ENERGY USERS' ASSOCIATION OF AUSTRALIA

ACCC Review of the Draft Statement of Principles for the Regulation of Transmission Revenues:

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EXECUTIVE SUMMARY

The Energy Users' Association of Australia (EUAA) welcomes the opportunity to contribute to the review by the Australian Competition and Consumer Commission (ACCC) of its *Draft Statement of Principles for the Regulation of Transmission Regulation* (Draft SRP). This is an important document that will impact on the future regulation of transmission services, which are paid for by consumers and also have an important impact on the performance of the National Electricity Market (NEM), including the energy prices in retail contracts. The EUAA also anticipates that the Ministerial Council on Energy will consider the SRP as it reviews transmission services in the NEM and that it could also be adopted by the National Energy Regulator (NER) for regulating transmission network services.

However, the EUAA is disappointed that the Discussion Paper is needlessly academic and theoretical, as are several of the Appendices, which makes it difficult to comprehend. In some instances the ACCC's arguments are also difficult to follow. In preparing its Discussion Paper for the Review, the ACCC did not adhere to principles of 'best practice regulation', the first of which is said to be "*effective communication and consultation … between the regulator and all stakeholders, so as to encourage transparent decision making processes.*"

It is also disappointing that the ACCC did not refer to more examples from the practice of economic regulation in both Australia and overseas, particularly by comparing its own approaches, judgements and decisions to outcomes from UK regimes; or address major issues that have been raised by end-users. There are many useful precedents in the practice of economic regulation in the UK, in particular, that are directly relevant to Australia and which could deliver benefits to end-users if adopted and implemented by Australian regulators.

UK experience confirms that these practices do not discourage voluntary support of regulated industries by financial markets. Just some of these, not referred to in the discussion paper, are:

- ensuring the cost of capital is set on an industry-wide basis at a minimum 'efficient' level necessary to satisfy the reasonable expectations of financial markets generally (and not focus solely on satisfying the expectations of individual NSP shareholders);
- aligning the timing for review of regulatory arrangements for TNSPs in different jurisdictions so that transmission is regulated as a single integrated system;
- providing effective and meaningful incentives for transmission operators to achieve efficiency while optimising the total cost of electricity supply to end-users; and

- aligning regulatory policies applying to both electricity and gas transmission so that users of both systems have similar incentives to invest in downstream activities.

An issue of fundamental importance to this review of the SRP by the ACCC is that end-users require time to organise resources, prepare for participation in the reviews and make meaningful submissions. This needs to be allowed for in the planning and execution of regulatory reviews. There is no evidence that the difficulties faced by end-users currently would be improved by the ACCC's proposals.

Whilst we welcome the formation of the NEM Advocacy Panel as a means of securing funding for end-user submissions and other input to regulatory reviews this is modest compared to the resources allocated by TNSPs and paid for by end-users out of transmission charges. An additional matter that the ACCC must also consider is that experience to date with the Panel has been disappointing in several important respects for reasons outlined in the submission. By contrast, TSNPs have access to all the information necessary to make their case (and exercise 'strategic behaviour'), and show they are prepared to put whatever resources they consider necessary to present, represent and advocate their interests.

Moreover, the lack of specific detail on the timing of the consultation periods proposed by the ACCC will compound the difficulties faced by end-users seeking to participate in regulatory reviews. The ACCC proposals would be improved by:

- fixing the commencement of each consultation period in advance so that end-users have a better basis for planning participation (and seeking funding support from the NEM Advocacy Panel);
- concatenating the two periods for consultation on the TNSPs application and the ACCC's consultants' analysis of the application;
- allowing more time for end-users to consider issues raised in the TNSPs applications and the ACCC's consultants' reports concurrently;
- fixing an end date for the review process so that TNSPs can publish revised tariffs well before the start of new fiscal years and end-users can budget for changes in transmission charges; and
- including a commitment to work with TNSPs to improve the communication of their tariffs to customers, retailers, distributors and jurisdictional retailers and to require them to develop some 'tools' to assist with this.

A major improvement in the ACCC proposals would be gained by aligning the regulatory review periods for all TNSPs. This would:

- substantially reduce the resources currently required to participate in multiple reviews, thereby reducing the cost of regulation;
- allow the ACCC to deal with common issues, such as:

- analysis and judgement on the value of parameters for estimating the weighted average cost of capital in exactly the same way for all TNPS;
- assessing the prudency and efficiency of expenditure, and application of comparative performance assessment (or benchmarking) using consistent data;
- create comprehensive 'service standards' for the whole transmission system that could include specific incentives for TNSPs to interact with the energy and ancillary services markets to optimise outcomes for end-users;
- create better targeted incentives for all TNSPs to operate efficiently, including through 'competition by comparison'; and
- provide for consistency with the regulation of distribution networks by jurisdictional regulators.

The EUAA remains concerned about the approach to asset valuations adopted by jurisdictional governments and regulators. In general terms, the key issue of concern is that end-users are forced to pay higher than efficient costs for energy because asset values have been set at levels that are neither efficient nor fair, nor are they based on the most practicable asset valuation methodology. In particular, the use of Depreciated Optimised Replacement Cost (DORC) is unfair to end-users because:

- DORC valuations are generally higher than Depreciated Actual Cost or Deprival Value;
- no account is taken in DORC methodology for payments already made by end-users for the costs of sunk assets meaning end-users are forced to pay twice for some assets; and
- the flow-on impacts of higher than efficient asset valuations disadvantage end-users subject to the pressures of internationally competitive markets.

These outcomes are compounded by adopting values for Weighted Average Cost of Capital that are demonstrably higher than relevant international comparators – a matter on which the EUAA has also made numerous submissions to the ACCC and other regulators.

Despite these concerns with DORC, the EUAA does not support the ACCC's preferred position on asset valuation because this would have the effect of removing an essential efficiency incentive for TNSPs. Nor does the EUAA see how the practical difficulties with valuation methodologies and information asymmetry can be effectively addressed with the ACCC 'fall-back' options. The EUAA would prefer that the ACCC further explore means to develop transparent and effective incentives for TNSPs to achieve efficient outcomes for all their activities.

The EUAA urges the ACCC to adopt regulatory principles in regard to the valuation of both 'fixed assets' and 'easements' that emphasises future efficiencies and delivery of

end-user benefit. Such principles would only allow re-valuation of assets if this can be demonstrated to enhance future efficiency and deliver benefits to end-users. End-users should only be required to contribute sufficient revenue to sustain existing used and useful assets and fund future 'efficient' assets.

The ACCC's proposals would be improved by explicitly adopting the following 'principles' to be included in the SRP:

(a) Acknowledge that there are no hard and fast rules for the appropriate approach to asset valuations.

(b) Acknowledge an intent to achieve valuations for sunk assets that are efficient, fair and practicable where -

  (i) an efficient valuation will be the lowest value that would allow the asset owner to recover efficient investment and would create the least distortion to efficient upstream and downstream investment. That is, the asset valuation methodology should explicitly consider the impact on investment in upstream and downstream activities.

  (ii) a fair valuation will be one where end-users fully fund efficient capital costs, but only do so once. That is, a fair valuation of sunk assets should pay attention to past depreciation schedules and returns on capital already paid by end-users on sunk asset investments and should focus on providing incentives for efficient future investment.

  (iii) a practicable asset valuation will be one that uses the most readily available information, with a methodology that is least likely to be subject to 'strategic' manipulation of information by asset owners.

(c) Explicitly aim to provide incentives for efficient future investment and efficient operation of networks.

(d) Explicitly prohibit change of easement asset values and retain easement values at historic actual cost in nominal terms. Where such costs cannot be established with certainty, easement asset values should be explicitly set at zero.

The ACCC should also review information on OFGEM's distributed generation work program and look closely at policies and mechanisms to establish appropriate incentives for NSPs generally to facilitate efficient investment in 'alternative' technologies that have the potential to deliver substantial benefits to end-users. Such policies and mechanisms should not be restricted to a focus on NSP's conventional responses. Furthermore, the ACCC should also consider how to ensure investments by end-users that have the effect of delivering benefits to other users of shared networks can be both facilitated and rewarded. Establishing regulatory principles that focus on future efficiency will assist in minimising the risk of asset stranding and deliver benefits to both end-users and TNSP owners.

The ACCC's proposals in regard to expenditure assessment also require substantial review.

The Discussion Paper appears to be based on an assumption that TNSPs would seek to commit capital expenditure (CAPEX) in excess of that necessary to meet the service obligations specified in the Code. The EUAA is not aware of any evidence to support such a view. Indeed, evidence suggests that TNSPs would seek to increase short-term profitability by cutting costs below revenue benchmarks, including by putting off CAPEX as long as possible. This is exactly what the basic 'incentive' in the regime is intended to achieve.

Other significant matters of concern relating to regulatory treatment of TNSP's expenditure proposals are that:

- the ACCC is proposing to introduce new 'rules' it acknowledges it cannot enforce and subject the TNSPs' execution of the *regulatory test* to *ex-ante* and *ex-post* reviews as the means of evaluating whether or not the TNSPs actual CAPEX is 'prudent' and its forecast CAPEX 'efficient', which has the hall-marks of the ACCC attempting to micro-manage activities that should be left to TNSPs;
- the SRP should include a 'principle' that the ACCC undertake and present a comparative analysis of actual and forecast CAPEX (and OPEX) in all its Determinations;
- the ACCC makes no specific mention of how it proposes to deal with exercise of 'strategic behaviour' that is widely recognised as a major negative feature of 'incentive regulation';
- it is not clear how the ACCC will deal with 'over-spending' of CAPEX, such as that reported by Transgrid in its current application;
- it is not clear how the ACCC's proposals will deal with the inevitable trade-off that TNSPs will make between CAPEX and operations and maintenance (OPEX) costs;
- the ACCC should also be wary of being dragged into an incremental 'cost-of-service' view of TNSP costs as it has done with insurance and risk pass-through (and incremental 'add-ons' in the assessment of cost of capital); and
- the ACCC should take a more pragmatic view of performance comparison and 'benchmarking' including adaptation of the techniques successfully applied by UK regulators.

As with most other sections of the Discussion Paper, the section on the Weighted Average Cost of Capital (WACC) is disappointing for the following reasons (at least):

- there is no acknowledgment of evidence presented by the EUAA and others that shows Australian regulators are making very different judgements on the cost of equity and WACC than their overseas counterparts;

- there are obvious errors in material referring to overseas experience; and
- there is no recognition (present in both Schedule 6.1 of the Code and the Draft SRP) that the use of the Capital Asset Pricing Model (CAPM) and estimation of WACC requires, and is totally dependent on, sound and well-balanced regulatory judgement.

The dominant 'regulatory principle' governing the treatment of WACC should be that the return on equity and cost of capital be set at levels that meet the reasonable 'efficient' expectations of financial markets. This is the only way that end-users can access the benefits of 'efficient' financing by prudent, well-managed companies. On the other hand, continuing to set values for return on equity and WACC that are transparently biased in favour of TNSPs holds out no prospect of end-uses being able to share in efficiency benefits as required under the Code.

Given the important role that the WACC plays in setting TNSP revenue (and prices), it is very disturbing to us that the ACCC continues to perpetuate unjustifiably high rates of return for transmission businesses that translate directly into higher transmission tariffs. The ACCC needs to keep firmly in mind that these costs are paid by Australian energy users operating in competitive markets and competing internationally. We estimate that the impact of this is to increase the WACC by some 100 basis points and that transmission costs are some $200 million per year higher because of this.

1. INTRODUCTION

The Energy Users' Association of Australia (EUAA) welcomes the opportunity to contribute to the review by the Australian Competition and Consumer Commission (ACCC) of its *Draft Statement of Principles for the Regulation of Transmission Regulation* (Draft SRP). This is an important document that will impact on the future regulation of transmission services, which are paid for by consumers and also have an important impact on the performance of the National Electricity Market (NEM), including the energy prices in retail contracts. The EUAA also anticipates that the Ministerial Council on Energy (MCE) will consider the SRP as it reviews transmission services in the NEM and that it could also be adopted by the National Energy Regulator (NER) for regulating transmission network services.

Whilst not stated explicitly, it appears that the ACCC intended the Discussion Paper to demonstrate how its principles are underpinned by the theory of economic regulation. In our view, the Discussion Paper is needlessly academic and theoretical, as are several of the Appendices, which makes the Discussion Paper difficult to comprehend. In some instances the ACCC's arguments are also difficult to follow.

The ACCC says in its current draft SRP that it is committed to adhere to principles of 'best practice regulation', the first of which is to be "*effective communication and consultation … between the regulator and all stakeholders, so as to encourage transparent decision making processes.*"[1] Circulating a Discussion Paper that is not clear and not easy to follow is not 'best practice regulation'.

It is also disappointing that the ACCC did not refer to more examples from the practice of economic regulation in both Australia and overseas, particularly by comparing its own approaches, judgements and decisions to outcomes from UK regimes; or address major issues that have been raised by end-users. There are two issues, in particular, that have been consistently raised by the EUAA over several years that are not even mentioned in the Discussion Paper. These include benefits that could come from adopting regulatory principles that:

- align the regulatory periods for all transmission network service providers (TNSPs) so that NEM transmission can be treated as though it is a single system;[2] and
- develop incentives to encourage TNSPs to optimise overall energy supply costs (and supply quality) to end-users.

[1] p (viii) and Section 1.3, *Draft Statement of Principles for the Regulation of Transmission Revenues*, ACCC, 27 May 1999.

[2] We note that the MCE is focused on measures to achieve this.

Both these principles would improve the practice of regulating TNSPs by lowering the cost of regulation and delivering better value to end-users.

Nor has the ACCC explicitly responded to, or commented on, material provided by EUAA in submissions to regulatory reviews for ElectraNet SA, SPI PowerNet and Transend that compares the decisions of Australian and UK regulators on the weighted average cost of capital (WACC). This material demonstrates that the ACCC has been, and is, making judgements on cost of debt that are comparable to judgements of UK regulators, but is setting return on equity at much higher levels than UK regulators. These differences have not been adequately explained by the ACCC. Nor has the ACCC explained why debt and equity providers would make different judgements about the "efficiency" of the TNSPs. These matters are taken up in more detail in Section 5.

The ACCC explicitly says that it "*expects that the Regulatory Principles will evolve in response to improvements in regulatory models and best practice worldwide*."[3] The EUAA has made reference in previous ACCC submissions to the 'problem of circulatory' in Australian regulators' decisions, with regulators successively referring to earlier decisions without adding quality to regulatory judgements. Reference to examples of regulatory practice in comparable overseas jurisdictions would have added credibility to the Discussion Paper, clarified points that the ACCC was attempting to make and introduced issues of importance to end-users, who are required to pay for transmission services.

There are many useful precedents in the practice of economic regulation in the UK, in particular, that are directly relevant to Australia and which could deliver benefits to end-users if adapted and implemented by Australian regulators. UK experience confirms that these practices do not discourage financial market support of regulated industries. Just some of these, not referred to in the discussion paper, are:

- ensuring the cost of capital is set on an industry-wide basis at a minimum 'efficient' level necessary to satisfy the reasonable expectations of financial markets generally (and not focus solely on satisfying the expectations of individual NSP shareholders);
- aligning the timing for review of regulatory arrangements for TNSPs in different jurisdictions so that transmission is regulated as a single integrated system (as mentioned above);[4]

[3] p 3, *Op Cit.*

[4] The alignment of the regulatory regimes in England, Wales and Scotland is being achieved by changes to energy law. Apart from the limitations created by clause 6.2.4(b) and (d) of the Code, there would appear to be no legal obstacle to aligning regulatory periods for NEM TNSPs. For example, the ACCC has indicated it will align regulatory periods for NSW and Tasmania. However, the ACCC has missed one opportunity to achieve this goal for all TNSPs. The next opportunities to achieve alignment will arise between June 2007 and June 2009 unless there is a fundamental change to

- providing effective and meaningful incentives for transmission operators to achieve efficiency while optimising the total cost of electricity supply to end-users; and
- aligning regulatory policies applying to both electricity and gas transmission so that users of both systems have similar incentives to invest in downstream activities.[5]

In some cases, the ACCC also appears to be presenting options for regulatory principles when it has already adopted practices that appear to 'close out' options being presented.[6] Accordingly, the Discussion Paper would have been more transparent if it had:

- focussed on 'regulatory practices' adopted by the ACCC;
- provided a detailed explanation of how and why these practices differed from 'regulatory principles' in the Draft SRP; and
- presented a comparison between the Draft SRP and practice (both in Australia and overseas) as the basis for consultation.

The way in which the Discussion Paper presents issues is far from transparent and discourages 'consultation' with energy users.

This submission attempts to provide positive and constructive comments on 'preferred positions' proposed by the ACCC from the perspective of end-users and propose fundamental 'principles' that should be included in the SRP. The structure of the submission reflects the order in which the relevant issues are presented in the ACCC Discussion Paper.

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clause 6.2.4(d) of the Code or agreement by affected jurisdictions through the Ministerial Council for Energy (MCE). Without changes to the current arrangements, alignment could not occur until June 2014.

[5] Currently, for example, large electricity generators pay none of the costs of the shared electricity transmission system (or losses in that system) but face the full cost of gas transmission, whereas large end-users (or other investors in gas-fired distributed generation) bear the costs for both gas and electricity network charges (and losses). This creates distorting incentives:

- to add gas-fired generation capacity at remote sites, particularly if the remote site is closer to established gas supply than the load centre the generator aims to supply; and
- discourages investment in cost-effective distributed generation.

UK regulators moved to address this anomaly in the mid-1990s. The ACCC paper does not even acknowledge that the anomaly exists, much less suggest anything to address it (and neither have jurisdictional governments).

[6] For example, the Discussion Paper deals at length with asset valuation and seeks input on options to be considered by the ACCC. But past practice appears to close out the option of not re-valuing assets. The ACCC has accepted re-valuation of assets in virtually all of the decisions it has made.

Another example is adoption by the ACCC of a value of 6% for the Market Risk Premium. The Discussion Paper appears to be suggesting that this figure is not controversial. But there is no compelling evidence in the Discussion Paper or in the references cited by the ACCC to support that position. The EUAA has presented evidence to the ACCC in numerous previous submissions that demonstrates that the way Australian regulators deal with parameter values in the Capital Asset Pricing Model, including MRP, is highly controversial. The lack of recognition of informed end-user views is extremely disappointing.

2. REVENUE CAP DECISION MAKING PROCESS

The Commission's preferred position: The Commission proposes to extend the regulatory review period to twelve months.[7]

The conduct of regulatory reviews is a critical issue for end-users, for two reasons. The first is that end-users experience difficulty in resourcing participation in the reviews. To date, end-users have not been able to access sufficient resources to fully participate in one single regulatory review undertaken by the ACCC. As detailed below, establishing the NEM Advocacy Panel has seen some improvements in this situation, but has created some new problems.

The second is that it is inevitable that the regulatory process 'suffers' from information asymmetry that favours TNSPs. Despite the fact that the National Electricity Code (Code) requires the ACCC to balance the interests of owners and users,[8] ACCC documents emphasise issues raised by TNSPs in their revenue applications and focus on the importance of ACCC judgements and decisions to the TNSPs' financial interests, while tending to ignore, neglect or minimise issues and financial impacts on end-users. This translates into regulatory judgements and decisions that are inevitably biased in favour of TNSPs, an outcome that is acknowledged by the ACCC in its determinations. The only credible way that information asymmetry can be re-balanced is for end-users to present arguments to regulators (in a useful and relevant form) that project their own interests and to be provided with the resources to do this.

2.1. CONSULTATION, END USER PARTICIPATION AND RESOURCING

An issue of fundamental relevance to discussion of the ACCC's preferred position is that end-users require time to organise for participation in the reviews and make meaningful submissions.[9] This needs to be allowed for in the planning for, and execution of, regulatory reviews. There is no evidence that the difficulties faced by end-users currently would be improved by the ACCC's proposals. The lack of any comment on end-user consultation or specific detail on the timing of the consultation periods proposed by the

[7] The timing of the ACCC's review process is specified in section 2.3 of the Draft SRP. This requires a TNSP to submit its application 8 months prior to the expiry of the current regulatory period and allows the ACCC to extend the period of review by up to two months on one or more occasions (at its own instigation or if requested by the TNSP). There is no specification of a deadline (prior to the expiry of the current regulatory period) for publication of the ACCC's Final Decision.

[8] For example, see clause 6.2.3(d)(5)(i).

[9] The EUAA acknowledges that it has sometimes experienced difficulty in meeting the ACCC's consultation timetables, including deadlines for submissions, because of its lack of resources. While the EUAA has welcomed the ACCC's flexibility in responding to our requests for this to be taken into account, this review should be used as an opportunity to address this difficulty as constructively as possible.

ACCC, for example, will continue the difficulties faced by end-users seeking to participate in regulatory reviews.

Clause 6.2.4(b) of the National Electricity Code (Code) specifies that a key requirement for the review process is to "*provide all affected parties with (both adequate notice* and*) a reasonable opportunity to prepare for, participate in, and respond to that process*". Without "*adequate notice*" and "*reasonable opportunity*", end-user views cannot be adequately prepared, presented or represented in regulatory reviews.

The ACCC's proposal aims to address the inability to complete any of the reviews undertaken to date within the 6 month period currently specified in the Draft SRP.[10] The review durations achieved to date are summarised in Table 1 below.

TABLE 1: KEY DATES IN ACCC REGULATORY REVIEW PROCESSES

Region/TNSP	Review Commenced[11]	Final Decision	Duration[12]	Regulatory Period	
				Effective Date	Expiry Date
NSW (1st review)	Before Dec98[a]	25 Jan 00	>13 months	1 Feb 00[b]	30 June 04
QLD	After 14 Feb 01[c]	1 Nov 01	~8 months	1 Jan 02	30 June 07
SA	After 16 Apr 02[d]	11 Dec 02	~7.5 months	1 Jan 03	30 Jun 08
VIC	After 30 Apr 02[e]	11 Dec 02	~7.5 months	1 Jan 03	31 Mar 08[f]
Murraylink	After 18 Oct 02[g]	1 Oct 03	~11 months	< 4 Nov 03[h]	30 Jun 13
TAS	After 14 Mar 03	Dec 03[i]	~8 months	1 Jan 04	30 Jun 09
NSW (Planned)	After 18 Nov 03[j]	Early Aug 04	<11 months	1 Jul 04	30 Jun 09

Source: Documents posted on the ACCC Website

Notes:

(a). ACCC released an Issues Paper in Dec 98, and a Draft Decision in May 99.

(b). Period commenced retrospectively from 1 Jul 99 with NSW TNSPs permitted to earn revenues in accordance with the pre-existing prices for the period between 1 Jul 99 and 31 Jan 00.

(c). The covering letter to Powerlink's application is dated 14 Feb 01.

(d). ElectraNet SA lodged its initial application on 16 April 02 followed by an additional submission on easement valuations dated 9 May 02.

(e). SPI Powernet lodged application on 11 Apr 02. VENCORP lodged application on 30 Apr 02. (f). The regulatory period expires on 31 Mar 08 for SPI PowerNet and 30 Jun 08 for VENCORP.

(g). Murraylink lodged an initial application on 18 Oct 02.

(h). The ACCC Final Decision to lapse on 4 Nov 03 unless Murraylink's classification as a Market Network Service Provider to cease by that date, or the Decision was subject to legal challenge.

(i). The ACCC issued a Draft Decision for Transend on 24 Sep 03.

[10] Proposed Statement S2.5 of the Draft SRP.

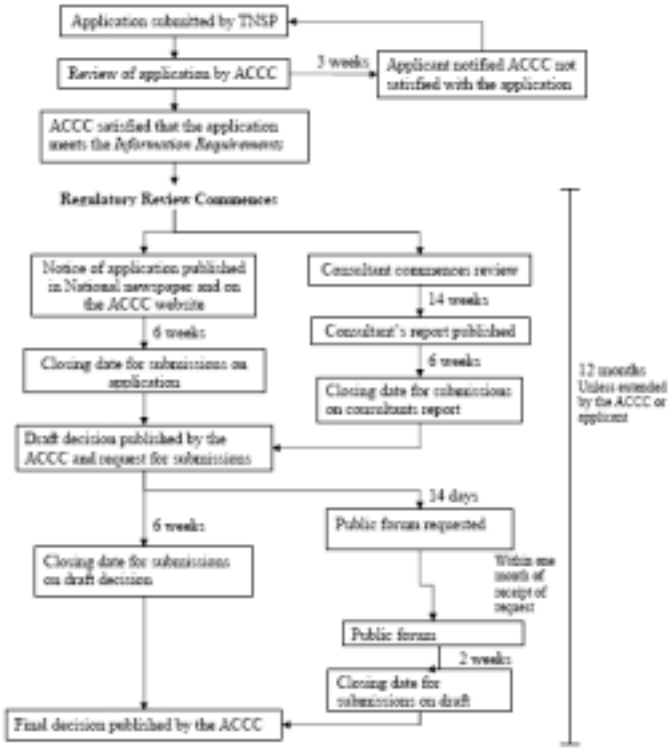
[11] Proposed Statement S2.1 of the Draft SRP obliges the ACCC to publish a notice in a national daily newspaper. The ACCC has posted notices of "*the process and timetable*" on its Website only for the Victorian, SA, Murraylink and the latest NSW reviews. None of the notices includes the date of publication. This means there is no easily accessible public record to show the ACCC fulfilled its obligations under clause 6.2.4(b) in regard to the Tasmanian, SMHEA and Queensland reviews. The ACCC should ensure the notices are posted on its Website (and dated).

[12] The estimates of Duration assume that the review period officially commenced (by publication by the ACCC of details of the review process) 14 days after the latest date that a TNSP submits information related to its application.

(j). Transgrid submitted an initial application on 26 Sep 03 and followed this with submission of three separate attachments, the latest of which was submitted on 22 Oct 03. EnergyAustralia made its initial application on 23 Sep 03 and followed this with submission of six attachments, the latest of which was submitted on 18 Nov 03.

The ACCC's proposal for the 12 month review process commences officially (as does the current process) with publication by the ACCC of a 'notice of application' by a TNSP. This occurs after the TNSP has satisfied the ACCC that the application meets the ACCC's *Information Requirements*. The diagram illustrating the proposed review process (see Figure 1 below) does not show the duration of all activities. This makes it impossible to determine exactly when periods of 'consultation' would occur, which in turn makes it more difficult for end-users to undertake detailed planning for participation in the 'consultation' phases of the reviews.

FIGURE 1: PROPOSED ACCC REGULATORY REVIEW PROCEDURE



Three periods of proposed consultation are shown in the ACCC diagram (Figure 1):

- The first is a period of 6 weeks duration following publication of the 'notice of application' by the ACCC.
- The second is a period of 6 weeks duration that follows release by the ACCC of Consultants' reports on the TNSP's application.

- The third is either:
  - a period of 8 weeks duration following publication by the ACCC of its draft determination; or
  - a period of 2 weeks duration following a Public Forum, if one is called.

The sequence of these consultations creates difficulties for end-users. End-users would find it more convenient, and more efficient, to deal with issues raised in the TNSP applications and the ACCC consultants' responses to these issues at the same time.

The EUAA agrees with the ACCC that the SRP should set out indicative consultation times and/or provide a commitment to provide for minimum consultation times at each major stage of a review. At the commencement of a review the ACCC should also publish a timetable including specific milestones, documentation to be published, consultation opportunities and their duration. This should be updated as required.

Moreover, it would help energy users to participate more effectively in TNSP reviews if the ACCC provided firmer indications as to its processes and the opportunities for consultation in a typical review. The EUAA would then be able to better plan for participation and would be in a better position to secure advocacy funding.[13] It would also help if the ACCC was to make it known to the NEM Advocacy Panel that it requires input from users and what that input should entail in terms of the scope of submissions.

The ACCC Discussion Paper comments on the "*continued criticism from interested parties that the Commission does not allow sufficient time for adequate response to be made*"[14] but does little to address these criticisms in its proposals, except add 2 weeks for stakeholders to comment on the TNSP's application and the ACCC's consultants' reports. This is insufficient to deal effectively with the concerns and difficulties of energy users and the ACCC is urged to consider the additional suggestions made in this submission.

It is also of concern that the ACCC has not specified a time for publication of Final Decisions and their price impacts (relative to, and well before, the expiry of the regulatory period). These issues are of direct and critical importance to end-users and their retailers.

[13] It is currently difficult for EUAA to coordinate funding applications and resources sufficiently in advance of the "consultation" component of the individual TNSP reviews. If this was clearer (because EUAA knew, in advance, more precisely when the "consultations" occurred), it would be possible to access resources and make better submissions. Advance notice would make it easier to prepare and present proposals for funding to the NEM Advocacy Panel, for example.

[14] p9, ACCC Discussion Paper

Advanced notice of firm timing for consultation periods could assist in planning for participation in regulatory reviews. And large end-users (in particular) and retailers[15] would benefit from having advance notice of changes in transmission charges. Many large end-users have had to deal with the budgetary implications of sharp rises in transmission charges within financial years.

In addition, it has been very difficult to interpret how the ACCC's Decisions with impact on transmission charges. It would help if the SRP included a commitment to work with TNSPs to improve the communication of their tariffs to customers, retailers, distributors and jurisdictional retailers and to require them to develop some 'tools' to assist with this.[16]

2.1.1. RESOURCING END USER PARTICIPATION

An additional matter that the ACCC must also consider is that a mechanism for resourcing end-user participation in regulatory processes has not yet been adequately developed. This is despite positive moves by the ACCC to authorise establishment of a NEM 'demand side participation' funding arrangement in September 2001.[17] Experience to date with the NEM Advocacy Panel has been disappointing in a number of areas:

- the Panel was not effectively constituted and in a position to commence funding of end-user advocacy until mid-2003 (i.e. 21 months after authorisation and 3 years after the proposal was initially raised with the ACCC and NECA);
- the Panel is inappropriately constituted (with two of the four members representing supply-side interests);[18]
- none of the Panel members has any direct experience or detailed understanding of the complex issues affecting end-users in economic regulatory reviews;
- the Panel requires applicants to be explicit about why, what, when, how and who they intend undertake a proposed project and what resources are required (which can

[15] Distributors and jurisdictional regulators would also benefit from early confirmation of any changes to transmission charges since they are responsible for passing on these costs to all consumers.

[16] For example, following the most recent ACCC determination for gas transmission charges in Victoria, GasNet posted a spreadsheet based tariff calculator on its web site. Although rather complicated to use, this is an example of what can be done to assist parties affected by tariff decisions.

[17] The ACCC first moved to support establishment of a funded 'demand side participation' process in a Decision published on 22 Dec 99 that required NECA to "*report into the feasibility and resourcing of an end-user advocacy group to participate in NEM decision making*". This was in response to a joint end-user submission (including the EUAA) made in early 1999.

The fact that is has taken four years for a NEM Advocacy Panel to be established and the fact that the Panel has not come to terms with the material needs of end-user participation in regulatory reviews is most unsatisfactory.

[18] The usual argument that the supply-side pays for the funds dispersed by the Panel through NEM fees is spurious. It is well known that end-users pay NEM fees as a pass-through in their electricity charges.

not be known in detail in the case of regulatory reviews until after regulators publish the NSPs' applications, the consultants' reports and even draft Decisions);

- the Panel's processes are complex, time consuming, slow, and (worse still) sometimes appear to be arbitrary (because decisions can be poorly explained, based on discretionary judgements and contain an element of 'second guessing' end user advocates);
- the Panel has not demonstrated a consistent basis for ranking applications, or for assigning meaningful value to alternative (or even competing) proposals;
- the Panel has made some decisions which prevent end-users from engaging competent specialist consultants who can analyse the normally complex NSP applications, consultation documents, consultants' reports and regulatory decisions and present information in a form that end-user advocates can use to influence regulators' decisions;
- the Panel has demonstrated a reluctance to consider multiple applications related to the same 'project' (which prevents some legitimate advocacy proposals and end-user representatives from participating effectively when this might assist in dealing with complex issues that arise as a regulatory review progresses); and
- the Panel has explicitly rejected a number of applications to fund representation and presentation by end-user advocates or consultants in regulatory proceedings.[19]

By contrast, TSNPs have access to all the information necessary to make their case (and exercise 'strategic behaviour'), and show they are prepared to put whatever resources they consider necessary to present, represent and advocate their interests.

2.2. 'PRINCIPLES' FOR INCLUSION INTO THE SRP

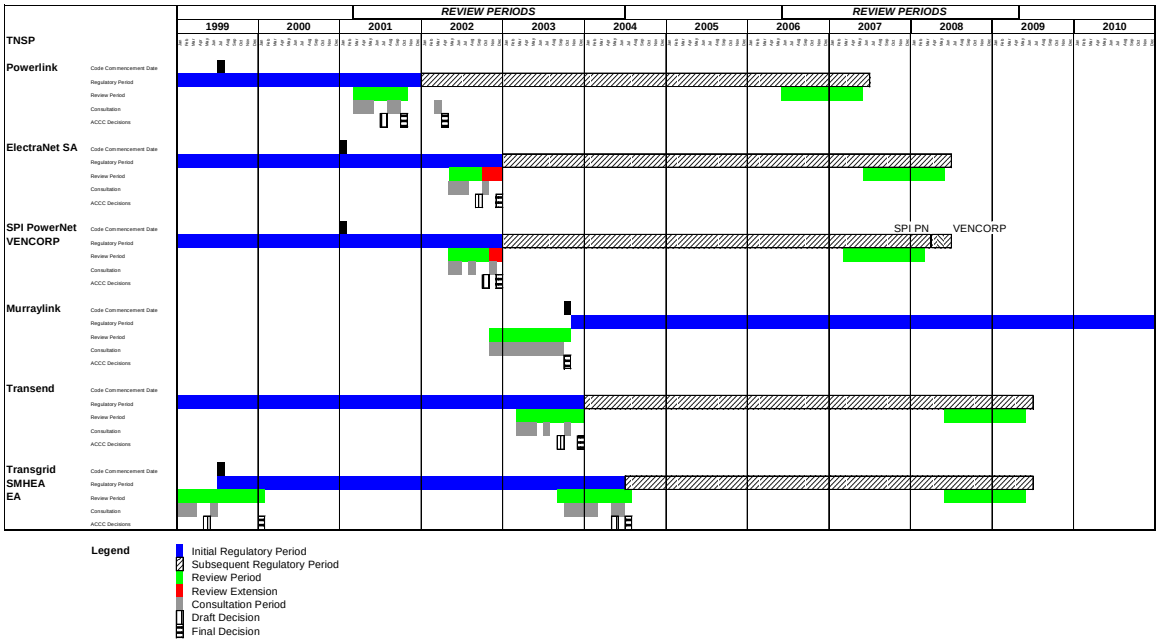
Extending the duration of the review process to 12 months has the potential to assist in addressing some of the challenges facing end-users, but only if the timing of 'consultation' processes is firm. The present proposal focuses too heavily on problems faced by the ACCC and TNSPs and does not adequately consider the requirements of end-users. Accordingly, the ACCC proposals would be improved by incorporating the following as 'principles' in the SRP:

[19] At its meeting in December 2003, the Panel explicitly rejected an application from the EUAA and Energy Action Group to participate in the current Transgrid review, even though no other similar application was before it. It also rejected part of an EUAA and EAG application on IPART's current NSW distribution review relating to representations to IPART and its Draft decision public forums and excised some elements of the consultant's scope of work (which prevented issues being adequately covered in the submission to IPART).

- fixing the commencement of each consultation period in advance so that end-users have a better basis for planning participation (and seeking funding support from the NEM Advocacy Panel);
- concatenating the two periods for consultation on the TNSPs application and the ACCC's consultants' analysis of the application;
- allowing more time for end-users to consider issues raised in the TNSPs' applications and the ACCC's consultants' reports concurrently;
- fixing an end date for the review process so that TNSPs can publish revised tariffs well before the start of new tariff years and end-users can budget for changes in transmission charges; and
- including a commitment to work with TNSPs to improve the communication of their tariffs to customers, retailers, distributors and jurisdictional retailers and to require them to develop some 'tools' to assist with this.

A major improvement would be gained by aligning the regulatory review periods for all TNSPs. Current timing of the reviews is determined by the date in which each jurisdiction applied the Code to their TNSP, with slight modifications to the duration of regulatory periods requested by TNSPs. As shown in Figure 2, this produces significantly different timing for the conduct of reviews for TNSPs (except for Tasmania and NSW in 2009) and we can see no real logic in continuing with this misalignment based purely on historical factors. End-users (and all other stakeholders) face the prospect of participating in regulatory reviews extending through to mid-2004 and then for the three-year period commencing mid-2006 through mid-2009 (repeated every five years). This is clearly inefficient and makes it virtually impossible for the ACCC to produce outcomes consistent with 'best practice regulation' or to deliver optimum benefits to end-users. The proposals contained in the Discussion Paper will do nothing to improve this situation.

FIGURE 2: TIMING OF TNSP REGULATORY REVIEWS 1999-2010



Source: Documents on ACCC website.

Aligning the regulatory periods and review processes has the potential to deliver substantial benefits to all stakeholders. It would:

- substantially reduce the resources required to participate in multiple reviews, thereby reducing the cost of regulation;
- allow the ACCC to deal with issues common to all TNSPs, such as –
  - analysis and judgement on the value of parameters for estimating the weighted average cost of capital in exactly the same way for all TNPS;
  - assessing the prudency and efficiency of expenditure, and application of comparative performance assessment (or benchmarking) using consistent data;
  - create comprehensive 'service standards' for the whole transmission system that could include specific incentives for TNSPs to interact with the energy and ancillary services markets to optimise outcomes for end-users;
  - create better targeted incentives for all TNSPs to operate efficiently, including through 'competition by comparison'; and
  - provide for consistency with the regulation of distribution networks by jurisdictional regulators.

The benefits listed above justify the ACCC incorporating the following additional 'principles' into the SRP:

(a) Achieve alignment of regulatory reviews for all TNSPs as soon as practicable.

(b) Undertake regulatory reviews for a single, multi-company, NEM-wide transmission system.

(c) Develop effective and relevant 'service standards' for the whole transmission system that include specific incentives for TNSPs to interact with the energy and ancillary services markets to optimise outcomes for end-users.

(d) Achieve consistency in approaches and incentives for network service providers to optimise outcomes for end-users.

3. REVALUATION OF THE ASSET BASE VERSUS THE MERITS OF ROLL-FORWARD

The ACCC Discussion Paper presents three options for dealing with asset revaluation. These are:

Option 1 – Periodic revaluation of the asset base

Option 2 – Lock-in the jurisdictional asset base

Options 3 – One off revaluation of the jurisdictional asset base and then lock-in

The Commission's preferred position: The Commission's initial view is to consider each revenue cap on a case-by-case basis but with the preferred position to lock-in at this stage, as there is no evidence to suggest that there are significant problems with the jurisdictional valuations. The Commission notes that the asset base includes both fixed assets and easements. The Commission's preferred position is to lock-in the asset base but if option 1 or 3 is adopted a number of questions are raised in regard to the implementation of DORC and the valuation of easements.

The section of the ACCC Discussion Paper dealing with asset valuation addresses a number of crucial issues but fails to bring them together in a coherent way. The 'issues' that the ACCC discusses are:

- *If the Commission decided to lock-in the jurisdictional asset base it would lock-in both the fixed assets and easements.*
- *If the Commission decided to revalue the jurisdictional asset base it would revalue the fixed assets using the DORC methodology.*
- *However, it might revalue easements using a DORC or historic cost methodology.*[20]

The EUAA has made numerous submissions to the ACCC and other regulators detailing concerns with the approach to asset valuations adopted by jurisdictional governments and regulators. These concerns were detailed initially in a paper prepared in July 1998,[21] which has been provided to the ACCC previously.

[20] p. 14, ACCC Discussion Paper

[21] *Energy Network Asset Valuation – Impact on Users*, Prepared for the Australian Cogeneration Association, the Australian Gas Users Group and the Energy Users Group, SA Centre for Economic Studies, July 1998.

In general terms, the key issue of concern is that end-users are forced to pay higher than efficient costs for energy because asset values have been set at levels that are neither efficient nor fair, nor are they based on the most practicable asset valuation methodology. In particular, the use of Depreciated Optimised Replacement Cost (DORC) is unfair to end-users because:

- DORC valuations are generally higher than Depreciated Actual Cost or Deprival Value;
- no account is taken in DORC methodology for payments already made by end-users for the costs of sunk assets, meaning end-users are forced to pay twice for some assets; and
- the flow-on impacts of higher than efficient asset valuations disadvantage end-users subject to the pressures of internationally competitive markets.

These outcomes are compounded by adopting values for Weighted Average Cost of Capital that are demonstrably higher than relevant international comparators – a matter on which the EUAA has also made numerous submissions to the ACCC and other regulators. The EUAA continues to support the views expressed in the July 1998 paper and the comments below are consistent with those views.

3.1. JURISDICTIONAL ASSET VALUES

Even though the ACCC's preferred position says "*there is no evidence to suggest that there are significant problems with the jurisdictional asset valuations*", the paper still appears to focus on re-valuation of initial asset values established by jurisdictions (referred to as "*'sunk assets' in existence and generally in service on 1 July 1999*"). In regard to the requirements of clause 6.2.3(4)(iv) of the Code, which allows for possible re-valuation of "*'new assets' brought into service after 1 July 1999*", the Discussion Paper list reasons for revaluing the asset base that include:

- a major advance in technology such as the development of new materials;
- mergers or change of ownership of transmission assets;
- major expansions or contractions of the network, such as may arise due to the development of a by-pass option;
- evidence that the TNSP is unable or unwilling to recover the full cost of service calculated for some sub-system; and

- a request by the TNSP facing by-pass for a significant economic write-down of part of its asset base.[22]

[22] p. 18, ACCC Discussion Paper.

3.2. TECHNOLOGICAL CHANGE AND ASSET VALUES

A presumption in the Discussion Paper that differs from presumptions in the Draft SRP is that technological change is not likely to impact on a TNSP and lead to 'stranding of assets'. The Draft SRP says the "*long term nature of network assets and stability of associated markets makes it unlikely that rapid change would unexpectedly strand common assets in less than a five year time frame. Therefore, the Commission may not need to consider a full DORC every regulatory period although there may well be a case for every 10 years*." This emphasis on the possible long-term impacts of technological change is missing from the Discussion Paper, as is reference to the possibility of 10 yearly re-valuations.

The EUAA does not have a strong view on the impact of technological change, but it does note that there is an increasing frequency of reports suggesting the cost of 'alternative' technologies (including Fuel Cells and even Solar PV) are forecast to drop significantly over the next decade.[23] The EUAA also notes that the UK regulator OFGEM has a specific work program examining the impact on NSPs of small-scale distributed generation technologies (including Combined Heat and Power plants) and is proposing incentives for NSPs to support adoption of these technologies.[24]

Widespread adoption of these newer technologies, although still some time off, would not only impact on electricity (and gas) distributors, but it could increase 'asset stranding' pressure on TNSPs or even allow 'bypass' of transmission networks for some users.

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[23] For example, the US Department of Energy, the Californian Government, and the Japanese and German governments each has major research and development programs supporting development of low-cost Fuel Cells (see: http://www.fossil.energy.gov/programs/powersystems/fuelcells/#top and www.seca.doe.gov). So does virtually every major motor vehicle manufacturer.

The U.S. Department of Energy says its "*goal is to cut costs to as low as US$400 per kilowatt by the end of this decade, which would make fuel cells competitive for virtually every type of power application*".

Origin Energy recently announced establishment of a AU$20 million manufacturing plant in Adelaide to mass-produce a new "Silver Cell" solar technology developed by ANU that may see the cost of establishing a fully solar powered home reduced by as much as $A20,000 (see: http://solar.anu.edu.au/pages/epilift.html).

[24] See OFGEM Media Release R/127, 18 December 2003 (http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/5426_r12703_18dec.pdf)

The ACCC should review information on OFGEM's work program and look closely at policies and mechanisms to establish appropriate incentives for NSPs generally to facilitate efficient investment in 'alternative' technologies that have the potential to deliver substantial benefits to end-users. Such policies and mechanisms should not be restricted to a focus on NSP's conventional responses. Furthermore, the ACCC should also consider how to ensure investments by end-users that have the effect of delivering benefits to other users of shared networks can be facilitated and rewarded.[25]

3.3. PROBLEMS WITH ACCC'S PREFERRED POSITION

Other problems with ACCC preferred position are:

- A key objective of the network pricing provisions of the Code "*is to regulate the non-competitive market for network services in a way which seeks the same outcomes as those achieved in competitive markets*".[26] A competitive market would de-value inefficient assets, and removing the threat of downward re-valuation of inefficient investments is hardly seeking "*the same outcomes as those achieved in competitive markets*".
- The ACCC has already implemented its 'preferred position' by notifying TransGrid that the opening asset base (for its recently commenced review) is to be determined on the basis of a roll-forward of the previous opening asset base.[27] This appears to 'rule out' the option of re-valuing the assets (although Transgrid's application also proposes that the ACCC accept upward re-optimisation, valued at a further $70 million, for 500kV assets 'optimised out' of the asset value adopted in its 2000 Determination).[28]

[25] Current regulatory policies focus on protecting 'efficient' NSP investment by rolling 'efficient' new investment into regulatory assets and 'requiring' end-users to pay for the assets through regulated revenue. This paradigm provides no similar 'protection' for investments by end-users that would have the same impact on shared networks as investment in network assets by NSPs. Unless this paradigm is changed, there is a risk that (initially) 'efficient' investments in network could become 'stranded' and 'efficient' investment by end-users discouraged.

[26] Clause 6.1.1 (b) (iii).

[27] p. 94, *Revenue Reset Determination 1 July 2004 to 30 June 2009*, TransGrid's Application to the Australian Competition & Consumer Commission, September 2003.

[28] See p. 98, *Op Cit*

- The majority of TNSPs have already taken advantage of the 'option' to increase asset values without having to make any actual new investment.[29] For example, the ACCC:
  - increased the value of Transgrid's assets by $90 million in 2000, or 4.6% above that suggested by IPART as appropriate based on its (IPART's) 1996 determination;
  - approved an increase in asset values for SPI PowerNet of $249.9 million, or 16.4%, in 2002;
  - approved an increase in asset values for ElectraNet SA by $17.5 million ,or 2.2%, in 2002;
  - accepted an increase in Transend's asset values by the Tasmanian Government of $72 million, or 15.9% (while commenting that the approach adopted by the Tasmanian government was not consistent with the ACCC's previous decisions[30]).
- The ACCC's proposals do not provide appropriate 'incentives' for TNSPs (and DNSPs) to accommodate emerging technologies in the most efficient manner such that NSPs minimise asset-stranding risk.
- Relying on application of the *regulatory test* to ensure economically efficient investment is not sufficient. As detailed in a previous submission by the EUAA and Energy Action Group,[31] the *regulatory test* is far from optimal as far as its impact on end-users is concerned. In addition, the test is applied to discrete (but large) investments and this would not necessarily result in overall investment efficiency by a TNSP.
- The ACCC is contemplating an increased use of 'benchmarking' of capital expenditure (CAPEX),[32] which could have the same effect on asset 'roll-ins' as would formal revaluation of assets by excluding asset values above a 'benchmark threshold'.

[29] Only Powerlink failed to benefit from the ability to revalue its assets (in 2001), but it that case the ACCC accepted the Queensland Government's roll-forward of depreciated optimised replacement cost (DORC) valuation. The EUAA fully expects that Powerlink will seek to follow precedents set by the ACCC and claim "re-optimisation adjustments" on the DORC valuation to 'capture' the value of any assets optimised out of the 1999 asset base by Queensland when it submits its reset application to the ACCC in 2004.

[30] This tacit acceptance of a 'grab for gold' by the Tasmanian government appears inconsistent with the ACCC obligations under clause 6.2.3(4)(iii) to ensure the "*value of these existing assets must not exceed the deprival value of the assets*".

[31] *ACCC Regulatory Test*, Report to the National Electricity Market Advocacy Panel from Energy Users' Association of Australia and Energy Action Group, December 2003.

[32] The EUAA fully supports moves to "benchmark" CAPEX for NSPS. This is an area where UK regulators are far ahead of their Australian counterparts.

- If the ACCC was to fall back on Options 1 or 3, it must still address the challenge of information asymmetry that (as a minimum) means TNSPs have a clear incentive to exercise 'strategic behaviour' and:
  - only identify circumstances where assets would be re-valued upwards;[33]
  - 'manipulate' information required for the ACCC (or its consultants) to conduct an effective asset value review; and
  - claim that the 'threat' of downward re-valuation increases business risk, thereby placing pressure on the regulator to lock-in (inflated) past asset values or justifying a higher value being assigned to the WACC.

The EUAA does not support the ACCC's preferred position on asset valuation because this would have the effect of removing an essential efficiency incentive for TNSPs. Nor does the EUAA see how the practical difficulties with valuation methodologies and information asymmetry can be effectively addressed with the ACCC 'fall-back' options. The EUAA would prefer that the ACCC further explore means to develop transparently effective incentives for TNSPs to achieve efficient outcomes for all their activities.

3.3.1. VALUATION OF SUNK ASSETS

An additional major issue of concern to end-users is the fundamental difference in the approach taken by Australian and UK regulators on the issue of valuations for 'sunk assets'. UK energy regulators rejected changes to values of pre-existing assets when this issue was raised prior to the first round of UK regulatory reviews in 1994. Essentially, the UK regulators exercised their discretion[34] to establish a starting asset value unrelated to DORC, deprival value or depreciated actual (or historic) cost. Instead they accepted what were, in effect, arbitrary asset values based on the initial share market float price that was much lower than values based on 'conventional' methodologies[35] on the basis that:

- revenue received from consumers was sufficient to finance continued use and operation of 'sunk assets' and future costs;

[33] The ACCC acknowledges that TNSPs would not voluntarily identify circumstances where they had made sub-optimal investments and refers to other impacts of information asymmetry. It is also noteworthy that the ACCC acknowledged, in its January 2000 Transgrid Decision, the practical issues that prevented Transgrid from establishing a Depreciated Actual Cost valuation and SKM from establishing an Optimised Deprival Value valuation for Transgrid's assets. The Productivity Commission also identified practical difficulties with DORC valuation methodologies in its September 2001 Inquiry Report *Review of the National Access Regime* the most important difficulty from the perspective of end-users being the substantial difference in value reported by different valuers of the same assets. Each of these cases confirm difficulties for most commonly accepted valuation methodologies. Such difficulties would have to be addressed if the ACCC retains the option to re-value assets.

[34] The discretionary powers of UK regulators appear similar to those given to the ACCC under the Code.

[35] UK regulators use the term Modern Equivalent Value.

- financial markets would (and did) accept a regulatory focus on future costs and efficiencies;
- there is no efficiency benefit in compensating owners for changes in value to 'sunk assets'; and
- regulatory 'principles' focussed on promoting and achieving efficiency of future investments and operation of regulated industries would deliver greater overall benefit to end-users.[36]

UK regulators have also specifically rejected proposals to increase the valuation of easements.

The long-term implications of this UK 'regulatory principle' are that consumer charges are based largely on the efficient costs of future activity and the maximum focus in the regulatory regime is on incentives for utilities to operate and invest efficiently. The EUAA commends these approaches to the ACCC and strongly recommends that they be reviewed and incorporated into the regulation of TNSPs in Australia.

The EUAA also recognises that, like many other critical aspects of asset valuation, supply-side interests and regulators may consider this a 'lost argument' because jurisdictional governments have clearly sought to maximise the value of TNSPs' 'sunk assets'. However, it is important to emphasise a critical difference between the practice of economic regulation in Australia and the UK and to stress that a key principle of economic regulation should be to focus of future outcomes rather than focus on past outcomes that cannot be changed. It is this 'principle' that should be incorporated into the SRP.

3.3.2. FIXED ASSETS AND EASEMENTS

The EUAA urges the ACCC to adopt regulatory principles in regard to the valuation of both 'fixed assets' and 'easements' that emphasises future efficiencies and delivery of end-user benefit. Such principles would only allow re-valuation of assets if this can be demonstrated to enhance future efficiency and deliver benefits to end-users. End-users should only be required to contribute sufficient revenue to sustain existing used and useful assets and fund 'efficient' future assets. In this context, there is no justification for upward re-valuing any sunk assets. This is especially the case for easements. Easements do not depreciate. Indeed, the value of easements is highly likely to increase, which

[36] UK regulators have all adopted mechanisms for evaluating the operational efficiency of regulated businesses that include various forms of econometric modelling and 'benchmarking'. The approach implemented by OFGEM for the current review of UK electricity distribution charges is described in pp 65-80, *Electricity Distribution Price Control Review - Initial Consultation*, Office of Gas and Electricity Markets (OFGEM), July 2003.

means it is inappropriate to apply the same principles that apply to depreciating fixed assets. Changing the value of easements delivers no benefit whatsoever to end-users, nor does the inclusion of asset values that were overlooked by jurisdictional governments. Where easement values have been included in regulatory assets, these values should be set using actual historical cost in nominal terms and re-valuation explicitly prohibited in the SRP.

3.4. 'PRINCIPLES' FOR INCLUSION INTO THE SRP

The ACCC's proposals would be improved by explicitly adopting the following 'principles' to be included in the SRP:

(e) Acknowledge that there are no hard and fast rules for the appropriate approach to asset valuations.

(f) Acknowledge an intent to achieve valuations for sunk assets that are efficient, fair and practicable where -

  (i) an efficient valuation will be the lowest value that would allow the asset owner to recover efficient investment and would create the least distortion to efficient upstream and downstream investment. That is, the asset valuation methodology should explicitly consider the impact on investment in upstream and downstream activities.

  (ii) a fair valuation will be one where end-users fully fund efficient capital costs, but only do so once. That is, a fair valuation of sunk assets should pay attention to past depreciation schedules and returns on capital already paid by end-users on sunk asset investments and should focus on providing incentives for efficient future investment.

  (iii) a practicable asset valuation will be one that uses the most readily available information, with a methodology that is least likely to be subject to 'strategic' manipulation of information by asset owners.

(g) Explicitly aim to provide incentives for efficient future investment and efficient operation of networks.

(h) Explicitly prohibit change of easement asset values, and retain easement values at historic actual cost in nominal terms. Where such costs cannot be established with certainty, easement asset values should be explicitly set at zero.

4. EXPENDITURE EVALUATION AND EFFICIENCY INCENTIVES

The ACCC Discussion Paper includes discussion of a range of issues related to assessment of prudency and efficiency of TNSP expenditure, efficiency incentives and means to improve the practice of economic regulation. The major issues relevant to end-users are dealt with in this part of the submission.

4.1. CAPITAL EXPENDITURE ASSESSMENT

The Commission's preferred position: The Commission's preferred position is to adopt the regulatory test when assessing and reviewing revenue proposals associated with augmentation and non-augmentation capex programs.

The ACCC's Discussion Paper says the 'issue' related to CAPEX is:

> "*In determining the revenue requirement at the regulatory reset, the Commission will examine capex from two perspectives. Firstly the Commission will conduct an assessment of the reasonableness and efficiency of a TNSPs' proposed capex program for the forthcoming regulatory period considering future demand growth, generating patterns, network limitations and any other relevant information. Secondly the Commission will consider differences between the forecast capex allowance approved in the previous revenue cap decision with the actual capex undertaken by a TNSP considering all relevant information for any variations between the two.*"[37]

The Discussion Paper appears to be based on an assumption that TNSPs would seek to commit capital expenditure in excess of that necessary to meet the service obligations specified in the Code. For example, the ACCC says that if it was to "*consider reviewing the prudency of large capital expenditure*" and "*seek assurances that the TNSP has complied with the requirements of clause 5.6 of the Code* (which, presumably, is in reference to application of the *regulatory test*)" that "*this may encourage the entity to spend what has been allowed, knowing that it will earn a return and not seek to achieve efficiencies in capital expenditure*".[38]

This suggests the ACCC holds a view that regulatory oversight creates incentives for TNSPs to pursue long-term returns by 'gold-plating' (over-investing in 'inefficient'

[37] p. 34, ACCC Discussion Paper

[38] p. 35, ACCC Discussion Paper.

assets) that 'overpowers' the incentive for TNSPs to pursue short-term profits by 'beating the regulator's revenue benchmarks'. The EUAA is not aware of any evidence to support such a view. Indeed, evidence suggests that TNSPs would seek to increase short-term profitability by cutting costs below revenue benchmarks, including by reducing and putting off capital expenditure as long as possible. This is exactly what the basic 'incentive' in the regime is intended to achieve.

4.1.1. BENCHMARKING AND PAST CAPEX TRENDS

The ACCC makes no mention in the Discussion Paper of the observed CAPEX 'spending habits' of TNSPs based on the four regulatory reviews it has conducted since the beginning of 1999. An examination of the 2000 NSW Decision and the 2002 Victorian Decision shows that the ACCC did not explicitly present comparative analysis of forecast and actual CAPEX for the initial (jurisdictional) regulatory period, notwithstanding the importance of this in terms of assessing past and future CAPEX.

Nor is the above view supported by experience in the UK where it is clear that regulated companies universally seek to increase profit by reducing costs below revenue benchmarks.[39] A comparison of forecast and actual CAPEX is something that is, and has always been, undertaken routinely by all UK regulators as one of the means of informing the regulators' judgements on prudency of past CAPEX and efficiency of future CAPEX.

However, it is possible for TNSPs to find themselves in circumstances where actual CAPEX costs are higher than forecast. A preliminary review of information in Transgrid's current application, presented in Table 2 below, shows this issue is by no means trivial. Transgrid is reporting actual CAPEX spending some $155.1 million (or 13%) above that forecast in 1999/2000,[40] which it says is due to *"variations to accommodate environmental and community considerations that became apparent during the public consultation and detailed design phases, changes in the market for supply of equipment, and 'latent' conditions that came into effect during the construction phase*."[41] That is, Transgrid is claiming that its costs were higher than expected because of 'unforeseen' circumstances.[42] The ACCC will have to find a way to determine the

[39] Even if this view was valid, the ACCC could 'solve' that problem by significantly reducing the weighted average cost of capital (WACC) rather than reduce regulatory oversight (or increase the level of intervention in the legitimate business activities of the TNSPs). This would reduce the incentives to 'gold plate' and deliver immediate benefits to end-users.

[40] Note that Transgrid "*includes approximately $70 million in 2001/2002 for re-optimisation of 500kV transmission assets*" as Actual CAPEX, which is, to say the least, creative. This amount has been excluded from the difference between Forecast and Actual CAPEX of $115.1 million.

[41] p. 98, Transgrid 2003.

[42] The three large NSW distributors also incurred substantially higher costs than those forecast for the current regulatory period. In these cases, the DNSPs claimed this was due to unexpected growth in demand and energy consumption.

validity of Transgrid's claim that the actual over-spent CAPEX was prudent and should clearly signal that it will do so far all TNSPs in the SRP. In doing so, it must also consider whether Transgrid's forecasting skills are adequate for a 'prudent, well-managed and efficient' business and should make it clear that it will do so in the SRP.[43]

TABLE 2: FORECAST AND ACTUAL CAPEX, TRANSGRID FY00-04

Financial Year	1999/00	2000/01	2001/02	2002/03	2003/04	Total
Forecast	**52.61**	**82.08**	**285.95**	**90.53**	**370.42**	**881.59**
Actual	**187.8**	**155.2**	**229.2**	**243.2**	**251.3**	**1,066.7**

Source:
Forecast CAPEX: Table 4.3 (p89) NSW and ACT Transmission Network Revenue Caps: Decision, ACCC, 25 January 2000.
Actual CAPEX: Table 8-1 (p 98) Revenue Reset Determination 1 July 2004 to 30 June 2009, TransGrid's Application to the Australian Competition & Consumer Commission, September 2003.
Note: Neither document specifies the basis for quoting the dollar values shown. It is assumed they are both in nominal dollars and no adjustment has been made for forecast or actual inflation impacts.

4.1.2. STRATEGIC BEHAVIOR BY TNSPS

The ACCC also needs to confirm that it will treat differences between forecast and actual CAPEX in a symmetrical manner when it is rolled into the regulated asset base. TNSPs are permitted to retain the benefits of 'out-performing' revenue benchmarks, which include benefits from under-spending CAPEX. Where they are 'required' to over-spend CAPEX, they should only be entitled to roll-in efficient actual CAPEX and should not be 'compensated' for 'holding costs' associated with the over-spent amount (and the same general 'principle' should apply to OPEX over-spend).

This would be consistent with regulatory judgements in distribution. The recent IPART Draft Determination proposes to allow roll-in by NSW distributors of above-forecast CAPEX judged to be 'prudent'.[44] That is, jurisdictional regulators have required NSPs to 'wear the cost' of depreciation and return on CAPEX over-spend in the current regulatory period associated with CAPEX over-spend even where the over-spent amount has been deemed 'prudent' or 'efficient'. This is symmetrical to allowing the regulated entity to retain the 'efficiency benefit' if they underspend the forecast CAPEX. UK regulators adopt a similar approach. This symmetrical treatment of CAPEX efficiency gains provides a clear incentive for regulated businesses to focus attention on forecasting all

[43] The ACCC's proposal does not identify how it will deal with Transgrid's 'explanation' of differences between the regulatory allowance and actual capital expenditure. Detailed explanations provided by Transgrid could satisfy the ACCC that higher than forecast CAPEX was 'prudent'. But it is not clear how the ACCC's proposals would distinguish between the impact of changes in 'external' requirements over which Transgrid has no control (as suggested by Transgrid) or poor forecasting. If the increased costs are the result of poor forecasting, the TNSP should be required to 'wear the cost' of poor performance.

[44] ORG adopted the same approach for CAPEX overspend by TXU in the 2002 Victorian gas distribution review.

aspects of their business, focus on mechanisms to achieve the most efficient outcomes and is consistent with outcomes in competitive markets.[45]

The Discussion Paper is also troublesome because it says the ACCC:

- proposes to develop a more rigorous process that TNSPs must adopt when assessing non-augmentation CAPEX which is consistent with the methodology outlined in the *regulatory test* (even though the ACCC acknowledges it cannot compel TNSPs to apply such a test during the regulatory period);
- will assess the likelihood that proposed augmentation CAPEX will pass the *regulatory test*, presumably by requiring its consultants to undertake a line item evaluation of the TNSPs proposed CAPEX; although –
  - how the consultants could do this within the timeframe allowed in the proposed review process is unclear; and
  - what this might imply for the TNSP whose forecast CAPEX was subject to a form of (preliminary) regulatory approval is also unclear;
- will conduct a review on whether the *regulatory test* application was conducted in accordance with the process and methodology outlined in the test; and
- is proposing to examine the use of 'benchmarks' as an alternative approach to assess CAPEX (subject to resolution of unspecified implementation issues).

That is, the ACCC is proposing to introduce new 'rules' it acknowledges it cannot enforce and subject the TNSPs' execution of the *regulatory test* to *ex-ante* and *ex-post* reviews as the means of evaluating whether or not the TNSPs actual CAPEX is 'prudent' and its forecast CAPEX 'efficient'. The implication of the ACCC's proposals is that it will find, by default, that it is micro-managing the TNSPs CAPEX program or even putting pressure on the TNSPs to undertake CAPEX because it has been approved or endorsed in the regulatory review process. The level of regulatory oversight implied in this process would, most likely:

- tend to shift responsibility for investment decisions away from the TNSPs who are in a best position to make such decisions; and
- have the effect of reducing incentives for TNSPs to pursue CAPEX efficiency savings that could deliver benefits to end-users in the longer term.

[45] The EUAA also notes that experience in the UK (and in Victoria) shows this approach provides clear and unambiguous incentives for TNSPs to exercise 'strategic behaviour' in its forecasts by over-stating the level of CAPEX costs. If regulators accept higher than efficient cost forecasts, the NSP reduces the forecast error risk and reduces the need to respond to 'efficiency' incentives.

The EUAA understands that there are challenges for regulators in making judgements about the appropriate level of expenditure that should be allowed in regulated revenue benchmarks. However, the process described in the Discussion Paper does not appear to be the best way to create incentives for TNSPs to pursue ongoing efficiency that will benefit end-users.

A principle adopted by UK regulators is, generally, to make judgements on an efficient level of CAPEX based on technical and econometric analysis of actual and forecast expenditure and then rely on profit maximisation incentives to produce efficient outcomes. Where regulators have accepted proposals for substantial increased levels of CAPEX, they have generally only required utilities to publish information comparing actual and forecast CAPEX and used this information to inform their judgements on efficiency and 'strategic' behaviour at the next regulatory review.[46] The EUAA would prefer that the ACCC include similar principles in the SRP.

A further matter of concern to the EUAA is that the ACCC makes no specific mention of how it proposes to deal with exercise of 'strategic behaviour' that is widely recognised as a major negative feature of 'incentive regulation'. Each of the UK regulators has specifically referred to the incentive for regulated companies to overstate forecast costs (and, in some cases, under-forecast sales volumes). If these forecasts are accepted by the regulators in the benchmark revenue, the companies are able to increase profits by achieving lower than forecast actual costs (or higher prices) and then claim this as an 'efficiency gain', which it clearly is not. The same incentives to exercise 'strategic behaviour' have been referred to by Victorian and NSW regulators, although they have yet to develop the means to deal with these negative incentives as effectively as the UK regulators. A graphic visual demonstration of the exercise of 'strategic behaviour' is presented in the following diagrams.

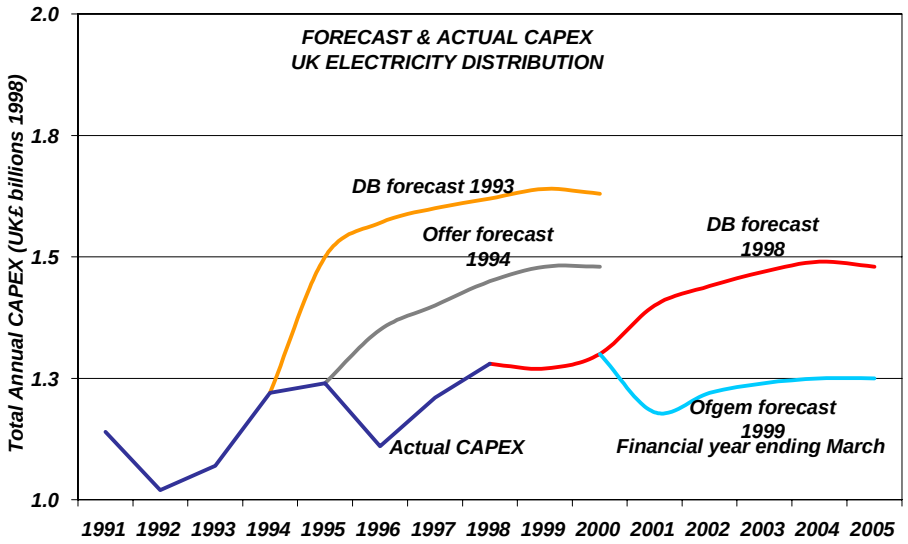
4.1.3. SOME EVIDENCE FROM OTHER REGULATORS

The diagrams show comparisons of forecast and actual CAPEX for electricity distribution in the UK and gas distribution in Victoria.[47]

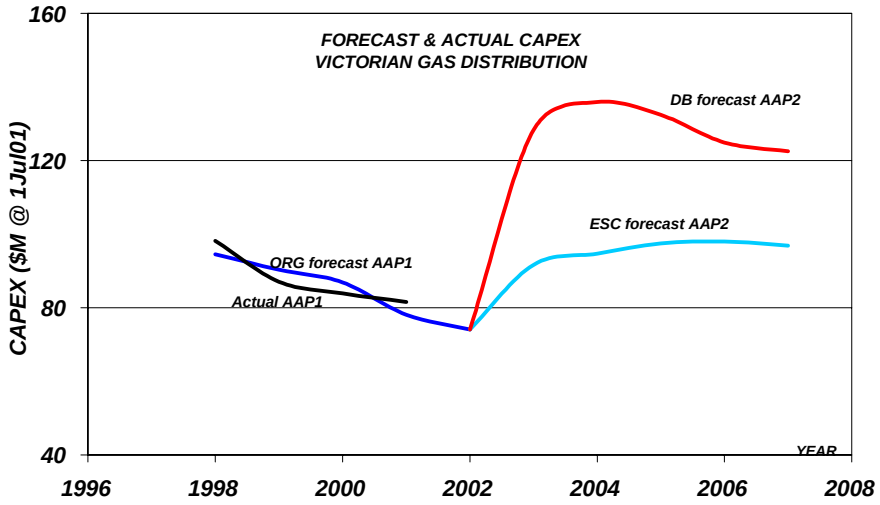
[46] This approach has been adopted by both OFGEM for the gas industry and by OFWAT. A similar approach was also adopted by the Victorian ORG for gas distribution.

[47] UK data has been used primarily because it is readily available and covers several regulatory periods; and because, along with using forms of 'benchmarking' analysis, this is a primary means of informing the regulators' judgement about the level of 'efficiency' in actual costs and 'strategic' behaviour in forecast costs. Australian regulators have tended not to publish (easily accessible) data comparing forecast and actual costs in their decisions. This is another area of marked difference between the practices of UK and Australian regulators.

FIGURE 3: FORECAST & ACTUAL CAPEX



Source: Pareto Associates Pty Ltd. Data taken from OFFER and OFGEM regulatory determinations.



Source: Pareto Associates Pty Ltd. Data taken from ORG documents.

The UK diagram best illustrates key points, many of which can also be observed in the Victorian diagram:[48]

- regulated companies tend to reduce CAPEX in the early part of the regulatory period (because revenue benchmarks include a component based on forecast CAPEX times WACC, which means profits increase by delaying CAPEX);

[48] Note that exactly the same observations are relevant to data for the UK gas transmission and UK water industries.

- regulated companies substantially overstate CAPEX requirements in forecasts, regulators 'prune' back CAPEX forecasts and companies generally still 'out-perform' the regulators' benchmarks;[49] and
- CAPEX spending rises towards the end of the regulatory period as companies react to the looming prospect of actual CAPEX being rolled into the asset base and address the need to construct needed assets that have been deferred so as to increase profits.

These observations demonstrate why regulators need to consider CAPEX trends, rather than single 'reference' years and why they need to carefully scrutinise forecasts provided by regulated companies.

The EUAA would be surprised if this same effect did not apply to TNSPs. However, the ACCC has not undertaken a detailed comparison of forecast and actual CAPEX in any of its previous determinations. This is very disappointing and not at all sympathetic to the needs of energy users. Accordingly, the SRP should include a 'principle' that the ACCC undertake and present a comparative analysis of actual and forecast CAPEX (and OPEX) in all its Determinations.

The difference in focus of UK and Australian regulators on the 'strategic' behaviour of NSPs appears to be influenced by the relative reliance that different regulators place on 'evidence' provided by the regulators' consultants. Both UK and Australian regulators employ technical consultants to review proposals made by NSPs. Generally speaking, the scope of work assigned to the consultants appears similar, with consultants asked to review actual and forecast expenditure (and sales volume) for prudency, efficiency and reasonableness. There are sound reasons for regulators to adopt this approach, not least because few regulators directly employ experienced engineers who are technically competent to make judgements on such issues.

However, the UK regulators generally use econometric techniques to analyse NSPs' proposals much more so than do Australian regulators.[50] The UK regulators also appear to place less reliance on information and judgement provided by consultants, preferring to use the analysis and information provided by the consultants as one input into the regulators' own econometric analysis. This has a number of advantages for both the regulators and end-users:

[49] Relatively close correlations between forecast and actual CAPEX in the Victorian gas industry data results from substantial above-forecast spending by TXU (that was clearly due to 'errors' in pre-privatisation forecasts). Data for the other two Victorian distributors shows exactly the same trend as the UK electricity distribution data.

[50] This process is described in some detail in documents posted on the OFGEM website and referred to in a later section of this submission.

- regulators clearly retain responsibility for judgements inevitably involved in regulatory decision making, including judgements about exercise of 'strategic' behaviour; and
- the potential for conflict of interest for consultants who advise regulators and NSPs is lessened [51] allowing consultants to focus on technical issues and analysis in their reports.

A beneficial outcome from this approach is that UK regulators' decisions retain more responsibility for issues related to exercise of 'strategic' behaviour. In addition, the output from the regulators' econometric analysis can be used as a form of generic 'benchmarking' of NSP performance that informs and improves the regulators' judgements on key issues.

4.1.4. CAPEX AND OPEX TRADEOFFS

Another issue that is not well explained is how the ACCC's proposals will deal with the inevitable trade-off that TNSPs will make between CAPEX and operations and maintenance (OPEX) costs.[52]

A prudent and well-managed TNSP would be expected to consider these trade-offs in the planning phase (during and after preparation of its revenue application) and prior to formalising commitment of CAPEX. Once CAPEX is committed, this would have some impact on OPEX costs. Treating CAPEX and OPEX separately, which appears to be the effect of the ACCC's proposals, is much less likely to lead to well-informed regulatory judgements than would be the case if the ACCC had access to information on the trade-offs and optimisation of CAPEX and OPEX. Again, this is something that all UK regulators attempt to do, and something the ACCC should emulate.

4.1.5. OFGEM'S APPROACH

The EUAA commends to the ACCC a recent publication by the UK energy regulator (OFGEM), which sets out in considerable detail the approach that will be adopted for assessing 'prudency' and 'efficiency' of expenditure during the forthcoming electricity distribution review.[53] The OFGEM approach involves using a range of techniques for

[51] The UK 'regulatory' consultancy market is also much more diverse and broader than is the case in Australia. This also allows consultants to deal with regulators and NSPs in a way that minimises actual or potential conflicts of interest more than is the case in Australia.

[52] It is noted, however, that this is an issue on which the ACCC has invited discussion (in the section of the Discussion Paper dealing with incentives).

[53] The approach implemented by OFGEM for the current review of UK electricity distribution charges is described in pp65-80, *Electricity Distribution Price Control Review - Initial Consultation*, Office Of Gas And Electricity Markets (OFGEM), July 2003

assessing efficiency and projecting future costs. OFGEM acknowledges that a degree of pragmatism will need to be applied in the final assessment of projected costs. However, it also recognises that it is important to explain in a transparent way how efficiency and future costs have been assessed and how they have been used to derive the allowed level of revenue. The approach adopted by OFGEM seems more likely to be suited to a 'transparent' explanation than that proposed by the ACCC.

4.2. OPERATING AND MAINTENANCE EXPENDITURE ASSESSMENT, BENCHMARKING AND EFFICIENCY INCENTIVES

The Commission's preferred position: The Commission's preferred position is to rely more on benchmarking in the future when assessing the TNSP's opex costs.

The ACCC Discussion Paper says the 'issue' being addressed is:

> "*to improve the incentives for TNSPs to reduce costs, but also making sure that the TNSP is adequately compensated for the costs they accrue. As a means of achieving greater incentives the Commission uses an efficiency carry-over. The efficiency carry-over mechanism rewards the TNSP with higher profits when the firm manages to lower its controllable costs.*"

The ACCC is also considering the use of external benchmarks "*as this may result in more efficient practice, as benchmarking breaks the nexus between the firm's actual costs and revenues*".

The section of the Discussion Paper dealing with OPEX includes extensive discussion of insurance and risk management (defined as external insurance, self-insurance and risk pass-through events),[54] but apart from referring generally to the possibility of applying 'benchmarking' techniques to assessment of future OPEX costs, contains little discussion of the ACCC's views on other OPEX cost components.

The EUAA acknowledges that insurance cost is a relevant issue that could have significant impact on end-users should a 'pass-through event' occur. However, the Discussion Paper incorrectly states that "*efficient expenditure on external insurance and self-insurance in the opex category … may be as much as 25 per cent of a TNSP's annual*

[54] Insurance and risk management costs are important, but are not expected to have a major impact on end-users. Accordingly, it is difficult to understand why this is covered in so much detail in the Discussion Paper.

revenue requirement."[55] None of the Decisions published by the ACCC provides details of total insurance or risk pass-through costs claimed by any of the TNSPs, but the figure of 25% is far too high. Appropriate figures appear to vary from as little as 0.3% for large 'high risk'[56] TNSPs (such as Powerlink) up to 2.7% for the smallest TNSP (Transend).[57]

The key issue for the ACCC is to ensure TNSPs have a clear incentive to achieve efficient insurance costs and to minimise the events that would qualify for a cost 'pass-through' to only those that are, without doubt, beyond the control of the TNSP and uninsurable (by efficient external or self-insurance). Clearly the ACCC's SRP and the decisions upon which it will depend would benefit by a statement to the effect that all future decisions will be based upon publication of comparative cost data and the setting of 'challenging, but achievable' cost benchmarks for 'less-efficient' TNSPs, as is the habit of UK regulators.

In this context, the EUAA is concerned that the ACCC is tending to be 'captured' by TNSPs using specific classifications of incremental cost, including insurance, as a basis for claiming additional revenue or cost pass-through. Other categories of cost that are subject to the same technique include 'debt and equity raising costs' and 'asymmetric risk costs' (in WACC). The EUAA would be most concerned if the TNSPs were using this technique and relying on 'creeping precedent' to recover these costs. For example, Transgrid says in its recent revenue application:

> "*The Commission has also approved cost pass-through arrangements for an expanded range of events in its more recent Decisions for SPI PowerNet, GasNet and Powerlink and in its Preliminary View in relation to Murraylink's Application for regulated status. Indeed, the Commission has endorsed the pass-through approach as an appropriate means of addressing risk for events that are outside of the TNSPs control.* "[58]

The EUAA expects the ACCC to stick to the position outlined in the original Transgrid Decision, which was:

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[55] p 44, ACCC Discussion Paper.

[56] The 2001 ACCC Queensland Decision makes reference to Powerlink's claim of the storm damage risk it faces because some of its assets are in regions subject to Cyclones. The EUAA anticipates that Powerlink designs major structures in accordance with accepted Engineering Standards that takes into account prevailing weather conditions. Accordingly, the major cost of 'risk' faced by Powerlink will be paid by end-users through the cost of building structures that comply with Engineering Standards. If this is so, inclusion of these "higher risks" in OPEX would involve an element of double counting. Even if Powerlink's concerns are appropriate, other 'major' TNSPs would therefore be expected to face lower 'risk costs' than Power link.

[57] It is unclear from the Draft Tasmanian Decision why Transend should face very much higher risk costs than larger TNSPs, or why the ACCC has accepted the much higher costs as 'efficient'.

[58] p 129, *Revenue Reset Determination 1 July 2004 to 30 June 2009*, TransGrid's Application to the Australian Competition & Consumer Commission, September 2003

> "*The Commission also expects that, by the time of the next regulatory reset, the appropriate projected cost of future insurance will be better able to be quantified and that, as such, it will no longer be treated as a pass through but will be subject to review by the Commission for reasonableness and efficiency as a normal part of operating expenditure.*"[59]

The same can and should be said in the SRP for other elements of OPEX. The EUAA expects the ACCC to include principles in the SRP that focus on ensuring both CAPEX and OPEX forecasts are 'reasonable and efficient' and free of any significant component of 'strategic' behaviour, and that TNSPs have clear incentives to pursue efficiency gains that will, ultimately, be passed to end-users.

As discussed below, the EUAA is supportive of benchmarking and comparative cost assessment as a means to inform regulatory judgements on 'efficiency'. But once again, it is of concern that the Discussion Paper is silent on the ACCC's views of 'strategic' behaviour in OPEX forecasts, which UK regulators demonstrate is just as important as in the case of CAPEX discussed above.

4.3. "BENCHMARKING" AND EFFICIENCY ASSESSMENT

In relation to other matters raised by the ACCC in this section of the Discussion Paper, which deal with OPEX efficiency assessment and benchmarking, the EUAA supports moves to adapt useful precedents from the UK.

The EUAA notes that the UK regulatory regimes have been subject to criticisms referred to by Bigger as attributes of 'low-power incentive schemes'. The UK regimes all include forms of "*relatively strict cost reviews, accounting disclosure requirements and audits*" and have been criticised as "*being costly – consuming regulatory resources – and are sometimes viewed as "intrusive", "micromanagement" or a violation of the normal commercial freedom of the regulated firm's managers*", although they do not equate to the US-style 'cost-of-service' approach where "*the regulator is put in the position of reviewing all the major expenditure decisions of the firm to determine if they were appropriate and were carried out at least cost.*"[60]

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[59] p 31, *NSW and ACT Transmission Network Revenue Caps 1999/00-2003/04 Decision,* ACCC, 25 January 2000.

[60] See paragraph 15, *Incentive Regulation and Benchmarking – Part I: Endogenous Costs and Carry-over Mechanisms*, Darryl Bigger, Undated.

The EUAA notes with concern that the ACCC's proposals for *ex-ante* and *ex-post* review of TNSPs application of the *regulatory test* to all major CAPEX (and presumably OPEX) projects has some attributes that would attract criticism of being very "low-incentive", particularly of putting "*the regulator in the position of reviewing all the major expenditure decisions of the firm to determine if they were appropriate and were carried out at least cost*".

The EUAA accepts that it is desirable to limit "*intrusive, micromanagement or a violation of the normal commercial freedom of the regulated firm's managers*". Regulated companies should have clear responsibility for running their businesses and providing services to end-users. However, the EUAA would only support moves to achieve that outcome through application of exogenous benchmarking if it can be demonstrated unequivocally that this would deliver greater efficiency benefits to end-users than is possible with the current approach.

At present, the information asymmetry advantage enjoyed by TNSPs is still far too great, their cost base not sufficiently efficient or robust, the data on exogenous benchmarks still incomplete and the ACCC too susceptible to 'capture' for end-users to have any comfort that moves to 'exogenous benchmarking' would do anything other than benefit TNSPs. It is also by no means clear what the impact of any change would be, including whether end-users would derive any benefit. Moreover, those advocating a move towards regulation by exogenous benchmarks, including virtually all energy network business, need to demonstrate what benefits energy users would derive from this. To date, there have been many claims, but little evidence, coming forward and there seem to be limited actual examples of such regulation being applied successfully in energy.

However, the EUAA is concerned about the tendency for TNSPs to seek incremental benefits through a process of 'creeping cost-of-service' regulation and notes that this might be reduced by moving away from a cost-based Building Block approach. There is also clear evidence that the regulation of TNSPs in Australia could be improved by adopting some of the features of the UK regimes, which include econometric analysis that has some similarities to benchmarking.

The EUAA would support moves by the ACCC to increase pressure on TNSPs by collecting and publishing comparative performance data and using this as a means to examine further moves toward development of a fully-fledged 'benchmarking approach'.

To this end, the EUAA urges the ACCC to develop a view that reflects the practical challenges involved in effective 'benchmarking'. In this regard, we note with some concern the reference to benchmarking and efficiency carry-over mechanisms, the Discussion Paper says:

> *"if the Commission chose to move to exclusive reliance on benchmarking (i.e., if the regulated prices depended entirely on exogenous cost measures) there would be no need to consider efficiency carry-over mechanisms and other incentive mechanisms which ensure constant incentives for efficiency. The problems with incentive mechanisms discussed in this chapter (such as the problem of ensuring constant incentives for efficiency) are related to how*

> *the regulated prices should depend on endogenous measures of cost – obviously, the greater the reliance on benchmarking the less the need to be concerned with these problems".*[61]

This is, in effect, suggesting that exogenous benchmarking is less information intensive than the current Building Block approach. But this would only be true if the benchmarking technique is able to account for exogenous factors that are specific to individual TNSPs. A firm that is already efficient (i.e. whose actual costs are as low as practicable given the circumstances in which the firm is operating, or that is already efficient relative to other firms) could be penalised relative to less-efficient firms by setting prices using TNSP-specific 'benchmark' data. Conversely, firms with higher relative, but still efficient, costs that are due to individual exogenous factors could be penalised by setting prices using industry-wide 'benchmark' data. There is a high probability that such problems would arise in the NEM because of differences in TNSP size, transmission networks, climate, topography, geography, generation and load types, all of which are exogenous factors often beyond the control of TNSPs.

A 'benchmarking' regime that did not take into account the exogenous factors affecting individual firms would be unsustainable.

Conversely, a 'benchmarking' regime that did take these factors into account would, in all probability, be more information intensive (perhaps not that much less so than existing approaches) because regulators would still have to separate exogenous and endogenous factors to establish appropriate benchmarks. The identification and separation of these internal and external factors is critical to any 'benchmarking' exercise, as is the judgement needed to assign appropriate weighting to them.

This is not the only practical challenge in developing a benchmarking approach to regulation.

Benchmarking relies on being able to develop a set of useful and relevant measures upon which to benchmark, and to be able to compare these on a reasonably similar basis with other businesses, which can be difficult. It also presupposes that there is a useful 'efficient' benchmark upon which to gauge the performance of all firms, desirably also including overseas performance. These issues make benchmarking more difficult, although they do not make it impossible.

[61] p 60, ACCC Discussion Paper.

In addition, if a firm considered it was being 'hard done by' in an exogenous benchmarking regime, it would immediately seek intervention by government or the regulator so that it could return to a state of operation acceptable to it. As Bigger notes in his paper:

> *"where it appears that regulated prices/revenues will fall significantly short of costs the regulated firm may be able (to) threaten shutdown or to defer essential maintenance of the capital stock indefinitely. Again, in the context of public utility sectors (such as electricity) this is unsustainable in the long run. … No matter how high the power of an incentive scheme "on the surface", a regulatory mechanism which threatens substantial departures of regulated prices from observed costs is not credible."*

This reinforces the point that exogenous benchmarking will not necessarily be less complex or simpler to implement than a Building Block approach, or require that much less information. However, it is also clear that regulation of NSPs in Australia would be improved by better comparative performance analysis that included some of the attributes of benchmarking. As noted earlier in this submission, the EUAA commends to the ACCC the recent paper produced by OFGEM that explains how a range of econometric analysis techniques are used to assess operational efficiency and inform the regulator's judgement.[62] These techniques are particularly relevant to assessing prudency and efficiency of OPEX (and CAPEX). However, the EUAA notes that even though the UK regulators:

- have established data collection and reporting procedures in place;
- are approaching their third 5-yearly regulatory reviews; and
- have the advantage of reviewing multiple companies at each review[63] (which greatly simplifies 'benchmarking' and performance comparison);

they still rely heavily on comparisons between forecast and actual expenditure within review periods as a key means of informing judgement on prudency of past expenditure and efficiency of future expenditure for individual companies. Accordingly, the EUAA would prefer to see the ACCC develop the existing regime to include some of the

[62] The UK water industry regulator has developed a range of formal 'benchmarking' techniques that are significantly more comprehensive that those adopted by OFGEM. These include various forms of econometric analysis (based on extensive and 'intrusive' data collection) and even 'paper bid' comparisons of standard CAPEX and OPEX projects where individual companies submit cost estimates for undertaking a standard project, using cost data that is consistent with their audited regulatory accounts.

[63] This comment relates to the regulation of multiple distribution companies. However, OFFER and OFGEM have also utilised comparative analysis of transmission companies by referring to data and performance of non-UK companies.

beneficial aspects of UK practices. Once this is achieved, it would then be possible to examine alternative approaches and compare them.

The EUAA notes that a primary purpose of the present regime is to provide end-users with access to monopoly network services that are more efficient and competitive, not to return these businesses to the days where they could earn excessive monopoly profits.

The EUAA also notes that the econometric techniques adopted by UK regulators for the assessment of OPEX efficiency informs the regulators' judgements on the exercise of 'strategic' behaviour due to over-stating of forecast OPEX costs by regulated businesses. In some respects, quantification of 'strategic' behaviour in OPEX forecasts is easier than is the case for CAPEX. OPEX trends are generally more uniform than CAPEX (which can be 'lumpy' if large increments of capacity are required) and past OPEX is usually a more reasonable indicator of future requirements. However, this does not 'discourage' firms from attempting to exercise 'strategic' behaviour in OPEX forecasts because the 'rewards' available from succeeding. Every dollar above 'efficient' cost accepted by the regulator yields one dollar of profit, which can be carried forward for 5 full years if the regulator also adopts an 'efficiency carry-over' mechanism.

4.4. 'PRINCIPLES' FOR INCLUSION INTO THE SRP

The ACCC's proposals would be improved by explicitly adopting the following 'principles' to be included in the SRP:

(a) Acknowledge that there are (undesirable) incentives for TNSPs to exercise 'strategic' behaviour in forecasting of outputs and costs.

(b) Commit to comment on and address the exercise of 'strategic' behaviour by TNSPs.

(c) Limit the role of 'expert' technical consultants to advising on technical issues related to TNSPs proposals.

(d) Commit to implementation of UK-styled econometric analysis of TNSPs performance, using data and information from consultants' reports as one of a range of inputs to that analysis.

(e) Use the output of the econometric analysis to establish a rational monitoring and comparative reporting regime for TNSPs that will assist in better informing regulatory decisions.

5. WEIGHTED AVERAGE COST OF CAPITAL

The Commission's preferred position: The Commission's initial view is to move towards benchmarking an equity beta from current market evidence and incorporating an upper confidence interval. In addition, the Commission's preferred position is to adopt a government bond rate that matches the regulatory period as a proxy for the risk free rate.

The Discussion Paper says the 'issue' in regard to WACC is:

> "*Electricity transmission is a highly capital intensive industry where the return on capital accounts for about half of the annual maximum allowable revenue. Small changes to the cost of capital can have a substantial impact on the total revenue requirement and ultimately on end-user prices. Hence, correctly assessing the return on capital is very important.*
>
> *If the return is too low, the regulated network will be unable to recover the efficient and fair costs of service, thereby reducing its incentive to reinvest in the business. Conversely, if the return is too high, networks will have a strong incentive to overcapitalise (gold plate), thus creating inefficient investment and high cost to users.*"

The paper also reaffirms the intention to use a cash flow modelling approach as specified in the Code simplified post-tax version of the Capital Asset Pricing Model (CAPM) that yields what is generally referred to as a 'Vanilla', post-tax WACC. This approach was adopted in Australia initially by the Victoria Office of the Regulator-General (ORG) in its December 2000 determination for electricity distribution, although the UK water industry regulator (OFWAT) had used it previously in its 1994 determination.

5.1. SETTING WACC AND THE CAPM

The use of a CAPM version that yields an estimate of 'Vanilla', post-tax WACC has some advantages (for end-users) in addition to the advantage (apparently) attributed to it by the ACCC of minimising problems with estimating parameter values used to determine the cost of equity capital[64] and being usual regulatory and corporate financial practice.

[64] p 70, ACCC Discussion Paper

The additional advantages for end-users are that:

- WACC can be estimated using simpler formulae than required when the impacts of taxation are taken into account with CAPM; and
- the estimates of different regulators are more easily comparable.

However, the section on WACC is disappointing in the following areas:

- there is no acknowledgment of evidence presented by the EUAA[65] (and others) to numerous ACCC regulatory reviews that consistently shows Australian regulators are making very different, and more costly, judgements to their overseas counterparts on the cost of equity and WACC that results in substantially higher revenues and transmission prices;
- there are obvious errors in material referring to overseas experience; and
- there is no recognition (present in both Schedule 6.1 of the Code and the Draft SRP) that the use of the CAPM and estimation of WACC requires, and is totally dependent on, sound and well-balanced regulatory judgement.[66]

The approach adopted by Australian regulators to setting return on equity and WACC is a critical issue for energy users (and for energy networks). It is one of the key issues in any review of energy network charges. Return on capital (*WACC x Asset Value*) accounts for more than 50% of annual revenue requirement of the NSPs and has a commensurate impact on transmission charges. Unfortunately, and inevitably, the importance of WACC to NSPs' revenue provides strong incentives for ambit claims and exercise of 'strategic behaviour' (i.e. gaming of the process, setting of parameters and associated information) by the NSPs. In the case of Australian TNSPs, a 10 basis point increase in WACC delivers in the order of $20 million per year more revenue. This is a powerful incentive to use every possible means to get regulators to set higher values than required to satisfy the 'reasonable expectations' of financial markets, which should be a key benchmark for regulators.

The experience of the EUAA through numerous regulatory reviews for energy networks strongly suggests that NSPs are constantly trying to find arguments to convince regulators that WACC's are being set too low. Although regulators have tended to adopt

[65] See EUAA submissions to ACCC on ElectraNet SA, SPI PowerNet and Transend for details.

[66] The Discussion Paper uses terms such as 'determine/calculate' when referring to the method of estimating the cost of equity' and uses 'judge' only once in reference to the available empirical evidence on the value for *gamma*. This implies a level of certainty and robustness in the estimation of WACC that is totally inappropriate and substantially in contrast to the emphasis clearly stated by UK regulators (and the Victorian ESC) that decisions on the value of WACC depend on regulatory judgement.

more transparent and consistent approaches to setting WACC over time, which is welcome, there are still some remaining inconsistencies, some ambiguities, some issues poorly explained and it is clear that NSPs are still heavily engaged in such tactics.

The ACCC SRP should, as far as possible, therefore make clear what approach will be adopted in setting WACCs for TNSPs; and that approach should include a requirement that regulators balance the interests of owners and end-users in setting WACC.

It is also abundantly clear that end-user input into reviews has been inadequately resourced, especially compared to that of the NSPs and that this creates an asymmetry in the information and argument provided to regulators. Therefore, regulators need to focus on overcoming this imbalance. Australian regulators, including the ACCC, have received only limited input from end-users and they are therefore being quite poorly informed about end-user views on these matters.[67]

5.2. WHY IS THE WACC IN AUSTRALIA STILL SO HIGH?

Material presented to the ACCC previously by the EUAA (and others) shows that, in the UK at least, regulators focus more on financial market expectations and impacts, preferring not to rely as much as Australian regulators do on the views of utility owners. That material shows a 'benchmarking' comparison of cost of debt, return on equity and WACC prepared by Pareto Associates and has been included in several submissions to the ACCC, as well as IPART and the ESC.

The approach taken is to use values of CAPM parameters selected by individual regulators to derive estimates of real, cost of debt, post tax return on equity and the 'Vanilla' WACC (real, post-tax). This allows a (nearer) 'apples-for-apples' comparison of the outcomes from regulatory decisions than is possible by using numbers derived from different versions of CAPM, or by using nominal values that do not exclude the impact of inflation.

The results of this analysis show that Australian regulators have made similar judgements to UK regulators on the cost of debt, but judgements on return on equity and WACC that are far higher and far more varied than those made by UK regulators administering similar incentive regulation regimes. The analysis also shows Australian regulators have

[67] The point was made earlier about the importance of advocacy funding for such input and the frustrations experienced with this to date. Specifically in relation to the WACC, the EUAA (and others) have made various proposals to fund advocacy work in this area but both the NEM Advocacy Panel and the Consumer Utility Advocacy Centre (CUAC) in Victoria have rejected several applications thereby ensuring that end user input is more limited.

endorsed outcomes that, unfortunately for end-users, ensure Australia's energy networks will be less 'efficient' (i.e. more costly to end-users) than in either the UK or US.

UK regulators have adopted CAPM values that yield a "Vanilla" WACC around 5.1% (real, post-tax). The ACCC has recently adopted values that yield a "Vanilla" WACC of 6.1% to 6.3% (real, post-tax). These results are generally consistent with work undertaken by NERA for the ACCC, which also shows that Australian regulators have been generous in the rates of return they have set for regulated businesses in Australia. If the ACCC used the same approach as UK regulators, costs to end-users for transmission services would fall by approximately $200 million/year.

This is not a desirable outcome for customers, especially those operating in competitive world markets.

Frankly, we are perplexed and disappointed that the ACCC has continued setting high rates of return, which translate through into excessive transmission charges. As long as this practice continues, the ACCC will be penalising energy users and rewarding inefficiency in energy networks. Such an outcome is contrary to good regulatory practice and the SRP needs to take steps to put an end to this and ensure rates of return that are fair and reasonable. This also makes a nonsense of the regular claims of regulated businesses that the ACCC is "too consumer friendly". In fact, it is setting returns that continue to penalise end-users.

The EUAA acknowledges that regulatory decisions that provide inadequate incentives for owners to invest would eventually harm Australia's economic interests, and those of end-users. But increases in the costs of regulated services due, for example, to excessive returns also play a direct role in diminishing the international competitiveness of Australian business.

Regulators must form robust views on these matters and minimise the degree of judgement. This is becoming more-and-more possible with the now substantial track record of regulatory decisions in Australia (and elsewhere). This makes it possible to refine the setting of WACC parameters and reduces the need for regulatory judgement (as well as regulatory risk). It also calls seriously into question the Productivity Commission position, in their report on the National Access Regime, that regulators should always err on the side of setting a higher WACC.

The EUAA's view is that this issue is best addressed through regulators undertaking careful analysis and making consistent, well-informed and independent decisions focussed on outcomes that emphasise broad economic benefits. They should steer away

from making decisions that protect the long-term interests of existing utility shareholders. The ACCC has a key role and responsibility here.

5.3. WHY IS THE MARKET RISK PREMIUM STILL SO HIGH?

The EUAA recognises that regulatory decisions on WACC must rely on judgement because none of the parameters required for CAPM can be directly measured. The EUAA's major concern is that the approach used by regulators appears mechanistic and focuses on analysis of historical data in determining values for individual CAPM parameters. We are also concerned that it relies heavily on one regulator following the decisions made by another and therefore is more prone to perpetuating mistakes. This focus on mechanistic analysis diminishes the value of other "evidence" available to regulators, such as the informed judgement of independent financial market analysts, which is typically given greater weight by UK regulators.

The EUAA is also concerned that material in the Discussion Paper, paraphrased in the ACCC's Preferred Position above, refers to controversy about equity beta values but presumes there is no controversy about the value of Market Risk Premium (MRP). The EUAA's view is that the value of both these key CAPM parameters is controversial.

The EUAA also recognises that, in the end, the value adopted by regulators for individual CAPM parameters is not as important as the final value of WACC that the parameter values yield. Ultimately, the value of any individual parameter, be it the MRP or equity beta, is only meaningful if the final value of WACC produced by the CAPM formulae can be demonstrated to be fair and reasonable to both utility owners and end-users.

In this context, the EUAA notes that financial markets have readily been willing to continue to fund energy networks in Australia and have commented approvingly about the decisions of regulators. On the other hand, we note with concern that there is nothing in the decisions of any Australian regulator to explain why Return on Equity and WACC must be higher for Australian utilities than for utilities in the UK and US.

However, the primary 'cause' of this outcome is clear. Comparison of data contained in regulators' decision documents shows that UK regulators adopt substantially higher values for the market risk premium (of 3.5% - 4.0%) than do Australian regulators, who all adopt values around 6.0%. The ACCC Discussion Paper says:

> *Regulatory decisions in Australia have used a historical MRP (ex-post measure) of between 5-7 % per annum representing the long run average return on Australian stocks. Decisions in the UK have used an historical MRP of 3.5 %. The rationale for such differences is that there are segmented*

> *stock markets, and investors require a higher risk premium to invest in the Australian market.*

It should be of concern to the ACCC that at least two aspects of this paragraph are wrong. The value adopted by UK regulators is not based on analysis of historical data. It is based largely on forecasts of expected returns provided to regulators by credible financial market sources independent of regulated companies. In addition, there is no mention in the cited reference[68] about segmented markets or investors requiring a higher risk premium to invest in the Australian market.

The EUAA has not seen any evidence that clearly supports the assertion that Australia's financial markets are segmented from world financial markets. Indeed, while there is evidence that debt costs are different (and this is taken into account by regulators) there is some evidence that Australia is fully integrated into competitive international debt and equity markets.

The only 'evidence' that purports to support such an assertion that has been presented in recent regulatory reviews was included in a presentation by Henry Ergas (NECG Consulting) at the SPI PowerNet/ElectraNet SA/GasNet WACC seminar in late June 2000. Ergas' use of this data appears to suggest that financial markets expect higher returns in Australia than in either the UK or the US. However, the data on which Ergas' presentation was based represents theoretical predictions of expected returns for non-market economies from one of three models presented by Erb *et al*.[69] Erb *et al* make no claims that their models accurately predict expected returns in market economies like Australia's. Actual market data for Australia, the US and the UK presented by Erb *et al* show expected returns for Australia (between 1979-1995) slightly below those for the US and UK. If the data presented by Erb *et al* is and remains valid, financial markets would expect the Australian economy to deliver the same returns as (or slightly less than) the UK and the US economies.

The EUAA acknowledges that there is a question as to whether data in the Erb *et al* paper (from 1979-1995) remains relevant for comparing the actual performance of financial markets in Australia, the UK and US in 2002. However, this is a matter that should be examined in detail by the ACCC before committing to a 'preferred position' that "*the Commission considers no changes should be made to the current approach of estimating the MRP*".[70]

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[68] *Research Roundtable – The Equity Premium* at http://papers.ssrn.com/paper.taf?abstract id=234713.

[69] *Expected returns and volatility in 135 countries*, C. Erb, C. Harvey, T. Viskanta, Journal of Portfolio Management, Spring 1996, pp. 46-58

[70] p 75, ACCC Discussion Paper.

The EUAA is still seeking an answer to an, as yet, unanswered question posed to the ACCC in the EUAA's submissions on SPI PowerNet, ElectraNet and Transend:

> *"Should/do financial markets see Australian utilities as being 'less efficient' or 'more costly' than their UK and US counterparts, particularly when other capital-intensive (but unregulated) Australian companies are able to be competitive internationally for capital and debt funding?"*

We believe that the answer to this question is that international financial markets do not see Australian utilities as less efficient and more costly to finance than their UK and US counterparts, but for some reason that has never been adequately and transparently explained, regulators persist with decisions that suggest the opposite and are out of step with financial markets.

These outcomes may well be the result of overly-cautious regulation, or regulatory error, and there is a real possibility that regulators are contributing to a reduction in the competitiveness of the Australian economy, which the EUAA considers is a critical issue for Australia's energy using (and world competitive) industries. The EUAA notes the following statement taken from the Draft SRP:

> *In summary, the market risk premium is an inherently poorly defined parameter with considerable uncertainty associated with its estimation. Ways to measure the market risk premium are evolving, and there is an ongoing debate. The Commission will use its judgement in setting the market risk premium, noting the views of market participants as to its value are just as important as its statistically determined value. The Commission considers that in view of the evidence available from financial markets and the direction of the ongoing debate there is good reason to believe the value should be reduced below what may have been considered conventional wisdom a year or so ago.*[71]

There is no fundamental difference between this view and the approaches adopted by UK regulators. That is, the dominant 'regulatory principle' governing the treatment of WACC should be that the return on equity and cost of capital be set at levels that meet the reasonable 'efficient' expectations of financial markets. This is the only way that end-users can access the benefits of 'efficient' financing by prudent, well-managed companies. On the other hand, continuing to set values for return on equity and WACC that are transparently biased in favour of TNSPs holds out no prospect of end-uses being

[71] p 78-79, Draft SRP

able to share in efficiency benefits through incentive regulation, as required under the Code.

5.4. 'PRINCIPLES' FOR INCLUSION INTO THE SRP

The EUAA is disappointed with the lack of progress on this important matter and the ACCC's seeming lack of appreciation or understanding about the setting of WACC, the MRP and the approach adopted by regulators elsewhere. The ACCC's proposals would be improved by explicitly adopting the following 'principles' to be included in the SRP:

(a) Correct the SRP for these problems and comment specifically on the impact on end-users of international comparisons for WACC.
(b) Adopt approaches to the WACC and its parameters such as the MRP that are better informed, more fair and reasonable, more in tune with overseas practice and less damaging to energy users.

This section has highlighted several important ways this should be done.

6. SERVICE STANDARD INCENTIVES

It is a substantial disappointment to the EUAA that the ACCC's Discussion Paper pays virtually no attention to the important issue of service standards, or to incentives for TNSPs to deliver services that add value to end-users. The Discussion Paper refers very briefly to the work carried out for the ACCC by SKM and the publication of the Service Standard Guidelines.[72] There is, however, no mention in the Discussion Paper, or in any other documents related to this review, of the activities of the Service Standards Working Group (SSWG) that was established by the ACCC following the Service Standards public forum held on 15 July 2003. Nor is there any reference in the Discussion Paper, or any other related documents, to the directions taken initially by the SSWG.

As stated in other parts of this submission, development of meaningful service standards and incentives to optimise overall benefits to end-users should be fundamental principles that are incorporated into the SRP.

The initial deliberations by the SSWG indicate broad support amongst industry and end-user stakeholders for moving towards service standard incentives for all TNSPs that would relate more to market outcomes. The EUAA strongly urges the ACCC to incorporate such sentiments into the SRP. However, in doing so, the ACCC should ensure that focus is kept on:

- ensuring benefits flow to those who pay for shared transmission services – that is end-users who currently pay 100% of the cost of the shared network;
- developing a consistent set of service standards that would apply uniformly to all TNSPs; and
- ensuring that commercial incentives for TNSPs are focussed on optimising benefits to end-users, are both positive and negative, are meaningful and are sufficient to motivate the required change in behaviour and performance.

This would be a significant advance on the limited service standards currently set under the Service Standard Guideline. The EUAA accepts that there are some crucial issues that must be explored, discussed and resolved before a comprehensive service standards incentive scheme can be implemented.

We urge the ACCC to move forward as quickly as possible in developing such a scheme. First steps towards achieving that outcome would appear to be:

[72] The Discussion Paper refers only to the draft Service Standard Guidlelines published in March 2003.

- incorporating it in the SRP; and
- establishing a monitoring, public reporting and incentive regime for all TNSPs that focuses on quantifying TNSP market impacts (using measures similar to those outlined in the SSWG papers) as soon as practicable.

7. CONCLUSIONS AND RECOMMENDATIONS

The EUAA welcomes the chance to make a useful contribution to the ACCC's review of the *Draft Statement of Principles for the Regulation of Transmission Regulation* (Draft SRP) and has made efforts to do so. Unfortunately, this contribution has been hampered by the Discussion Paper, which is, in parts, difficult to follow and which contains a number of factual errors.

The EUAA recommends that the ACCC re-consider a number of its proposals and 'preferred positions'. In particular, the EUAA recommends that the ACCC:

1. Closely examine its current practices for setting transmission revenue and compare these, in detail, with similar practices of the UK regulators.
2. Fix the commencement of each consultation period in advance so that end-users have a better basis for planning participation (and seeking funding support from the NEM Advocacy Panel).
3. Concatenating the two periods for consultation on the TNSPs application and the ACCC's consultants' analysis of the application.
4. Allowing more time for end-users to consider issues raised in the TNSPs applications and the ACCC's consultants' reports concurrently.
5. Fixing an end date for the review process so that TNSPs can publish revised tariffs well before the start of new fiscal years and end-users can budget for changes in transmission charges.
6. Develop a 'regulatory principle' to align the timing for review of all NEM TNSPs as soon as practicable.
7. Undertake regulatory reviews for a single, multi-company, NEM-wide transmission system.
8. Develop comprehensive 'service standards' for the whole transmission system that include specific incentives for TNSPs to interact with the energy and ancillary services markets to optimise outcomes for end-users.
9. Achieve consistency in approaches and incentives for network service providers to optimise outcomes for end-users.
10. Acknowledge that there are no hard and fast rules for the appropriate approach to asset valuations and that the DORC approach is flawed and damaging to energy users.
11. Acknowledge an intent to achieve valuations for sunk assets that are efficient, fair and practicable where:

a. an efficient valuation will be the lowest value that would allow the asset owner to recover efficient investment and would create the least distortion to efficient upstream and downstream investment. That is, the asset valuation methodology should explicitly consider the impact on investment in upstream and downstream activities;

b. a fair valuation will be one where end-users fully fund efficient capital costs, but only do so once. That is, a fair valuation of sunk assets should pay attention to past depreciation schedules and returns on capital already paid by end-users on sunk asset investments and should focus on providing incentives for efficient future investment;

c. a practicable asset valuation will be one that uses the most readily available information, with a methodology that is least likely to be subject to 'strategic' manipulation of information by asset owners.

12. Explicitly aim to provide incentives for efficient future investment and efficient operation of networks.

13. Explicitly prohibit change of easement asset values, and retain easement values at historic actual cost in nominal terms. Where such costs cannot be established with certainty, easement asset values should be explicitly set at zero.

14. Acknowledge that there are (undesirable) incentives for TNSPs to exercise 'strategic' behaviour in forecasting of outputs and costs.

15. Commit to comment explicitly on the exercise of 'strategic' behaviour by TNSPs.

16. Use 'expert' technical consultants to advise on technical issues related to TNSPs proposals, not to provide regulatory judgements, which should be the preserve of regulators.

17. Commit to implementation of UK-styled econometric analysis of TNSPs performance, using data and information from consultants' reports as one of a range of inputs to that analysis.

18. Use the output of the econometric analysis to establish a rational monitoring and comparative reporting regime for TNSPs that will assist in informing regulatory judgement.

19. Undertake a comparison of forecast and actual CAPEX and OPEX for each TNSP as one of the means of informing judgements on prudency of past expenditure, efficiency of future expenditure and exercise of 'strategic' behaviour by TNSPs.

20. Confirm the symmetrical treatment of differences between forecast and actual CAPEX when it is rolled into the regulated asset base.

21. Include proposals to deal with the inevitable trade-off that TNSPs will make between CAPEX and operations and maintenance (OPEX) costs.
22. Minimise opportunities for TNSPs to seek ‘cost-of-service’ pass-throughs (and other incremental ‘add-ons’) and set reasonable and efficient CAPEX and OPEX benchmarks that are ‘challenging but achievable’ for efficient, well-managed firms.
23. Explain why financial markets see Australian utilities as being 'less efficient' or 'more costly' than their UK and US counterparts, particularly when other capital-intensive (but unregulated) Australian companies are able to be competitive internationally for capital and debt funding. If this cannot be explained, establish in the SRP that in future WACCs will reflect overseas practices that do not continue to penalise Australia energy users, including firms competing in world markets.
24. Develop a dominant ‘regulatory principle’ governing the treatment of WACC based on return on equity and cost of capital set at levels that meet the reasonable ‘efficient’ expectations of financial markets, not the expectations of individual TNSP shareholders.