurate in each geographic area, movements in GDP, changes to regulations, conditions on planning approvals, better information on asset condition, environmental considerations and the experience of utilities responding to regulatory regimes. EnergyAustralia believes equating over-spend to framework failure is too simplistic.

EnergyAustralia believes that the criteria for changing the capital investment framework should refer to the certainty of investment, and the flexibility of allowing a business to innovate and choose the most efficient projects. It should not be based on wishes to minimise infrastructure investment overall or minimise resources required to regulate it.

The ACCC argues that the existing *ex-post* framework exposes TNSPs to significant investment uncertainty. EnergyAustralia agrees and would argue that the absence of explicit criteria to assess prudent investment is a key source of this uncertainty. The absence of explicit criteria effectively provides full discretion to the regulator to question all investment and planning decisions *ex-post* with the potential for some investments to not be accepted as prudent and therefore not be allowed a return. This level of risk is unacceptable to EnergyAustralia.

EnergyAustralia supports a framework that makes investment criteria explicit and that provides discretion to the business to determine priorities and the appropriateness of investments.

4.5.2. The process of change

The ACCC's proposed capex incentive framework provides explicit investment criteria and allows investment discretion. In this respect it has EnergyAustralia's support. However, the regime itself is still being developed and as such is difficult to support in full until such time as it is set down with certainty.

EnergyAustralia has long held the view that the concurrent assessment of EnergyAustralia's revenue cap for the 2004-2009 period and the review and redesign of the capital investment framework represents a failure of process by the ACCC. Despite raising these issues at the outset, the ACCC has continued on its path to redraft the Statement of Regulatory Principles and redesign the framework whilst applying it in practice.

The concurrent review has delayed the finalisation of EnergyAustralia's revenue cap by up to a year. More importantly, the implementation of the new framework has fundamentally changed the risks borne by TNSPs in the NEM.

The ACCC has acknowledged this and in April 2004, requested that both TransGrid and EnergyAustralia choose which framework was preferred by each TNSP to be applied in the 2004-2009 period. EnergyAustralia agreed to assist the ACCC in its development of its new *ex-ante* framework but made no commitment to support a new framework until further details of the framework were finalised.

EnergyAustralia has reassessed its capital strategy in light of the draft SRP and its more recent proposals for the treatment of excluded projects. EnergyAustralia believes that the *ex-ante* framework proposed by the ACCC has potential advantages over the current *ex-post* review in some limited instances. However, the increases in risk for EnergyAustralia will require utilisation of both the excluded projects and off-ramp provisions before EnergyAustralia believes the risks inherent in the frameworks are equivalent.

4.5.3. A framework developed in haste

EnergyAustralia is concerned that the ACCC has hastily put together its new regulatory framework. Within six months of the ACCC setting out its initial thinking about an *ex-ante* capital investment framework, both TransGrid and EnergyAustralia have been required to submit new capital forecasts that the new framework into account. However, within this six month period, the ACCC has changed aspects of its proposed new framework, in some case, more than once. Happily, many of the changes have addressed concerns raised by TNSPs, which highlights the importance of adequate consultation in such a critical area.

EnergyAustralia is concerned that the framework will still be in its early stages of development when the framework is applied to TNSPs revenues in NSW for the 2004-2009 period. In 1998, EnergyAustralia and TransGrid were the first TNPSs to have the (then new) *ex-post* framework applied to revenues. The *ex-post* framework went through a development phase during the following five year period to include new elements, such as self-insurance, into the framework that benefited TNSPs whose revenue caps began later in the period. Unfortunately for EnergyAustralia and TransGrid, history is repeating itself and a brand new framework is being applied to TNSP revenues in NSW before all aspects of the framework and their inter-relationships have been fully understood. This is very disappointing and the implications are alarming to EnergyAustralia.

4.6. Other considerations under the incentive framework for capex

4.6.1. Customer connections

EnergyAustralia operates largely as a distribution network. However, part of its network is defined as a transmission network due to the strict application of the definition of transmission contained in the Code. While most customer connections occur at the distribution level, there are an increasing number of high voltage connections being requested by large industrial customers in the Sydney and Hunter regions.

There are a number of customers that have discussed connection options with EnergyAustralia and which could connect to the network in the 2004-2009 period. Most of the customer

connections are at the planning or inquiry stage only and have no firm scope of costs associated with them.

Generally, when a customer connects to the network the customer covers part (or all) of the cost associated with connection. However, customers do not pay for shared assets. If the customer connection were to take place in an area where there is sufficient transmission network capacity, it is likely that the customer's contribution to that connection asset could meet the total costs of the connection (ie., only customer specific connection assets would be required). However, in many cases a customer requests a high voltage connection in a part of the network where there is neither capacity at the connection point nor capacity further upstream to meet the customer's connection requirement. In such circumstances, the customer's contribution is likely to fall far short of the required network investment (as the contribution does not cover assets that could be shared).

EnergyAustralia seeks clarification as to how the ACCC's *ex-ante* cap caters for customer connections. It appears that such unforeseen customer connections would fall in to the off-ramp category. However, for the event to be triggered, the customer connection costs would need to be above the 5% annual materiality threshold. Where the cost of connecting a customer did meet the 5% threshold, the regulator would be able to review the revenue cap to ensure that the TNSP received an appropriate return for meeting its obligations to connect. However, it is possible that an individual unforeseen customer connection could cost less than the threshold and therefore would not be captured at all by the revenue cap effectively resulting in the TNSP not being paid for meeting its obligations under the Code to connect that customer.

In some cases, a customer has already inquired about a connection and therefore the event would not strictly be 'unforeseen'. In this case, it would appear that the connection would be more appropriately characterised as an excluded project – foreseeable, has the potential to be significant but is uncertain in terms of scope and cost.

As mentioned above, EnergyAustralia has identified a number of customer connections that could be made to its transmission network in the 2004-2009 period. However, at this stage, none of the connections are certain to proceed.

EnergyAustralia's proposal

EnergyAustralia believes that it would be prudent to treat all its customer connections the same, regardless of whether the project is foreseen or unforeseen. EnergyAustralia does not believe that it is appropriate that different thresholds, different incentive mechanisms and different approval processes should apply to customer connections simply because the TNSP had knowledge of them or not at the time it made its submission.

EnergyAustralia would argue that it is not appropriate that a threshold or an incentive mechanism be applied to customer connections. TNSPs face Code obligations to connect customers to their network and the costs of meeting these obligations should be recognised by the regulator as prudent and necessary investment. As mentioned above, EnergyAustralia's policy is that customers pay for all dedicated assets and that EnergyAustralia pays for shared network assets.

Given the obligation to connect customers, EnergyAustralia does not believe it is appropriate that a threshold apply before such spending is recognised. The size of the customer connection does not lessen or increase the obligation faced by EnergyAustralia to connect customers and it is not reasonable for a TNSP to bear the costs of meeting these requirements.

EnergyAustralia proposes that no allowance be included in the revenue line for customer connections that it can foresee at this time. However, should such an event occur, EnergyAustralia proposes that the actual cost of the investment (less customer's contribution) be included in the RAB (including holding costs) at the end of the period. This will ensure that EnergyAustralia receives an NPV neutral return for investing in shared assets that result from customer connections. It also ensures that customers at large do not pay for connections that may not take place within the regulatory period.

EnergyAustralia believes that it is appropriate that a specific mechanism be applied for customer connections as the TNSP itself has no control over the location of the customer or the timing of the customer's connection request. Furthermore, as the TNSP has no discretion as to whether to supply the customer or not, it is appropriate that the TNSP is paid in full for the costs of connecting that customer.

5. INCENTIVE FRAMEWORK FOR OPERATING AND MAINTENANCE EXPENDITURE

EnergyAustralia recognises the need for, and encourages the development of, incentive regulation. When effectively constructed, it can present the opportunity for business to benefit from becoming more efficient and in turn pass those benefits on to consumers. EnergyAustralia considers the ACCC's proposed efficiency carry-forward mechanism as a complex and impractical addition to the existing incentive framework. The benefits it is intended to bring in terms of strengthening the incentive to achieve efficiencies are heavily outweighed by the costs and practical difficulties associated with its implementation. Therefore on balance, EnergyAustralia believes that the ACCC should continue to rely on the incentives inherent in the existing framework to deliver desired efficiencies.

5.1. Benchmarking

EnergyAustralia acknowledges that benchmarking provides a useful role in assessing the reasonableness of operating expenditure requirements claimed by TNSPs. But, it is for this purpose only that EnergyAustralia believes the ACCC should consider the results of benchmarking.

EnergyAustralia appreciates the attractiveness to the ACCC of pursuing a mechanism for developing target expenditures that avoids the current endogenous cost build-up approach, which is burdened with detailed information. Benchmarking, however, provides no better alternative, as it:

- fails to take into account the different age and risk profiles of Australian TNSPs;
- necessarily assumes homogeneity across Australian transmission businesses that does not exist[11];
- ignores the interdependency of replacement capital expenditure and maintenance expenditure (ie., the 'capex / opex trade-off') where, under the ACCC's current proposal, the former will be embedded into an *ex-ante* cap and the latter will be pre-determined by some arbitrary reference to exogenous cost drivers; and
- ignores service standard outcomes which are intimately tied to maintenance expenditure.

EnergyAustralia is concerned that the ACCC continues to entertain the prospect that benchmarking can be used to determine future operating and maintenance expenditure targets. EnergyAustralia believes that the ACCC's intention to develop a working group to deliver a benchmarking performance report by the end of October 2006 will confirm that Australian TNSPs are sufficiently different, to the extent that to pursue exogenous measures in setting opex targets will lead to inappropriate outcomes.

In light of the reasons presented above, EnergyAustralia maintains that benchmarking is most effectively used only as a 'sanity check' in determining the reasonableness of targeted operating and maintenance expenditures – not to be used to establish the targeted future opex level.

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[11] The ACCC recognise this in the draft SRP as well: "*the ACCC has concerns that TNSPs in Australia may not be comparable because of their different scope and scale of activities.*" p. 26

5.2. Self insurance

EnergyAustralia believes that the matters that need to be addressed by a TNSP in establishing an allowance for self-insurance costs are unnecessarily and inappropriately onerous. The ACCC has identified, for example, the need for a TNSP to confirm board resolution of the TNSP's intention to self-insure. In the case of EnergyAustralia, this decision is operational in nature and as such rests with general management. The decision to self-insure has been reflected in EnergyAustralia's submission to both IPART and the ACCC on the respective price and revenue reviews for the 2004-2009 period.

5.3. Pass through

EnergyAustralia believes that a flexible mechanism is required to address circumstances that may arise within a regulatory period that are significant in nature and not anticipated at the time of the Determination. EnergyAustralia welcomes the ACCC's decision to allow for pass-through of certain costs associated with specific events that are outside the control of the TNSP.

EnergyAustralia has included specific comments relating to the most recent draft of the ACCC's standard Pass Through Rules in Appendix A of this submission.

5.3.1. Pass through and off-ramp provisions

EnergyAustralia is unclear what the relationship between the Pass Through Rules and the off-ramp mechanism are. It appears that many of the defined Pass Through Events listed in the draft Pass Through Rules could in fact have ramifications for capital investment, and therefore that such events could trigger both mechanisms.

It is important that the Pass Through Rules remain intact as they form an important part of the balancing of risks within the regulatory framework, particularly where opex is concerned. However, it is also important that the operation of the off-ramp mechanism (which we understand will apply to capex only) is clearly defined and made explicit. This would provide clarity for TNSPs and other stakeholders on whether the off-ramp mechanism actually offers any flexibility in addition to what is already provided by the Code[12] and what is provided for in the Pass Through Rules.

5.4. Efficiency carry-forward mechanism

5.4.1. Objection to the introduction of a carry-forward mechanism

In its submission to the ACCC on the revenue-reset for the 2004-2009 regulatory control period, EnergyAustralia stated that it did not support the introduction of a carry-forward mechanism. EnergyAustralia continues to hold this position. It considers a carry-forward mechanism administratively complex for little observed benefit. Moreover, the rolling carry-forward mechanism preferred by the ACCC has the scope to introduce significant variability to revenue which can detrimentally affect the management of cash-flows by a TNSP. This significant variability will also have downstream pricing implications for end-use customers.

[12] in terms of reopening the revenue cap to take account of material error or a change of circumstances.

The ACCC heralds the importance of building incentive properties into the regulatory framework in its draft SRP. In fact, it is a Code requirement for the ACCC to "provide TNSPs with incentives…to increase efficiency"[13]. The ACCC's introduction of a carry forward mechanism for opex appears to satisfy this requirement. But as outlined previously, the ACCC fails to acknowledge that current revenue cap already delivers a powerful incentive to achieve efficiency gains. The carry-forward mechanism does lengthens the period of time in which the benefits (or losses) are experienced by a TNSP, however this on its own is not sufficient to justify the introduction of an additional incentive mechanism. EnergyAustralia argues that there is no need to strengthen the existing incentive on the basis that:

- Carry-forward programs tend to be overly complicated and difficult to administer, particular where they are subjected to a number of exceptions. The amendments to the carryover mechanism proposed by the ESC in Victoria in its 2001 Price Determination, for example, demonstrates the difficulties associated with effecting such an efficiency mechanism, given its operational intricacies [14]. IPART also recognised practical implementation concerns in its 2004 Determination for Electricity Distribution Pricing, earlier noting that "(i)t is not clear… that the benefits to be gained from such a measure outweigh the practical difficulties associated with its implementation"[15];
- Carry-forward mechanisms by definition involve more than one regulatory control period. As the ACCC cannot bind the future exercise of statutory powers, a TNSP would need to rely on the ACCC appropriately recognising its previous decision on this issue, which creates uncertainty. The resulting uncertainty has the potential to diminish the incentive properties of the mechanism, and conflicts with the larger objective of the Code for providing certainty for investment.

  The ESC acknowledges that it cannot bind itself to its own long-term efficiency carryover mechanism[16], and so the businesses must rely on the stability of the regulator to follow precedent in effecting its decisions over time. Given that the ACCC has already undertaken wholesale changes to the SRP after only one regulatory control period (and at each of our regulatory resets) we are concerned that wholesale changes have become the norm. We also note that, just as the ACCC cannot bind itself in the future, it also cannot bind another regulator (ie., the AER) in the exercise of that different regulator's statutory powers, further diminishing EnergyAustralia's confidence in the certainty of the regulatory environment;

- Spending above the (efficient) forecast target to improve service quality, may appear as a loss of efficiency. Were the carry-forward mechanism not capable of identifying discrete expenditures aimed at improving service quality (and nothing in the mechanism proposed by the ACCC suggests it could) then this could create a disincentive for investment in what might otherwise be considered by customers as worthwhile improvements to service standards; and

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[13] National Electricity Code, clause 6.2.3(d)(1).

[14] The carry-over mechanism introduced by the ESC in its Price Review was subject to appeal and a subsequent re-Determination was issued when the Appeal Panel decided that the mechanism needed to take account of the differences between forecast and actual demand. ESC, *Electricity Distribution Price Review 2006 Final Framework and Approach: Volume 1, Guidance Paper,* June 2004, p. 70

[15] IPART, *Regulatory arrangements for the NSW Distribution Network Service Providers from 1 July 2004, Issues paper*, p. 39

[16] ESC, *Electricity Distribution Price Determination 2001-05: Volume One, Statement of Purpose and Reason*, Sep 2000, p. 84.

- The current service standards incentive mechanism is geared to drive improvements in how opex is spent – achieving greater output from the same level of input. Thus to EnergyAustralia it is not obvious that the efficiency carry-forward mechanism complements a service incentive mechanism.

5.4.2. Carry-forward mechanism compromises balanced objectives

As noted earlier in Chapter One, EnergyAustralia is particularly concerned that the ACCC may not have given adequate attention to the interactions of newly-proposed incentive mechanisms. Ideally, the incentive mechanisms for cost and service improvements should operate consistently. EnergyAustralia asserts that this is not the case. For example, under the proposed framework, the benefits accruing to the TNSP as a result of cost cutting under a five year carry-forward period will outweigh a single-year service quality incentive reward. This presents a dysfunctional incentive to reduce expenditure at the expense of service levels. The ACCC is effectively proposing a framework that will bias cost reductions over service improvements, potentially compromising the stability of service.

5.4.3. Concerns over transitioning to the efficiency carry-forward mechanism

Notwithstanding EnergyAustralia's opposition to the introduction of a carry-forward mechanism for opex, EnergyAustralia would have major reservations should the ACCC adopt the mechanism in the form reflected in its draft SRP. Indeed it is not even clear from the draft SRP when the carry-forward mechanism will come into effect and in what manner the TNSP will be transitioned to this new framework.

The ACCC has clearly defined how it intends to transition to its proposed capex incentive framework. Unfortunately, the ACCC has not given commensurate attention to how it intends to transition to a carry-forward efficiency mechanism for opex. It is for this reason that EnergyAustralia seeks clarification as to when and in what fashion the ACCC intends to move to the carry-forward approach if indeed one is adopted. EnergyAustralia seeks assurance that the carry-forward mechanism will not be applied as part of EnergyAustralia's 2004-2009 revenue reset. That is, only cost data should be collected during the 2004-2009 regulatory control period with a view to applying financial adjustments, if any, for the following (2009-2014) regulatory control period[17]. Given that the framework is intended to provide incentives to influence future behaviour, imposing rewards or penalties *ex-post*, by definition, can have no impact on incentives within that period. Furthermore, to apply a mechanism retrospectively is not consistent with the principles of minimising regulatory risk and uncertainty.

5.4.4. Domestic experience

A carry-forward incentive mechanism, as noted earlier, has been introduced by the ESC for the Victorian electricity distribution businesses. Some of its key elements include:

- Carry-forward period of five years (implying a sharing of benefits between the business and consumer of around 30:70 in NPV terms);

[17] Correspondence with the ACCC suggests that this mechanism will not apply to EnergyAustralia in the 2004-09 regulatory control period.

- Operation will focus on the difference between benchmark forecasts and outturn expenditure relating to both opex and capex;
- Retrospective adjustment to benchmark forecasts to account for differences between forecast and outturn growth in demand;
- Efficiency gains and losses will be treated symmetrically; and
- A floor of zero set on the carry-forward amount in any one year (ie., there will be no negative carryover in any year of the future regulatory period).

The ESC introduced a carryover mechanism after considerable public consultation and gave due consideration to all aspects of its operation. Similar to ESCOSA[18], it has formed the view that it is appropriate to have a floor of zero on the carryover amount. The ESC recognised that carrying forward a negative efficiency loss would reduce revenue below the level determined by the building block approach to be fair and necessary. EnergyAustralia agrees that a mechanism that allows accumulated losses to be carried forward into the following regulatory control period would not be consistent with the requirements of the Code to ensure a "sustainable commercial revenue stream".

In its issues paper on an efficiency carryover mechanism, the Queensland Competition Authority (QCA) also raised potential concerns over carrying forward accumulated losses[19]:

> *(R)equiring a business to carry forward accumulated losses may not only penalise the business but may also penalise the customer as the business may be forced (or elect) to run down service quality rather than undertake the necessary investment in its infrastructure in the face of less than sufficient revenues.*

As EnergyAustralia proposes later in this Chapter, we believe that, should the ACCC introduce a carry-forward mechanism, there are some positive elements that can be taken and incorporated from the efficiency mechanism in place for Victorian electricity distributors.

5.4.5. Symmetric versus asymmetric mechanism

The *ex-ante* firm cap for capex is, by definition, asymmetric, as expenditures above the firm cap are not recognised (whereas expenditures below the cap are recognised). The efficiency carry-forward mechanism for opex proposed in the draft SRP, however, is symmetric in nature. That is, efficiency gains and losses are carried forward in the same manner for a specified length of time (in this case, five years), regardless of whether the expenditures are above or below the initial targets.

From the ACCC's final decision on the access arrangements for GasNet[20], it is noted that the ACCC disapproves of an asymmetric approach to the carry-forward mechanism on the basis that it allows scope for regulatory gaming – the ability to manipulate inter-period spending such that gains can be achieved without any real efficiency occurring. EnergyAustralia contends that although in theory the potential for regulatory gaming in the manner described above may

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[18] ESCOSA, *Electricity Distribution Price Review: Efficiency Carryover Mechanism, Working Conclusions*, April 2003, p. 26.
[19] QCA, *Issues Paper: Efficiency Carryover Mechanism*, Sep 2004, p. 9.
[20] ACCC, *Final Decision: GasNet access arrangement 2002*, Nov 13, 2002, p. 272.

appear possible, the practical reality is that there is little if any scope for effecting such large-scale adjustments to expenditure timings.

We also note the obvious inconsistency with the asymmetric approach proposed by the ACCC for its treatment of capital expenditure, notwithstanding the ACCC's unwillingness to accept the firm cap it has put forward is asymmetric at all.[21]

EnergyAustralia's proposal

Although EnergyAustralia questions the practical reality of regulatory gaming, we submit that an alternative symmetric approach to carrying forward efficiency gains and losses may be developed should the ACCC decide to adopt an efficiency carry-forward mechanism in its SRP. The approach we envisage is not dissimilar to that adopted by the ESC as part of their 2001 Electricity Distribution Price Review. Under the mechanism EnergyAustralia envisages, a floor of zero must be placed on the carry-forward amount for any given year. Should an efficiency loss occur in a given year, the carry-forward amount is set to zero and the implied negative value will be used to offset any efficiency gain in the following year only[22].

EnergyAustralia believes that adopting this approach provides adequate incentive to pursue efficiency gains while at the same time avoids both the immediate concern for regulatory gaming (as described above) and unduly punishing TNSPs who may legitimately overspend in light of unforseen costs.

5.4.6. Correction mechanism

The ACCC recognises that there are inherent difficulties in determining a carry-forward amount for the last year of the regulatory control period. As a result, the ACCC intends to incorporate a correction mechanism. Details of the manner in which the correction mechanism will work are not addressed and so we are not able to provide substantive comments on this issue other than to re-emphasise the additional complexities associated with introducing an efficiency carry-forward mechanism with little if any solid evidence to suggest that one is needed.

5.4.7. Benefit sharing

EnergyAustralia notes that the adoption of a five year carry-forward period conflicts with the recommendations of the ACCC's own consultant, Darryl Biggar. In his paper[23], achieving consistency in the 'power of the incentive' is an important consideration, one best achieved over a four year carry-over term. The ACCC's SRP heralds 'consistent incentives' as a key factor in the decision of an efficiency mechanism and the form it will take. Yet the adoption of a five year carry-forward term seems to contradict this priority (at least on the advice of the ACCC's own consultant).

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[21] The ACCC argues that reference to the level of the cap itself is requisite in establishing whether or not the proposed *ex-ante* firm cap on capex is asymmetric. ACCC, *Statement of Principles for the Regulation of Electricity Transmission Revenue Background Paper*, Aug 18, 2004, p. 84. EnergyAustralia emphatically disagrees with this assertion.

[22] Deferring a negative for one year only represents a departure from the decision of the ESC in its 2001 Electricity Distribution Price Review. In their decision, negatives will accumulate over the regulatory period (to the extent that they are not offset by positive gains), noting that a floor of zero applies in any given year.

[23] Darryl Biggar, *Incentive Regulation for Recurrent Expenditure: Benchmarking and Carry-Overs,* March 9, 2004.

It is also worth noting that under the current operation of the revenue cap, customers already receive the vast majority of benefits. The introduction of the carry-forward mechanism will only serve to increase the proportion of benefits that accrue to the business.

5.4.8. Addressing taxation effect on efficiency gains

It does not appear that the ACCC has taken into account the tax on the efficiency carry-forward amount. In effect, what this means is that for every permanent one dollar efficiency, a TNSP is only rewarded 70 cents of the value created. Without making an explicit adjustment to take account of the inhibiting tax effect on an efficiency gain, the ACCC is subjecting a TNSP to an asymmetry in the incentive framework where the penalty for efficiency losses exceeds the reward for efficiency gains of the same magnitude. Fortunately, the ACCC recognises the general concern over dampened incentives in the draft SRP:

> *"…if a dollar reduction in expenditure leads to a dollar reduction in revenue in the next regulatory period, the firm will have less incentive to reduce expenditure than if a dollar reduction in expenditure was only partially taken into account by the regulator, leading to, perhaps only a 25 cent reduction in revenue".*[24]

Consequently, EnergyAustralia expects that the ACCC, in order to ensure that a consistent incentive exists to achieve efficiency gains and avoid efficiency losses, will appropriately adjust for the effects of taxation on carry-forward efficiency gains.

5.5. Determining future opex targets

The ACCC has not given a clear indication as to any particular approach to setting future expenditure targets. This is unfortunate given the desire of TNSPs for, and the obligation of the ACCC under the Code to provide, certainty and predicability in the regulatory environment within which TNSPs operate. The ACCC only goes so far as to make the general statement that forecasts will be based on past expenditures, refusing to indicate anything more concrete "for a variety of reasons". EnergyAustralia believes this is neither an appropriate nor acceptable basis for non-committal, leaving TNSPs subject to further uncertainty. The ACCC's unwillingness to indicate a particular approach stands in marked contrast with earlier comments in the draft SRP:

> *"the incentive to reduce recurrent expenditure depends on the future behaviour of the regulator. Therefore, if the regulatory regime is to have incentive properties which are predictable the regulator should commit in advance to a particular approach to taking into account past expenditure information when setting future targets for recurrent expenditure."*[25]

EnergyAustralia submits that the ACCC should indicate a method for determining future opex targets. EnergyAustralia suggests that such a method must incorporate a step adjustment based on the verifiable claims put by TNSPs at the time of their respective reviews, reflecting the forecast volume and nature of activity required in the subsequent period.

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[24] Ibid, p. 30.
[25] Ibid. p. 30

6. THE WEIGHTED AVERAGE COST OF CAPITAL

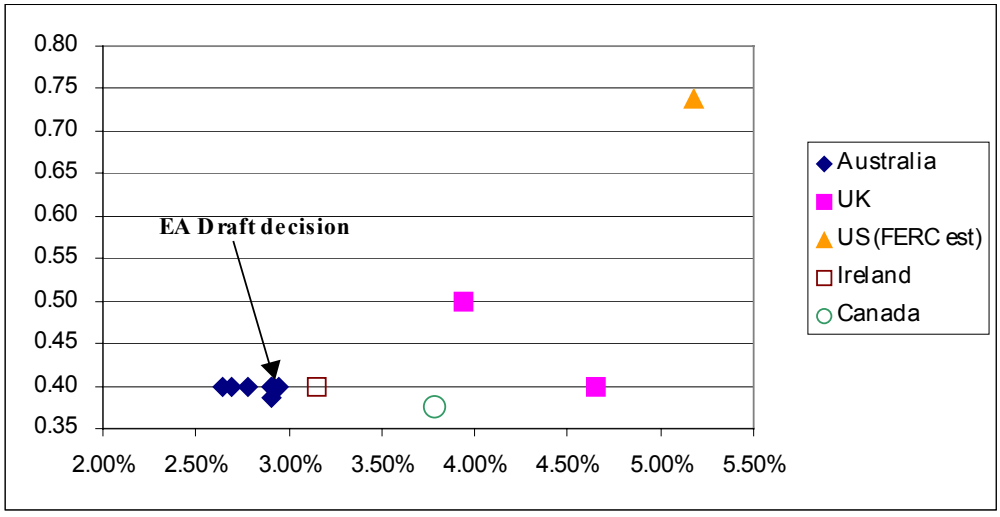
EnergyAustralia believes that the WACC provided by regulators generally throughout Australia is materially below comparable international benchmarks. The WACC as calculated by the ACCC in its 2004 draft NSW Transmission Decisions and as suggested in the SRP effectively maintains this relative disadvantage.

Whilst EnergyAustralia maintains its concerns at the quantum of the returns that will be provided by the WACC framework contained in its Statement of Regulatory Principles, EnergyAustralia hopes that the approach proposed by the ACCC will at least place halt on the ever reducing WACC being provided in each subsequent regulatory decision. In this respect, the ACCC's transparency is welcomed.

6.1. International comparisons

The WACC in the ACCC's draft decision and as contemplated in the SRP - while similar to previous decisions by the ACCC in electricity transmission - is still considerably lower than that implicit in comparable decisions adopted by overseas regulators. Figure 3 sets out the margin of the vanilla WACC over the prevailing 10 year Government bond for various electricity transmission decisions, with these all reflecting the outcome that would have occurred had the relevant overseas regulator adopted a market risk premium of 6%. EnergyAustralia's advisers on WACC, NECG, believe that this is the most credible approach to comparing international WACC allowances.

Figure 3: Comparison of electricity transmission decisions



Source: NECG submission to the Productivity Commission, September 2003 (Number 56). ACCC decisions since this date have been added (Murraylink, Transend, Transgrid/EnergyAustralia).

NECG notes that while this approach to comparing regulatory decisions has been criticised by the ACCC and its consultants, the Allen Consulting Group, neither party has provided a superior approach to analysing WACC allowances in regulatory decisions. The only alternative provided by the ACCC was the comparison of total returns. However, this approach is a more

restrictive measure as it assumes that investors expect the real exchange rate to remain constant and that there is no country risk premia embedded in risk free rates[26].

Of even greater concern, is the apparent competition between regulators over the past several years to lower the WACC provided to the regulated businesses that was allowed in the previous regulatory decision. The regulatory risks that such a framework create should not be underestimated, particularly in the current environment where infrastructure businesses are seeking capital to fund significant network investments over the next five years.

EnergyAustralia notes that the "headline" WACC referred to by the ACCC is only an *ex-ante* forecast of returns, and is not linked to actual returns earned by TNSPs. To the extent that allowed revenues are insufficient to cover actual costs based on the regulator's *ex-ante* assumptions, the TNSPs actual returns will suffer.

6.2. The ACCC's proposed approach to WACC

EnergyAustralia believes that stopping the downward spiral of allowed regulatory returns is the first step in ensuring that investors in regulated infrastructure businesses will be able to earn a commercial return on their investments. EnergyAustralia believes that the certainty provided by the Statement of Regulatory Principles is key to opening the necessary levels of investment capital that will be required to fund the significant network infrastructure development required to meet Australia's energy needs over the coming years.

However, the certainty provided by the Statement of Regulatory Principles would be enhanced if the ACCC were to clearly articulate the process, scope and timing of the reviews of the WACC parameters referred to in the current draft. Of particular interest to EnergyAustralia is the ACCC's approach to reviewing the debt margin and the equity beta, as the ACCC's approach to these parameters in its draft Transmission Decision have been cause for some debate.

In the draft Decision for EnergyAustralia, the ACCC used firm-specific information to determine a credit rating. Further, the method of calculating the credit rating appears flawed, as EnergyAustralia understands that the ACCC's methodology inappropriately included non-network information in its calculation of the credit rating. EnergyAustralia therefore recommends that caution needs to be exercised by the ACCC when reviewing the benchmark assumptions to ensure that only the relevant network information is used to derive the credit ratings. If the ACCC is intending to rely on information provided to it by consultants or credit ratings firms, the ACCC must ensure that the credit ratings reflect only the relevant network information.

In response to the ACCC's draft decision, EnergyAustralia highlighted that market-observable data must be normalised to ensure that the basis for comparisons and benchmarking are in fact appropriate. This is crucial where the ACCC is intending to use the analysis of the market data to set benchmark values for the beta and gearing to apply to all TNSPs.

Therefore, when considering future reviews of the beta to apply to TNSPs some of the considerations that should be examined include:

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[26] For further details see NECG's submission to the Productivity Commission Review of the Gas Code in March 2004 (DR97).

- an assessment of comparable companies in Australia and overseas;
- regulatory decisions and associated regulatory risks; and
- an assessment of the factors that impact on the sensitivity of the TNSP's returns to movements in the economy.

7. FINANCIAL INDICATORS

7.1. Value of including historical ratios

The ACCC recognises that it has a Code obligation to provide for a sustainable commercial revenue stream which includes a fair and reasonable rate of return having regard for, among other things, “any other financial considerations”. In the draft SRP, the ACCC has opted to use a myriad of financial indicators to determine the effect of the revenue cap on the TNSPs financial viability and ability to obtain credit. Some relate to ratios used historically by the ACCC in previous revenue cap decisions, others are common ratios used by Standards and Poors.

EnergyAustralia believes that the use of a wide range of financial indicators helps mitigate the possibility of any bias in the resulting conclusions drawn from the analysis. For the simple EBIT ratios, direct comparisons to historical outcomes would deliver a more useful guide as to the reasonableness of prospective ratios. Yet in EnergyAustralia’s draft Determination the ACCC presented an isolated view of these ratios, and in doing so the ratios provided little or no meaning. EnergyAustralia suggests that the ACCC be required to review financial ratios in light of historic ratios, from which a trend can be established to further aid in determining the effect of the revenue cap decision.

7.2. Inappropriateness of referencing external credit ratings

EnergyAustralia believes that, as part of assessing the financial viability and ability to obtain credit of our transmission business, it is inappropriate for the ACCC to reference our long term credit rating as a consolidated entity as reported by Standard and Poors. The draft SRP makes no reference to drawing comparisons from S&P’s report on long term credit ratings, yet the financial analysis performed by the ACCC as part of EnergyAustralia’s current revenue cap review process does. EnergyAustralia as an incorporated entity includes Distribution, Retail and External businesses, none of which are subject to the review of the ACCC. Drawing reference to the credit rating of the entire company is completely inappropriate and will invariably lead to erroneous outcomes, particularly where the rating is used to influence the determination of an appropriate debt margin. This is particularly the case should the ACCC move to a relatively more riskier *ex-ante* framework for capital expenditure that exposes a TNSP to higher risk of asset stranding.

A similarly crude approach was adopted by the ACCC in its imposed Access Arrangement for the Moomba-Sydney Pipeline (MSP) system. In this particular case, the ACCC had (inappropriately) included AGL’s credit rating in a pool of industry participants to derive an average for that industry. In its judgement on appeal, the Australian Competition Tribunal (ACT) noted that there was “no logic or reason to [include AGL’s credit rating in the averaging of the industry] and there is no material to suggest it has any support in the theory or practice of statistics”. By including EnergyAustralia’s non-Transmission businesses in its financial indicator analysis, the ACCC has fundamentally taken the approach it took to MSP - one ruled illogical and statistically unsupported by the ACT.

7.3. Articulation of assumptions underpinning financial indicator analysis

EnergyAustralia seeks further articulation from the ACCC on the assumptions underpinning the financial indicator analysis. We raise this in light of EnergyAustralia's current revenue cap decision, where the ACCC has modelled EnergyAustralia's cash-flows on a simplistic extrapolation of historic information. EnergyAustralia contends that the ACCC should have adopted an approach that models cashflows based on expected cash outcomes, given that the weighted average cost of capital is developed in a forward looking framework.

APPENDIX A – RESPONSE TO THE ACCC PASS THROUGH RULES

EnergyAustralia is pleased to have the opportunity to respond to the ACCC's most recent draft of the standard Pass Through Rules. EnergyAustralia is pleased to note that many of the issues raised in our comments in response to the draft determination have been taken into account in this version of the Rules. However, there are a number of issues that require further clarification prior to EnergyAustralia being able to indicate its support and endorse the rules.

Regulated Pass Through

Clause 2.2	Network (Grid) Support Event – EnergyAustralia has not proposed inclusion of this event type but seeks clarification of what circumstances might be covered by such an event, in particular what is the scope of "network support". It is unclear at this stage whether this event would be relevant to EnergyAustralia.
Clause 2.4 (a)	EnergyAustralia acknowledges that it would be difficult and counter-productive to attempt to define "material", and that it is desirable that the issue of what is "material" should be determined in each particular circumstance. It may however be useful if the ACCC provided guidance as to when a Pass Through Amount might be material. Does the ACCC propose to add further guidelines as to what would be "material" ?
Clause 2.4 (b) & (c)	EnergyAustralia agrees that the Pass Through Amount should be determined by having regard to whether the TNSP has aggravated the effect of the event. How does the ACCC intend to verify whether a TNSP has aggravated the event? In addition, it is not clear how clause 2.4.(b)(ii) will operate. How could a TNSP do something inconsistent with good electricity industry practice that reduced the net financial effect of the Pass through event?
Clause 2.4 (d)	What type of information does the ACCC envisage a TNSP would provide to ensure that the ACCC is satisfied that there is no allowance already included in the revenue cap for a similar event?
Clause 2.4 (g)	As indicated above, it appears that a Network (Grid) Support Event is not likely to be relevant to EnergyAustralia, but EnergyAustralia requests further detail as to the type of actions which would be caught by this event.

Procedure

Clause 3.1 (d)	The requirement for the TNSP to notify ACCC *within one month* of it becoming aware of a negative pass through amount is a very short timeframe. EnergyAustralia seeks an extension of time for this, particularly if notification required the TNSP to fully outline all aspects of the pass through event as would be required if a positive pass through event was triggered. A more reasonable timeframe would be "as soon as practical and in any event within three months of the TNSP becoming aware of the event". Furthermore, it is worth noting that a *one month* timeframe does not

	apply to notification of Pass Through Events that will result in a positive Pass Through Amount. Given that the same amount of work will be involved in preparing a notification for a positive or negative pass through, it is appropriate that the time frame for notification not be materially different to allow for adequate preparation of supporting material.
Clause 3.3 (c)	EnergyAustralia does not agree that provision of the insurance policies that are in place at the time the determination is made are relevant to the ACCC's decision until such time as a Pass Through Event is triggered. The decision to hold insurance or self-insure against an event is a decision made by the business and should not be specifically scrutinised by the regulator until such time as circumstances change that require specific analysis, such as a Pass Through Event. The ACCC should specifically articulate the basis upon which the provision of such insurance policies, annually as a matter of course, is justified by clause 6.2.5(c) of the Code, ie on what basis are they required to enable the ACCC to perform its regulatory functions under the Code? In EnergyAustralia's case, insurance will be sought for the entire network. Provision of the premiums themselves will therefore be of little use to the ACCC in assessing the specific impact on the transmission business.
Clause 3.3 (c)(ii)	The requirement for each TNSP to provide copies of insurance policies whenever these change from the original policies represents micro-management of the businesses interests. Again, these premiums, invoices etc are not relevant until such time as an Insurance Event is triggered. EnergyAustralia would expect that such information would be provides as part of its Notice application to ACCC that a Pass Through Event had been triggered. Furthermore, EnergyAustralia would argue that the Pass Through mechanism has worked well without prior disclosure of such information.
Clause 3.4 (b)	EnergyAustralia does not think it appropriate for commercially sensitive information to be provided to interested parties. This is particularly the case with the provision of insurance policy information.
Clause 3.5 (b)	EnergyAustralia agrees with the clause that provides the ACCC's agreement to the pass through amount unless otherwise notified within the Assessment Period. This allows reasonable compensation for an event to be forthcoming within a timely period.

Definitions

Assessment period	EnergyAustralia agrees that the two month timeframe, stretching to a maximum of four months represents a reasonable assessment period.
Insurance Event	EnergyAustralia acknowledges the ACCC's specific recognition of costs that are within the deductible but that may be material. This is important to maintain consistency if the ACCC removes the portion of

	the self-insurance premium included for these costs.
Network (Grid) Support Event	EnergyAustralia seeks clarification as to what circumstances this Event constitutes.
Relevant Tax	EnergyAustralia notes the ACCC's specific inclusion of the words "levy" to take account of the new industry levy which is likely to apply as a result of the energy reforms. EnergyAustralia also notes the other words of the clause that allow for similar imposts to be included as a relevant tax.
Service Standards Event	EnergyAustralia notes and acknowledges the very broad provision to capture a range of events which may impact on the cost of providing *prescribed services*, in particular clause (a)(iii) which refers to "substantially varying the manner in which the TNSP is required to undertake any activity forming part of *prescribed services."* EnergyAustralia submits that the reference to "substantial" is not necessary in this clause because <u>any</u> variation in the manner in which the TNSP is required to undertake any activity which results in the TNSP incurring materially higher or lower costs should be considered a Service Standard Event. It is not appropriate for the test to be that the variation in the manner in which the TNSP be required to undertake any activity be substantial as well as the cost impact being material.