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First proposed guidelines  
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### **AER's First Transmission Guidelines**

I welcome this opportunity to provide the AER with EnergyAustralia's response to the range of issues raised by your first transmission guidelines.

Whilst the attached submission discusses a range of issues relating to your first guidelines, I would like to make three comments in particular. At the outset, I wish to reinforce EnergyAustralia's commitment to working with the AER to develop a robust set of regulatory arrangements that deliver balanced long-term incentives to match EnergyAustralia's long-term network investments. Beyond being the right thing to do as a responsible corporate citizen, it is quite simply prudent commercial practice. Regulatory arrangements that are unbalanced, untested or open to opportunistic behaviour will create short-term incentives and outcomes unlikely to be in the longer term interests of all stakeholders. They would be subject to being changed over time in regulatory or political responses to perverse or counterproductive outcomes.

I would therefore emphasise the request made in EnergyAustralia's submission that the AER undertake an additional round of consultation, following a release of draft guidelines developed with stakeholder input. I recognise that you are not required to by the Rules to undertake an intermediate round of consultation, however given the gravity of some of the issues raised by EnergyAustralia and other interested parties, it is clear to my mind that such consultation will be necessary to ensure an effective and balanced set of regulatory arrangements.

Finally, while EnergyAustralia is a TNSP, our major focus is on our distribution network, which accounts for over 85% of our regulated assets and revenues. Indeed, as you may be aware, EnergyAustralia has submitted a rule change application to the AEMC with the intention of having a single regulatory determination for its transmission and distribution businesses. It is with this in mind that EnergyAustralia has framed some of its comments on the transmission guidelines, in anticipation that the distribution guidelines will adopt similar principles and processes. I understand that comments and lessons from this current transmission process will have a material impact on their development, and therefore am keen to see the development of the AER's approach to these guidelines, accepting that different challenges which will arise from the distribution Rules.

If you have any queries regarding this submission please do not hesitate to contact me on (02) 9269 4171.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'H. Colebourn', written in a cursive style.

Harry Colebourn  
Executive Manager – Network Regulation & Pricing



**EnergyAustralia**<sup>®</sup>

# Submission to AER First Transmission Guidelines

May 2007



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# Executive Summary

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EnergyAustralia is pleased to provide this submission to the AER for its consultation of the AER's first transmission guidelines. Generally, EnergyAustralia welcomes the draft guidelines. However EnergyAustralia has several concerns or comments which relate principally to:

- The need for an additional round of consultation. The processes set out in the transitional arrangements under the Rules only provide for one round of stakeholder input. EnergyAustralia believes that the AER should adopt common regulatory practice and include an additional round of consultation in recognition of the importance of the issues raised in the draft guidelines, and the material concerns that EnergyAustralia and others have raised in respect to several aspects of the draft guidelines.
- The PTRM and asset roll-forward model both “hard code” the use of straight line depreciation. EnergyAustralia believes that the Rules provide for the TNSP to provide the AER with depreciation schedules using depreciation methods that are compliant with the Rules. EnergyAustralia is concerned that the PTRM and the roll-forward model do not reflect the Rules in this respect and should be redesigned to allow for the Rule compliant depreciation figures prepared by the TNSP to be inserted into the models.
- EnergyAustralia is pleased that the submission guidelines have limited the use of mandatory headings to the identification of key reporting topics, as referenced in Appendix A. This approach is seen as being critical for catering for a range of diverse TNSPs operating in specific environments with differing business and management drivers. The ability to adopt discretionary headings that allow such factors to be appropriately communicated is critical to ensure that the nature of the TNSP in question is fairly represented by the financial information prepared for the submission, and to facilitate consistent reporting from prior years that will protect the time series of information necessary to inform the AER's decisions.
- EnergyAustralia has concerns stemming from the provision of audit assurances. EnergyAustralia does not believe that, as presented, such assurances will afford the AER significantly greater confidence in the information TNSPs provide. In particular EnergyAustralia's experiences and advice it received on such matters as part of our 2004 distribution review raises doubts at the practicalities of the proposed audit applying to forecast information, and EnergyAustralia will be happy to provide further information regarding that advice if sought by the AER.
- EnergyAustralia does not believe that the market measures required by the Rules for implementation in a service incentive regime can be realistically applied to EnergyAustralia. It has been clearly articulated by the ACCC in the past EnergyAustralia does not impact on market (spot price) outcomes. Therefore EnergyAustralia is of the opinion that only the reliability measures foreshadowed in the Rules can reasonably apply to EnergyAustralia. However, as the Rules change the focus the reliability regime that was previously adopted by the ACCC EnergyAustralia is conscious of the need for further work to be undertaken to ensure that all of the key elements of the measures required by the Rules can be adequately defined and reported against.
- With respect to the operating expenditure carry-over incentive mechanism EnergyAustralia believes that in its current form this mechanism is unworkable and must be reviewed from scratch. The mechanism as currently proposed is captured by the impact of stochastic variances, leads to perverse and non-intuitive outcomes and finally is open to such gaming potential as to make its ongoing use unsustainable. One of EnergyAustralia's primary commercial objectives is the development of a sustainable regulatory regime that is sufficiently robust as to provide a long-term framework that will support long-term investments. The operating expenditure carry-over incentive mechanism fails this critical test.

# 1 Procedure for Developing the Transmission Guidelines

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The AER's timing and process in the development of the Transmission Guidelines is of concern to EnergyAustralia. It appears that because there is a significant amount of work that the AER must undertake to produce all the required guidelines, the consultation process has been foreshortened. It should be noted that the AER's proposed approach meets the requirements set out in the transitional arrangements for the guidelines development, however EnergyAustralia is hopeful that the AER will expand the minimum consultation required under the Rules to include additional consultation phases as set out below in light of the substantive concerns raised by EnergyAustralia and other interested parties, and to reflect best practice consultative procedures.

Most regulatory consultations, especially on important matters like those being considered here, normally have two consultation stages, where the views of interested parties are sought:

- There is a document or discussion paper to initiate consultation.
- The regulator then makes a draft Rule/Determination/Guideline on the initial proposal. At this stage the regulator has had time to consider the relevant issues raised.
- Final submissions are considered in the regulatory body's final Rule/Determination/Guideline.

EnergyAustralia considers the transmission guidelines to be at the first proposal stage. The Rules specify that the AER must reach the final milestone in September 2007.

A further part of a full consultation process is often a public forum to hear what interested parties have to say.

In the current process, there does not appear to be a plan to release "draft guidelines" that nail down the detailed issues that are raised by the first proposed guidelines. It is principally those details that are absent that appear in the remainder of this submission.

EnergyAustralia submits that there are sufficiently material matters being raised by EnergyAustralia and other stakeholders to the current round of consultation to warrant an additional round of consultation. Furthermore, EnergyAustralia believes that all stakeholders, including the AER, would benefit from a public forum or round table discussion on the material issues raised by the first guidelines.

## 2 Post-Tax Revenue Model

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### 2.1 Summary

The Post-Tax Revenue Model (PTRM) has been used by the ACCC/AER for several years now and many of the associated issues have already been the subject of review and consultation. EnergyAustralia is generally satisfied that the model does what it is purported to do.

There are only two issues that EnergyAustralia wishes to raise in this round of consultation: one raised by the AER with respect to timing assumptions within the PTRM; and an apparent oversight that has been identified by EnergyAustralia that is required to be addressed for the PTRM to facilitate the transmission Rules.

### 2.2 Timing Assumptions for capex and depreciation

The question of the timing of recognition of capital expenditure and depreciation has been an ongoing matter of consideration since the initial PTRMs were used for the 1999 TransGrid and EnergyAustralia transmission decisions. This has again been raised in the current consultation. While EnergyAustralia does not dispute the fact the current timing assumptions in the PTRM are a simplification that may result in marginal benefits one way or the other, EnergyAustralia believes that the current approach is both pragmatic and transparent and does not warrant change.

Attempting to refine the timing assumptions that have been used in the PTRM for some time now would not be a simple affair to undertake accurately, and indeed the number of adjustments that would need to be undertaken for the PTRM to be precisely correct in respect of timing is likely to mean that some of the adjustments would be missed. For this reason and the significant increase in the complexity of the model, with a commensurate reduction in transparency that would arise from a change, EnergyAustralia submits that the existing timing assumptions should remain unaltered.

### 2.3 Depreciation Method

EnergyAustralia notes that the PTRM “hard codes” the depreciation method, limiting it to the straight-line method. This is inconsistent with clause 6A.6.3(a)(2) of the Rules that explicitly provides discretion to the TNSP to establish the appropriate depreciation method. This is because the AEMC recognised that the TNSP has the best information to make assessments as to the use of the asset over its economic life.

EnergyAustralia believes that this may be an oversight, and that the pre-existing PTRM has simply not been updated for this aspect of the new Rules. However, EnergyAustralia would expect the necessary adjustments to facilitate the discretion as set out above into the PTRM.

There are a range of options that could be used by the AER to ensure that the model and its operation reflect the Rule requirements and EnergyAustralia would like an opportunity to discuss the range of those options, and their potential procedural and information burdens. This issue is discussed in more detail below in response to the roll-forward guideline.

## 3 Roll-Forward Model

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### 3.1 Summary

EnergyAustralia is concerned that the roll-forward model does not explicitly allow for pre-existing differences in previous decisions to be protected and accounted for when conducting a roll-forward into the new regulatory period. This is clearly a critical weakness if an explicit allowance is not made to protect the integrity of previous regulatory decisions, thereby introducing unnecessary regulatory risks into the framework.

Further, EnergyAustralia does not believe that the current approach to interpreting and implementing depreciation over the economic life of assets is required for the roll-forward model to be Rule compliant, and that the proposed approach introduces significant compliance costs for EnergyAustralia without any discernable public benefits to offset these additional regulatory costs that will ultimately be born by EnergyAustralia's customers.

EnergyAustralia submits that the AER should reconsider its assessment of the compliance of the as-incurred arrangements with the Rules, and provide roll-forward models that allow the TNSP to elect with framework to adopt, consistent with its empowerment under the Rules to provide the AER with its depreciation schedules.

### 3.2 Protection of Past Decisions

The roll-forward model must ensure the integrity of current regulatory decisions and the roll-forward approach that is contained within those decisions if it is intended to apply to rolling forward current decisions, rather than being purely forward looking and applied to new AER decisions.

Of particular concern is the potential inconsistency in how inflation is applied in the roll-forward model compared to how it was applied in determining the outturn revenues during the previous regulatory period. To eliminate this potential inconsistency, the proposed roll-forward model should be adjustable to substitute any alternative approach to the application of inflation necessary to make it consistent with the previous revenue cap decision.

Protecting the integrity of the current regulatory decisions is a critical issue in both procedural fairness and regulatory risk terms. While EnergyAustralia has every confidence that the AER did not intend that the roll-forward model would override current regulatory decisions, it is critical that such matters be resolved at this stage, to ensure that they do not get overlooked during the intense workload of the upcoming regulatory reviews, and that they are directly addressed in the next round of consultation.

### 3.3 Compliance of the Roll-Forward Model with the Rules

EnergyAustralia does not believe that the current guideline adequately captures the various elements of the Rules relating to the calculation of depreciation. The Rules establish the responsibility for calculating the depreciation of the RAB over the various economic lives of the supporting assets. The roll-forward model does not cater for this requirement of the Rules by:

- Not providing for the TNSP to present the AER with the appropriate calculation of depreciation, in accordance with the Rule requirements; and
- Dictating in the model the straight-line method of depreciation, which as recognised by the Rules may not be the most appropriate method in all circumstances to represent the use of the asset over its economic life. The model needs to provide flexibility for the TNSP to set the appropriate method in most circumstances. As discussed above, EnergyAustralia believes that this may well be an oversight stemming from the existing version of the PTRM, but nonetheless should be corrected.

Therefore, EnergyAustralia submits that in its current form the roll-forward guideline is not compliant with the Rules. To address this issue, EnergyAustralia believes that the appropriate response is to simply provide input cells for the TNSP to enter the annual depreciation associated with each asset class that is reported in the roll-forward model.



It would then fall to the TNSP, as envisioned by the Rules, to provide depreciation schedules to the AER that set out its calculation of depreciation in accordance with its assessment of the economic life of assets and consistent with the basis upon which the revenue cap decision was made.

By adopting this approach, the AER is not required to establish any detailed calculations within the roll-forward model to accommodate assessments of the economic lives of assets or the calculation of the various acceptable depreciation methods that may be employed by the TNSP. This would simplify the model and the accompanying guideline, and improve both its alignment with the Rules objectives and the roll-forward model's functionality.

### 3.4 Applicability of a Single Approach to Depreciation and Economic Life

EnergyAustralia does not believe that a simple adoption of general purpose accounting concepts within the conceptual framework of economic regulation is always desirable, consistent with the economic regulatory objectives, or even practical in several circumstances.

EnergyAustralia is currently at the early stages of a major renewal cycle for its network. As part of this replacement program, EnergyAustralia has already encountered situations where it is uneconomical to source a new site for replacement substations. This has forced EnergyAustralia to consider and undertake replacements on the same site. EnergyAustralia's network does not have the redundancy to decommission a major substation for several years while its replacement is being built.

As a result, EnergyAustralia has been forced to be more creative in the way it undertakes the replacement of critical elements of its network such as substations. An approach increasingly being used by EnergyAustralia is to stage the work, often as follows:

- Stage 1 might involve a range of small augmentations to facilitate load transfers on the 11kV system, to allow a greater supply capacity to come from adjacent substations;
- Stage 2 would partially decommission and demolish the existing substation, in such a manner that the part that remains in service continues to supply load;
- The third stage would rebuild the out of service portion of the substation and then commission the new equipment. This would then enable the remaining old section of the substation to be decommissioned for reconstruction; and
- Finally, the reconstruction of the substation would be completed and all equipment commissioned.

This is problematic for the roll-forward to accommodate in an arithmetic or hard-coded manner as the new asset is effectively "commissioned" in stages. The underlying asset is not completed until the last stage and would not be recognised using a basic "commissioning" convention, despite the active service it is delivering to customers in intermediate stages.

Further there are some assets that are purchased and held as emergency spares. EnergyAustralia depreciates these assets even though not installed or "commissioned". These assets provide the very real and valuable service of risk management that supports the delivery of the required customer reliability experiences. As they form part of the network service (which EnergyAustralia receives regulated revenues for), and they have a finite shelf life deteriorating even when not in use, they begin their economic life from the time the cost is incurred.

These practical engineering matters are not easily represented in any simple or workable construct of accounting lives, depreciation or economic life that could be dictated in policy or pre-modelled in an excel spreadsheet.

The solution to this problem and the problem of recognising the myriad small distribution projects lies in the AER amending its guidelines to reflect the Rules in relation to depreciation by accepting the Rule compliant depreciation schedules prepared by the TNSP. Practically, it will be near impossible for the AER to ever develop a set of guidelines or a financial model that will adequately cater for the range practical day to day "exceptions to the rule" that arise in building and managing a network, and this has been recognised and addressed in the Rules developed by the AEMC.

## 4 Submission Guideline

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### 4.1 Summary

EnergyAustralia is generally supportive of the First Proposed Submission Guidelines. However, there are some concerns, some of a mechanical nature and some of a conceptual nature, which we outline below.

### 4.2 Submission guideline

EnergyAustralia is generally comfortable with the AER's First Proposed Submission Guideline in so far as it outlines what has become accepted as normal regulatory process.

#### 4.2.1 Information provided shall be verifiable

Guideline 2.7 requires the business to ensure that the information provided is "verifiable". In order to comply with this Guideline, it will be important to ensure that we understand what is meant by "verifiable".

For example, in the context of historical information, there is scope for an independent reviewer to determine if revenues have been correctly recorded with regard to approved tariffs and consumption volumes.

In contrast, forecasts, by their very nature, are not "verifiable" in that they cannot be said to be "true". Rather, a forecast can be reasonable or unreasonable. In this regard, forecasts could be found to be reasonable on the basis of their development under a sound methodology and having regard to relevant information from the marketplace.

EnergyAustralia supports the AER Guideline's definition of "verifiable" - that forecast information can be traced back to the analysis from which it was produced, and that the components of that analysis can be traced back to other analyses or assumptions as necessary.

#### 4.2.2 Audit of revenue proposal

EnergyAustralia finds the concept of an audit of the revenue proposal to be particularly problematic. The revenue proposal is very much a forward-looking document, in which forecasts of future load and demand (based on forecasts of future climatic conditions, population growth and demographics, appliance penetration, etc), condition and loading of assets and forward-looking costs of labour, materials, equipment and services combine in myriad ways to culminate in the composite building block revenue proposal.

The forecasts prepared by the network business in the context of its revenue proposal necessarily reflect a wide range of climatological, demographic and engineering expertise. In conducting an audit of the revenue proposal, the audit firm would necessarily be required to rely on a wide range of internal and external experts. With the financial audit firm, as suggested by the form and construction of the template audit reports provided in Appendix B, unable to opine on the work of the various experts, the value of a financial audit would effectively be reduced to a test of clerical accuracy.

Furthermore, during the 2004 distribution review process in NSW it was proposed by IPART that the submissions would be required to be audited prior to their submission. EnergyAustralia raised concerns at that time whether it was reasonable to undertake a true and fair view audit of 7 years of forecast information. Therefore we sought advice from our regulatory account auditor who indeed informed EnergyAustralia, and subsequently discussed with IPART, that as a general rule it was difficult to gain authority to provide an audit opinion on matters of up to 6 months into the future, and that 7 years was simply out of the question.

While the template proposed by the AER in Appendix B to the submission guidelines indicates that the report would not be an audit *per se*, it does nonetheless require an opinion to be expressed on the correctness of the forecasts. EnergyAustralia believes that similar concerns would be raised by an auditor that we attempted to engage to meet the AER's audit requirements would similarly constrain their ability to accept such an engagement. To EnergyAustralia's knowledge the only type of review that would generally be acceptable would be a verification that the methodologies described in the submission to develop the forecasts were indeed those undertaken. EnergyAustralia understands that any obligation to express an audit opinion would not be accepted on forecasts of up to 7 years into the future.

EnergyAustralia therefore questions the appropriateness and usefulness of the audit requirements.

On practical grounds, the requirement for the business to provide audit assurance is both time consuming and duplicative. Considering that it takes up to two years to develop a revenue proposal, EnergyAustralia estimates that two to three months may be required for an auditor to conduct a non-trivial review of it. The requirement for an audit brings forward the practical completion date for the submission for a TNSP, thus leaving a bigger gap between the submission being completed and the start of the new period (i.e. a gap of up to 2 years).

It is also not clear that an audit would reduce the amount of work required to be undertaken by the AER in assessing the revenue application. As the assessment of the revenue application against the Rules is the AER's area of expertise, it would appear that an audit would be restricted to a clerical check of the revenue application.

EnergyAustralia considers that the audit envisioned by the Guideline adds a time lag to the process but does not contribute significantly to the AER's assessment of the revenue application.

At a principle level, EnergyAustralia is concerned about the signal that such an audit requirement sends to the relationship between the regulator and the regulated business. The requirement for an audit implies a sense of distrust from the very earliest days of the regulatory relationship.

Finally, the Guidelines state that the AER "may" require an audit. Given the lead time required for preparation of submissions (i.e. at least 12-18 months), the requirement for an audit would need to be made clear at least 2 years in advance of the submission being required for a TNSP to be able to schedule an audit into its submission preparation timetable.

The inherent uncertainty as to whether an audit will or will not be required is unacceptable and should be managed by requiring the AER to specify whether an audit is required 2 years in advance.

#### 4.2.3 Scope of revenue proposal

EnergyAustralia supports the 13 month time frame for the regulatory process to be conducted, and undertakes to work genuinely and diligently to see that the timetable is met.

As outlined in its submission on the Rules, EnergyAustralia considers that it will be important to know, at an early date, what services are covered by the revenue proposal, and how those services are to be regulated. Before filing its proposal, the TNSP must have a firm understanding of which services are to be regulated under which from of regulation. i.e. prescribed services, negotiated services etc.

### 4.3 Submission guideline templates

EnergyAustralia considers that the AER's intention relating to the submission Guideline templates is encapsulated in the following section:

Guideline 3.2 (b)

..... a TNSP may, within the context of the *mandatory headings*, define *discretionary headings* that are most appropriate to conveying an understanding of the TNSP's business.

As discussed more fully below, EnergyAustralia takes considerable comfort that the AER is taking a "substance over form" approach to the regulatory templates as envisioned in Guideline 2.4.

EnergyAustralia is very supportive of this flexibility and recognition that different TNSPs manage their respective networks according to different drivers.

#### 4.3.1 Mandatory headings

Guideline 3.3 indicates that the mandatory headings are specified in Appendix A to the Guideline. Appendix A lists only the titles of the schedules to be provided in the pro forma statements – for example, Historic Opex by Category by year.

A review of Appendix A would indicate that this is the full extent of the mandatory headings to be included in the regulatory reporting requirements. EnergyAustralia applauds the AER's flexible approach to this matter.

The greater the extent to which there are mandatory headings in the Guideline, the lesser the scope for the TNSP to provide information to the regulator to assist the regulator in understanding the business and

the substance of the revenue application related to that business. Greater flexibility in regulatory reporting requirements allows the TNSP to provide information in a manner that is consistent with its own business methodology. Allowing flexibility enables greater transparency and an ability to compare regulatory information with existing accounting and financial systems. This will also allow the business to prepare ad hoc information on a consistent basis, should it be requested by the regulator.

A more rigid Guideline would require a “shoe-horning” of costs into a format that does not reflect the way the network is managed and capital is planned. Moreover, this process would invariably involve a widespread re-allocation of costs that would produce reports that would not align with the business’ reporting systems. A more flexible approach is clearly more consistent with providing relevant information.

EnergyAustralia is most pleased that the AER has taken this flexible reporting approach. Our review of the pro forma statements included on the AER website indicates that they have been built according to a particular presumption of the management and expenditure drivers of the business. EnergyAustralia’s drivers for capital and operating expenditure (for example, compliance with mandatory licence conditions relating to planning standards and reliability) differ materially from those suggested in the pro forma statements. It would not be possible for EnergyAustralia to convey an understanding of its business were it to be restricted to the specific format and illustrative headings of the pro forma statements. Moreover, it would not be possible for EnergyAustralia to provide information in a manner consistent with prior reporting.

EnergyAustralia strongly supports the flexible reporting framework reflected in the draft Guideline.

#### 4.3.2 Discretionary headings

Guideline 3.3 provides that:

- (a) ...the *discretionary headings* applied by a TNSP shall be:
- (1) consistent with the *discretionary headings* applied to the historic regulatory information provided; and
  - (2) applied consistently to subsequent forecast regulatory information ...

EnergyAustralia considers that, in practice, all TNSPs will require some modification to the templates in order for them to (a) align with previous reporting to give the regulator an historical basis for assessing the subject application, and (b) align with the investment and operational drivers of the transmission business.

To this end, consistent with Guideline 3.3(c), EnergyAustralia will be pleased to meet with the AER in the process of preparing its revenue application, to ensure that the AER understands the nature of EnergyAustralia’s business and how the regulatory information has been prepared to reflect the cost drivers applicable to the business.

#### 4.3.3 DNSPs as TNSPs

EnergyAustralia has particular concerns in this area. EnergyAustralia is the only business that is fundamentally a distribution business that, by virtue of a definitional feature of the Rules, is also currently a transmission business.

The proposed templates, understandably, do not lend themselves to meaningful information reporting for distribution businesses such as EnergyAustralia. This is true in a number of key areas:

- EnergyAustralia designs, plans and operates its network as a single holistic network. The drivers for transmission investment may therefore relate more to the design of the broader distribution network than to a specific transmission investment.
- When a TNSP connects load to its system, it is generally connecting a non-related DNSP or customer. In EnergyAustralia’s case the DNSP connected to its transmission system is generally itself.
- TNSPs generally augment their Regulatory Asset Base through capital expenditure. In EnergyAustralia’s case, there are frequent circumstances in which an asset, originally built as a distribution asset, becomes a transmission asset (under the Rule definition) by virtue of another asset

being constructed which allows transmission loop flows through the distribution network. The current templates do not allow for this type of “reclassification acquisition” of transmission assets.

EnergyAustralia is keen to work with the AER to develop modified templates that reflect the design, planning and operation drivers of our transmission network, and also adequately reflect the unique characteristics of the regulatory interplay between EnergyAustralia’s transmission and distribution networks.

#### 4.3.4 Changes to discretionary headings

Consistent with the discussion above, EnergyAustralia considers that a historical time series of comparable information is important to allow the regulator to understand the business. Businesses do change over time, as does the regulatory landscape in which it operates. Accordingly, there needs to be scope for the discretionary headings to evolve to be able to cope with these changes in the business and its environment.

Guideline 3.3 places a restriction on varying the discretionary headings:

3.3(d) A *TNSP* may vary the *discretionary headings* from those used in a preceding revenue cap application of *Revenue Proposal* if: ...

(2) The AER issues written approval after receiving an application from a *TNSP* for a variation....."

The “application and approval” process has not been outlined either in terms of when such an application would be made, the process for approval, or the criteria under which that approval may be granted or withheld. The AER should remedy this by providing more clarification on these issues.

## 5 Cost Allocation Guideline

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### 5.1 Summary

The role of the Cost Allocation Guidelines is set out in Clause 6A.19.3 of the Rules. They “must give effect to and be consistent with the Cost Allocation Principles” and are also required to set out the “format”, “detailed information”, “categories of transmission services which are to be addressed” and “acceptable allocation methodologies” that are to be included in the Cost Allocation Methodology.

The purpose of the Cost Allocation Principles, and the Cost Allocation Methodology that is prepared in accordance with those principles, is set out in clause 6A.19.2(1) of the Rules. This is to enable the AER to replicate the reported outcomes by the application of the TNSP’s detailed cost allocation policies and principles used to allocate costs between different services.

While EnergyAustralia believes that generally the AER’s cost allocation guideline will enable such replication of reported outcomes, EnergyAustralia holds some concerns in the manner in which it is achieved by the guidelines, and seeks clarity on one key issue.

### 5.2 Clarity of the Depth of the Allocation Methodology

EnergyAustralia is concerned that the cost allocation guideline and the associated explanatory document and issues paper, taken together appear inconsistent regarding the level of services at which the cost allocation is intended.

Specifically, the document appears inconsistent as to whether the cost allocation methodology is allocating costs to each service, or to categories of similar services. EnergyAustralia has been led to understand that the allocation of costs was intended to be to categories of services, rather than to each individual service provided by a TNSP, or in EnergyAustralia’s case, to each of over 40 services provided to both transmission and distribution customers regardless of their mode of connection.

This clarity is critical to EnergyAustralia’s review and analysis of the cost allocation guideline. EnergyAustralia understands that it was intended that the cost allocation guideline would require disclosure of the methodology for allocating costs to categories of services based on the control arrangements being:

- Direct control – standard;
- Direct control – alternative;
- Negotiated services; and
- Un-regulated services.

If this indeed holds true EnergyAustralia believes that the proposed cost allocation guidelines would operate in a fairly similar manner to the current IPART cost allocation arrangements, including the operation of associated instruments. The IPART arrangements have proved to be workable and are generally supported.

If however, this is not the case and the guidelines prescribe cost allocation to be undertaken to the individual service level EnergyAustralia would consider the guideline to be a material change in regulatory arrangements, and arguably in excess of what would reasonably be required to undertake the regulatory functions related to establishing the revenue/price controls for the categories of services outlined above. Moreover the guideline would likely impose significant regulatory costs on the TNSPs that would ultimately be borne by customers, without the commensurate public benefits that would be required to validate the imposition of materially higher obligations.

Therefore EnergyAustralia requests that the AER confirm that the cost allocation methodologies are only required to develop the required cost allocation data to allow allocation to the categories of services outlined above. Further the AER will need to ensure that the respective documents refer to categories of services on a consistent basis, to avoid any potential confusion in the guideline’s application.

### 5.3 Assistance Offered by Guidelines

EnergyAustralia has continually advocated that one of the classic benefits offered by guidelines published by regulatory authorities is the identification of safe harbours. These are process, approaches, or methodologies the regulated business can be assured the AER will accept, as they have been pre-assessed as being compliant with the AER's guidelines.

EnergyAustralia believes that the cost allocation guideline above all other guidelines is the most amenable to the identification and use of safe harbour provisions, and that the AER should seek to include in the guideline those methodologies that it believes are generally acceptable approaches to cost allocation. EnergyAustralia is not suggesting that alternative cost allocation approaches not included in such a safe harbour list should be considered inappropriate by the TNSPs or the AER. Rather, such alternatives are likely to be appropriate in a smaller range of circumstances, and therefore cannot be approved for general use.

EnergyAustralia submits that each TNSP is in the best position to propose cost allocation methodologies that best represent the underlying nature of its activities, their relative impacts on the business and its financial accounting parameters. Therefore, it is critical that each TNSP have the freedom to select and propose cost allocation methodologies that provide the best representation of its functions and outcomes provided that it is Rule compliant.

Therefore to protect the integrity of the TNSPs' ability to propose Rule compliant cost allocation methodologies, EnergyAustralia believes that as a matter of principle the AER's pre-emptive ban on using the avoided cost basis to undertake cost allocation should be removed. This approach may not be endorsed as acceptable for general application, but its relevance to the situations in which its use is proposed should be considered before is assessed as compliant or otherwise with the Rules.

## 6 Service Incentive Scheme

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### 6.1 Summary

The AER has published its “first proposed” transmission Service Target Performance Incentive Scheme” pursuant to Rule 6A.7.4(a).<sup>1</sup> There are two reasons that make EnergyAustralia particularly interested in the development of this scheme:

1. EnergyAustralia is a transmission network (as well a distribution network) for the purposes of economic regulation by the AER; and
2. EnergyAustralia is specifically referred to in the AER’s first proposal.

The AER has asked five specific questions. This response provides answers to some of those questions but mainly attempts to address higher level issues specific to EnergyAustralia’s position as a combined DNSP/TNSP.

The AEMC’s Rule changes have changed the previous focus of the service performance incentive scheme. The shift from a cost cutting focus of the ACCC to a focus on the market impact of reliability has resulted in EnergyAustralia not fitting into the mould of a “typical” transmission network.

The Rules require the AER to set an s-factor scheme as a market impact incentive, not an efficient cost cutting incentive, which to some extent makes the pre-existing ACCC scheme redundant. Further, in EnergyAustralia’s case, the cost cutting incentive is not appropriate due to the comprehensive and proscriptive nature of the licence conditions set by the NSW Minister for Energy and Utilities in 2005. The NSW licence conditions apply to the whole of EnergyAustralia’s business – both transmission and distribution.

A market impact incentive applied to EnergyAustralia’s transmission network would be inappropriate because the operation of EnergyAustralia’s network has no influence on the spot price. This fact appears to make the Rules’ required incentive scheme unworkable in this context. The proposed scheme is directed at the large transmission networks that directly impact the spot price rather than EnergyAustralia’s network. The result is an incentive scheme that is not ‘fit for the purpose’ for EnergyAustralia.

### 6.2 The new chapter 6A

EnergyAustralia concedes that the chapter 6A Rule has introduced a requirement for the AER to develop an incentive scheme, which may be impossible to create as intended.

The ACCC’s service standards guidelines were developed to help mitigate undesirable incentives inherent in a revenue cap form of regulatory control. That is, it was thought that given the fixed revenue, a network might simply cut costs at the expense of service quality to make more profit.

With this in mind, placing an incentive on TNSPs to maximise or maintain service quality, helps to ensure efficiency. In principle, EnergyAustralia agrees with this concept.

Clause 6A.7.4(b)(1) of the Rules has introduced a requirement for an incentive scheme that should:

- provide greater reliability at times most valued by users; and
- improve and maintain reliability of those transmission elements most important in determining spot prices.

Again, EnergyAustralia agrees with this concept, but notes it is particularly hard to achieve. The AER has undertaken a heavy workload to examine the market impact of transmission congestion, which might provide some insight into the development of an incentive desired by the Rules.

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<sup>1</sup> AER, First Proposed Electricity Transmission Network Service Providers Service Target Performance Incentive Scheme, Version 1.0, January 2007



EnergyAustralia is particularly concerned that the burden to create such an incentive scheme by September will drive the implementation of an untested scheme, with unintended perverse incentives. This is particularly an issue for EnergyAustralia because the transmission scheme would be applied to its transmission network, even though it is licensed as a distribution network, which raises regulatory overlap and workability issues.

The AER has stated that such market impact incentives present a 'significant challenge' and they will be finalised by April 2008 to apply for the TransGrid, EnergyAustralia and Transend regulatory resets in 2009.

To date the AER has stated that the market impact of transmission congestion does not apply to EnergyAustralia:

*Since NEMMCO only models constraints on the transmission networks and EnergyAustralia is not, for these purposes, a TNSP, it has not been included in this analysis.*

*The AER will publish the market impact indicators in its weekly and annual reporting. It will also provide analysis of major events. Energy Australia will not be included in the analysis as NEMMCO does not treat its assets as transmission assets for purposes of modelling transmission constraints.<sup>2</sup>*

Despite the fact that EnergyAustralia is not deemed to be a transmission network for NEMMCO wholesale market purposes, the AER's transmission scheme will apply regardless. This appears to be a shift in the AER's thinking and has led to EnergyAustralia to restate its past position in this submission.

As stated above, clause 6A.7.4(b)(1) of the Rules requires the scheme to provide market impact incentives using reliability parameters. This, put simply, is the founding single principle in the Rules that the scheme must be designed to achieve. It can be thought of as having two limbs of reliability, that is:

1. at time most valued by users; **AND**
2. for elements most important in determining the spot price.

These two limbs are discussed in detail below, however prior to that discussion there must be some consideration of reliability itself.

## 6.3 Reliability

The AER has done a lot of work measuring transmission reliability in aggregate form. Thus measuring reliability for such a scheme seems quite achievable. However the problem with looking at reliability in an aggregate sense is that some outages temporarily reduce reliability measures but do not reduce the service provided to customers and are cost effective.

One example is an outage for maintenance during a time of low demand. At times of low demand there can still be redundancy in the network and as such, there is enough capacity to sustain a short or medium duration transmission outage whilst an element is out of service for maintenance. Short-term outages are generally incurred outside the daily periods of peak demand, but at higher costs arising from paying over time to workers. The trade-off is to take the outage during times when labour costs are low (i.e. during normal working hours) and having lower probabilistic reliability because it happens to be a high demand time.

It can be easily seen how over time, the debate ended up moving from a discussion about generic reliability incentives to incentives for networks to maximise reliability at "times" when it is most valued by users.

## 6.4 Time most valued by users

In addition to the time of reliability, the AER is required to make an informed judgement about what user's value in terms of reliability. This is more complicated than simply looking at retail peak and off-peak times. Different users with different consumption patterns will value reliability differently depending on a range of factors, including:

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<sup>2</sup> AER, Indicators of the market impact of transmission congestion – Decision, 9 June 2006, pg 13.

- the location of their network connection;
- their use for the energy;
- demand on the network; and
- preference for risk.

Analysing all these factors is a difficult task. It is not an impossible one though, with appropriate statistical techniques, user consumption and valuation studies and the right data. All of this would need to be done on a business specific basis to account their specific customers' preferences.

A way to simplify this work might be to use demand as a proxy for the user's valuation of reliability at certain times. If this was the case EnergyAustralia would warn that such a proxy should be sufficiently detailed to account for spatial demands.

Using a network wide peak demand indicator may result in poor incentives. That is, there would be many parts of the network that have low demands at the time of total network demand peaks. It would be meaningless to include those low demand areas in an incentive parameter at that time.

The immediate thought is that there must be locational peak demand indicators for reliability. This might be a way forward, however the quantity of detail required for such an incentive is not insignificant.

The guidelines do not appear to have identified a reasonable way to determine what "time" is most valued by users. Instead, it appears that developing the first limb of this incentive does not seem to be a task that can be completed rigorously by September 2007. Nevertheless, this is what the Rules require the AER to achieve.

In contemplating the difficulty of this task set for the AER, EnergyAustralia believes it is appropriate for the AER to leverage off the existing reliability parameters developed by the ACCC. This is what the AER has proposed but without any specific consideration of the times most valued by users which seems to be an integral part of the intended scheme.

## 6.5 Elements most important in determining the spot price

The AER has analysed the market impact of congestion on their networks. The marginal constraint cost (MCC) data collected by the AER seems to be the most suitable to identifying the most important transmission elements. However in calculating the MCC there a large number of assumptions, including that generator bids would not change if a constraint equation had not been invoked.

The large amount of manual processing of data to result in a usable indicator of the most important transmission element means that it is far from an automatic repeatable process. Without such a feature an incentive would be pointless because it would be too difficult to figure out, as a TNSP, what actions it should take to achieve the intended efficiency.

The assumptions further mean that the indicators may not be as reliable under a more dynamic arrangement. Much of this is an unknown and until a measure is developed and tested, in a paper trial sense, the effect of the incentive scheme is unknown.

The above discussion was in general terms, but specifically in relation to EnergyAustralia more must be considered. It has already been acknowledged that 'for this purpose' EnergyAustralia is not TNSP. It has no constraint equations in the National Electricity Market Dispatch Engine (NEMDE) and thus by definition it cannot affect spot prices.

For this reason it would be impossible to design a parameter defining the EnergyAustralia transmission network elements that are most important in determining the spot price. Without an ability to directly impact the spot price, how would EnergyAustralia be able to respond to this limb of the incentive scheme?

## 6.6 Asset ratings

The AER is already aware that NEMMCO's dispatch engine does not include any of EnergyAustralia's line ratings in its constraint equations. However the Rules require the incentive scheme to take into account the age and ratings of the relevant transmission system. EnergyAustralia considers this to be a very

important part of setting an appropriate incentive and the absence of any such consideration in the AER's documentation is a concern.

The reliability of an element is affected by both type of asset and its condition (for which in some circumstances age can be used as a proxy), as well as its ratings and utilisation.

A large portion of EnergyAustralia's transmission system comprises oil-filled underground cables, which are subject to different failure modes to overhead tower lines and have long maintenance and repair times (typically weeks or months) Furthermore live line working and maintenance practices applied to overhead construction cannot be applied to underground cables. There is thus a need to consider the type of asset as well as its age.

The age profile of most TNSPs worldwide is characterised by peaks of investment in the 1960's and early 1970's. As a result the age profile of networks do not remain constant over time, and it is thus not possible to assume that the conditions and ratings of old assets are averaged out by new assets. Thus system availability over the medium term would not be expected to be on average the same over time.

Thus reliability would be expected to be increasing or decreasing as a result of life cycle and local environment factors of individual manufactures or classes of equipment rather than solely as a result of maintenance practices.

This would be a large statistical exercise of looking at the relationship between asset age and individual asset reliability, network configuration and asset rating/utilisation to model the probabilistic network reliability. This is not something that could be completed by September 2007. The absence of an explicit acknowledgement of this requirement is of concern and calls for another round of consultation on a draft scheme.

Another requirement is for the scheme to take account of any existing incentives in the regulatory framework and any other regulatory obligations.

## 6.7 Other incentives and obligations

In carrying forward the previous ACCC service standards guidelines it appears that a review of the incentives offered within the regulatory framework and other regulatory obligations have not been accounted for.

EnergyAustralia is already subject to the ex ante capital expenditure framework, the contingent project regime and in the next regulatory period an 'efficiency carry-over' mechanism will apply. All of these incentives determine how a TNSP invests in and operates its network. In turn these business decisions will affect the reliability of the network. The effect on reliability may or may not be significant and/or immediate, but the AER must "take account" of these incentives in developing the transmission incentive scheme.

Another regulatory incentive that must be accounted for is the ACCC's last determination, where EnergyAustralia's proposed replacement capital expenditure was significantly reduced. As a result the replacement of a number of assets have been deferred until unacceptable failures occurred, with consequent impacts on network security.

Undertaking a full analysis of these issues will require much more time than the 7 months allowed by the Rules. Nevertheless, EnergyAustralia would like to see the AER acknowledge these requirements and the need for detailed analysis in its next round of consultation.

EnergyAustralia has comprehensive regulatory obligations in the form of distribution license conditions. On 1 August 2005 the NSW Minister for Energy and Utilities imposed license conditions on NSW DNSPs':

- design planning criteria;
- reliability standards;
- individual feeder standards; and
- customer service standards.

It would not be desirable for the AER to set an incentive target that was a higher hurdle than that set by the Minister. It would be illogical to have a Minister set an appropriate standard of supply for the NSW public and have the network penalised by meeting that standard rather than some higher standard set by the AER.

To the extent possible, the AER should review the NSW DNSP licence conditions when developing the next version of the scheme. Each TNSP is likely to have its own regulatory obligations, which would overlap with the AER's scheme.

EnergyAustralia would like an opportunity to comment on how the AER has addressed these regulatory obligations. Again this supports the need for consultation on a draft scheme, prior to the release of the final scheme.

## 6.8 Data collection

It is questionable whether the Rules have allowed enough time for the AER to employ the rigour required to develop a scheme that produces the incentives desired by the Rules. Even the existing reliability parameters may need more attention. In some respects, the Rules have required an entirely new scheme because the focus on time and spot prices was not accounted for in the service standards implemented to date.

With the development of new parameters to account for times of outages and the impact on spot prices, it is essential to gather sufficient data to establish a benchmark level for each parameter. If it is not possible to obtain data for the new parameters from existing sources the AER should collect data over the next regulatory period. This would allow some analysis of how workable any new parameters are. EnergyAustralia's experience of data collection for the current arrangements is positive. It has worked with the AER to make the service standards in the current revenue cap workable. It is arguable that the potential new parameters will be, by their nature, more complicated and result in more issues of workability.

Another way to view this is that the parameters can be defined for the incentive scheme but the weights set to zero until the next regulatory determination. In this view the parameters formally are part of the scheme but the effect of gathering the needed data. This will allow both business and the regulator to learn before a new risk is introduced to the framework.

EnergyAustralia supports the use of existing data sources, where possible, to establish a history for the new parameters. If this occurs some parameters may be suitable for introduction in the upcoming resets. However without comprehensive data the AER should not set an economic incentive without a period of data collection.

## 6.9 Process to amend the scheme

The generic consultation process outlined in the Rules seems appropriate for the review of the AER's service performance incentive scheme. However, the timing of this process is problematic, with EnergyAustralia's reset commencing on 1 July 2009.

The AER's final scheme is expected to be in place by the end of September this year. This only leaves 22 months between when the final scheme is published and EnergyAustralia's next reset. The Rule requirement in this regard is that the TNSP submit proposed amendments no later than 22 months ahead of the commencement of the next regulatory period. It then follows that no amendments within 15 months of the commencement of a regulatory period can be applied to that regulatory period.

Given these timeframes, EnergyAustralia would not have the opportunity to propose any amendment to the final scheme for the purpose of the next regulatory period, which places more weight on the need for a full consultation during this process.

## 6.10 Additional consultation

At the current time, where incentive schemes are becoming a more popular regulatory instrument, it is inevitable that the service performance incentive scheme will be elevated beyond the current level of influence. Such schemes have received attention because of the potential windfalls they could cause if poorly designed. Transmission users could, through inaction or inappropriate actions of TNSPs, become winners or losers.

There is a lot of work and testing that must be done prior to such a scheme becoming effective. Thus EnergyAustralia requests that in the 4½ months between receiving submissions and releasing a final scheme, the AER publish a draft scheme or hold a workshop outlining how it will address all the issues raised herein. This seems essential because the issues raised do not appear to be considered in the first proposed guidelines.

The Rules, clause 11.6.17, anticipate that the AER might find it reasonable to publish more information or hold conferences in relation to the guidelines. The AER's intent in this regard has not been expressed explicitly. In this regard, EnergyAustralia would be pleased to hear the AER had already anticipated another round of consultation in some form. This extra consultation would ensure the AER is meeting its mission to adopt the world's best practice in regulation.

This additional consultation is more important to the NSW businesses that, due to the Rules, do not have an opportunity to propose an amendment to the scheme prior to it being implemented in the 2009 regulatory reset.

## 7 Efficiency Carryover Mechanism

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### 7.1 Summary

EnergyAustralia is unable to support the proposed efficiency benefit sharing scheme (the scheme) in its current format and with its current approach to calculating the incentive amount to be carried forward.

EnergyAustralia is concerned that constructing a benefit sharing scheme in the current formulaic manner does not address key conceptual issues surrounding the overall regulatory regime. Significantly, the current formula can deliver material NPV losses to a business that over the regulatory period spends the same real operating expenditure as was forecast in the determination, but simply over a different profile. Therefore a TNSP can be significantly penalised for meeting the end service outcomes at the same real cost of service over the regulatory period due to the program being influenced by stochastic variances or delays in its commencement. Furthermore, the current formula is easily susceptible to year on year gaming of the incentive that could potentially deliver material revenue outcomes which have no relationship to efficiencies.

EnergyAustralia is also concerned that the current scheme does not articulate many key elements critical to understanding the nature of the scheme, its operation, its objectives, and exceptions. Indeed, the only aspects of the scheme that are clearly articulated are the desire for a 5-year incentive period and the basic scheme formula that is clarified by way of worked example.

Therefore EnergyAustralia strongly recommends that the AER review in some detail the options for the scheme moving forward and the necessary documentation that should accompany the scheme. Following its review of the scheme and considering submissions, the AER should release a further draft of the scheme for consultation before progressing to a final version of the scheme, as the issues identified by EnergyAustralia are expected to require a material change to the nature of the proposed scheme.

### 7.2 Relationship between the scheme and the regulatory regime

EnergyAustralia is concerned that the link between setting the initial operating expenditure targets and the operation of the scheme does not appear to have been an active consideration in developing the scheme. For example, in a situation where the AER has been actively involved in establishing the forecast operating expenditure for the regulatory period, there is a question as to what degree future efficiencies have already been included in the construction of those forecasts. The operation of the scheme imposing negative efficiency carry overs in this situation in particular would appear to be a double hit to the TNSP, particularly where it disagreed that the forecast operating expenditure targets set by the AER were achievable.

The operation of the scheme with negative efficiency carry overs does not appear to adequately recognise the repeat nature of the regulatory process. By the very nature of the repeat game combined with random events the TNSP will be forced over time to reveal efficiencies either explicitly or implicitly. Either the TNSP will reveal efficiencies to take advantage of the increased returns inherent in the operation of overall regulatory regime for a period of time, or it will reveal efficiencies as a matter of survival to offset the damaging impacts of unexpected cost pressures during a regulatory period that would otherwise damage its commercial outcomes.

Therefore it is clear that a symmetric benefit-sharing regime merely duplicates the natural process that would occur without such intervention, but that in doing so accentuates the relative gains or losses that the TNSP will face.

### 7.3 Objective of the scheme

EnergyAustralia believes that the objective of the scheme is not to create incentives for the TNSP to operate more efficiently, as these will occur as a matter of course arising from the incentives inherent in the overall regulatory regime. Rather, EnergyAustralia believes that the objective of the scheme should be to provide incentives for the TNSPs to bring forward future efficiencies to maximise their NPV benefit to all consumers via the sharing mechanism.

If the objective of the scheme is indeed to maximise the value benefit to all consumers of potential efficiency gains, then the scheme should be constructed in such a way as to provide the TNSPs with the

incentive to reveal potential efficiencies earlier, rather than delaying rigorous review for efficiencies as a strategic response to un-forecast events or cost pressures.

EnergyAustralia does not believe that in its current construction that the scheme will achieve the objective of maximising benefits for consumers, whilst rewarding the TNSP for its efforts, as discussed below. Further, EnergyAustralia submits that to provide incentives to actively seek and bring forward potential efficiencies that will maximise the NPV of efficiencies for customers that the incentive should be positive only.

## 7.4 Functionality of the scheme – are the outcomes intuitive

Rudimentary scenario analysis by EnergyAustralia has raised serious concerns regarding the scheme's functionality in achieving rational outcomes, let alone achieving its objectives.

It has become clear that the scheme's incentive is primarily influenced not by the magnitude of efficiencies or inefficiencies over the period, but rather the profile of expenditure, irrespective of any efficiencies or inefficiencies that arise. This is a critical weakness in the scheme's ability to achieve (without intervention) rational outcomes.

Attachment 1 is a worked example, constructed in a similar manner to that presented in the draft scheme. The example is based on a scenario where the TNSP has forecast, and the AER accepted, an operating expenditure program of works, say fire mitigation around network easements. However, at the last minute government authorities have delayed the works due concerns regarding execution of the works. The works are delayed a year as the matter is addressed and in year t+1 (the second year of the regulatory period) the TNSP is allowed to proceed with its initial program. However, due to the delay and the desire to ensure that all network assets are protected from bushfire the TNSP compresses all of the works into the remaining 4 years of the regulatory period. It should be noted that the TNSP is a firm negotiator and has strong financial controls and despite compressing the work program and suffering a delay, incurs precisely the same real operating expenditure costs for the program of works as it initially forecast for the revenue cap.

Intuitively it would not be unreasonable to expect that if the TNSP spends the same amount that it forecast, but due to uncontrollable events was unable to spend that money on the same profile, that it would nonetheless be neutral in its treatment by the regulatory regime, i.e. the TNSP would be no better or worse off than if it had spent according to forecast.

However, the scenario in Attachment 1 shows this intuitive outcome is not achieved by the scheme. Indeed under the scenario presented the TNSP would be substantially worse off in value terms over the subsequent period.

This sensitivity to variances around the mean trend is a significant weakness of the scheme as it is currently constructed, which would deliver random and potentially irrational outcomes relative to the underlying nature of events. If stochastic variations in annual outcomes are added to the assessment of the scheme in Attachment 1, the outturn will not provide the desired incentives for TNSPs to reveal efficiencies.

In its issues paper, the AER indicated that it would consider using its judgement when assessing the nature or application of negative carry overs. While this is encouraged and strongly supported in this style of scheme, it will be more effective in managing events that result in additional operating expenditure in a single year or for managing a sustained change in the profile of costs to the forecast profile. It is not clear that exercising judgement will be effective in addressing a situation such as described in Attachment 1 where the annual incentive carry overs do not result in a systematic annual or directional variance that would act as a trigger for intervention.

## 7.5 Application of the scheme to costs

An issue rightly raised in the issues paper is whether the scheme should apply to all operating expenditure costs and the scheme's relationship to regulatory mechanisms such as the pass through mechanism and the reopening provisions.

In short, EnergyAustralia does not believe that the scheme should apply to costs that are not forecast at the time of the revenue cap decision. Mechanisms such as the pass through provisions require a specific assessment of costs relating to the specific issue, and that as a result of this focus, the unexpected nature

of the costs, and the truncated time to prepare cost forecasts all suggest that the scheme should not apply.

There may be specific types of operating expenditure that are exogenous, and therefore uncontrollable, which may not be consistent with the nature of operating expenditures more generally. For example local government rates payable on land held by the TNSP cannot be controlled in any reasonable manner by the TNSP but are nonetheless required to be paid.

Further, there are operating expenditure costs that will arise from time to time from the application of accounting standards and/or reviews of provisions for future costs, such as superannuation or leave entitlements. The recognition of additional operating expenditure as a result of a change in accounting standards does not change the underlying nature of the costs or services that were evidenced at the time of the revenue cap decisions and should therefore be excluded. Additionally operating expenditure arising from one off adjustments to accruing provisions such as leave entitlements and superannuation should likewise be excluded. Such changes will typically be a result of a profiling error over several years, and as a result it is expected that the setting of the initial forecast would have been in error, and that the adjustment is correcting this error. As the error will most likely have been inherent in the setting of the forecasts, the scheme should exclude such adjustments as the base was in error.

Finally, there is the potential for TNSPs to be subject to cost increases arising from matters covered by the pass through arrangements, but due to the magnitude of the cost change not reaching the required materiality threshold they do not trigger the pass through provisions. EnergyAustralia believes that it is reasonable to consider such cost increases outside of any efficiency carry-over scheme, as it is recognised that costs of this nature are beyond the scope of what has been provided for in the revenue cap decision, and therefore if the costs are beyond the scope of the revenue cap as a whole they should also be considered beyond the scope of the incentive scheme.

EnergyAustralia therefore recommends that the AER should develop a non-exhaustive list of exclusions, or classes of exclusions, to the scheme to provide regulatory certainty as to its application. Further, the development of a non-exhaustive list would provide further guidance to the market as to the nature, objective, and target of the scheme. Such guidance will ensure that the TNSPs and other stakeholders can enter the regulatory review processes with increased certainty of how the final decision will operate and the incentives that the regime taken as a whole creates.

## 7.6 Assessment of the incentive properties of the proposed scheme

The scheme as proposed at this stage provides a range of incentives to TNSPs, and not all of them would appear to be consistent with the objective of the scheme or desirable outcomes of the regulatory regime as a whole. In fact, it would appear that the scheme provides perverse incentives that have no relationship to the achievement of efficiencies in the delivery of transmission services.

EnergyAustralia has observed that the operation of the scheme provides incentives around the relative rate of change in operating expenditure between individual years in the regulatory period. The incentive that this creates is to manipulate the profile of operating expenditure over the regulatory period as changing the profile can result in significant positive efficiency carry overs, assuming that operating expenditure can be adequately controlled by the TNSP, even though the overall operating expenditure in real terms remains unchanged over the course of the regulatory period. This outcome is clearly contrary to the objective of the scheme, and would likely result in regulatory intervention that would suspend and amend the scheme, creating further regulatory change risks.

Alternatively, if the TNSP is unable to exercise effective control over its overall operating expenditure to take advantage of the incentives above, or takes a longer term view of sustainable expenditures, the TNSP is has a strong incentive to keep expenditures as close to the forecast profile as possible. Variances from this profile will result in stochastic gains and losses. The example in Attachment 1 shows how a delay in an operating expenditure program resulting in the TNSP not achieving the forecast rate of change in annual operating expenditure will deliver significant revenue stream losses. This is a powerful incentive to ensure that expenditure, one way or another, is as close as possible that forecast in the revenue cap.

These observations lead to the unavoidable conclusion that the operation of the scheme will promote a year by year management approach to operating expenditure throughout the regulatory period. This is contrary to conventional wisdom where the regulators provide a revenue stream for the regulatory period, and allows the network to manage any temporal matters within the regulatory period. In effect, this



scheme would involve the AER in the day to day management activities of the TNSP, rather than providing it with a framework and revenue stream to effectively manage and optimise its operations.

## 7.7 Further work to develop a more robust scheme

EnergyAustralia submits that the AER must review submissions from interested parties and recommence the consultation process with a more robust and tested scheme. More effort is required to test whether a proposed scheme is susceptible to stochastic variations that have no relationship to efficiencies or inefficiencies.

Having considered the proposed scheme EnergyAustralia does recognise that the construction of the scheme clearly resulted in less sensitivity and less extreme results than if the scheme were simply based on a nominal year on year difference. Further, it appears that the AER was attempting to provide a focus on underlying trends in operating expenditure by virtue of the formulas used in the scheme. If this is indeed an accurate observation then it is clear that the AER would need to consider longer time periods for comparing trends between actual and forecast in order to construct a scheme that is less sensitive to random statistical variations in actual costs.

EnergyAustralia has not undertaken analysis of how such an approach could be constructed to meet the objective of providing incentives to bring forward efficiency gains, and that those incentives should be consistent in effect for efficiencies achieved in any year of the regulatory period. However, EnergyAustralia is keen to work with the AER to develop a Rule compliant scheme that delivers reasonable and intuitive outcomes.



# Attachment 1 – Worked Example of the Impacts of Profile versus Efficiencies

|                          | T           | t+1  | t+2  | t+3  | t+4  | t+5  | t+6  | t+7  | t+8  | t+9  |
|--------------------------|-------------|------|------|------|------|------|------|------|------|------|
| Forecast opex            | 1000        | 1050 | 1100 | 1150 | 1200 | 1250 | 1300 | 1350 | 1400 | 1450 |
| Actual opex              | 950         | 1030 | 1120 | 1170 | 1230 |      |      |      |      |      |
| Incremental gains/losses | 50          | -30  | -40  | 0    | -10  |      |      |      |      |      |
| Efficiency Carryover     |             |      |      |      |      |      |      |      |      |      |
| Yr 1                     |             | 50   | 50   | 50   | 50   | 50   |      |      |      |      |
| Yr 2                     |             |      | -30  | -30  | -30  | -30  | -30  |      |      |      |
| Yr 3                     |             |      |      | -40  | -40  | -40  | -40  | -40  |      |      |
| Yr 4                     |             |      |      |      | 0    | 0    | 0    | 0    | 0    |      |
| Yr 5                     |             |      |      |      |      | -10  | -10  | -10  | -10  | -10  |
| Carry Forward amount     |             |      |      |      |      | -30  | -80  | -50  | -10  | -10  |
| Opex used for pricing    |             |      |      |      |      | 1220 | 1220 | 1300 | 1390 | 1440 |
| <b>NPV difference</b>    | <b>-180</b> |      |      |      |      |      |      |      |      |      |