TransGrid

Draft National Electricity Amendment (Transmission Last Resort Planning) Rule 2006

Draft Rules Determination

TransGrid Submission

29 January 2007

The AEMC's Draft Last Resort Planning Power Rule – TransGrid Submission

1. Introduction

This proposed Rule change has significant implications for TransGrid. Specifically, TransGrid is involved with the ongoing review of potential interconnection of the largest NEM region (NSW) with the other two largest NEM regions, Queensland, and Victoria. In addition, there are the challenges of accommodating (and possibly removing) the Snowy region, and the potential interactions with the other NEM regions. In this regard, the AEMC may be aware of the 'opportunity lost' in relation to regulated interconnection between NSW and South Australia, and the subsequent establishment of the Murraylink interconnection.

Accordingly, TransGrid is probably the most affected party by the implementation and operation of this power, particularly if the exercise of this power is not subjected to appropriate checks and balances. Among other matters, the unnecessary invocation of this power would impose real costs and, more importantly, divert vital and scarce power system development skills from an essential and challenging development program. With this in mind we ask that the AEMC gives due weight to the following opportunities to improve on the draft Rule change:

- ensuring that the Rule operates as a "Last Resort" planning mechanism that produces efficient outcomes in the long interests of customers, rather than as a device to advance the market positions of individual participants or other vested interests;
- ensuring that due process is followed in the last resort planning mechanism, in particular that:
  - The AEMC acknowledges the benefits from increased transparency that would be derived from separating the bodies responsible for defining and granting the Last Resort Planning Power ('LRPP') and the body vested with the LRPP;
  - there is a separation between the body that effectively sponsors a *potential transmission project* and the body that has the LRPP; and
  - the directed party (or parties) are consulted before any decision to invoke the LRPP.
- requiring that the directed party (or parties) are adequately compensated for the cost of complying with a direction to undertake the Regulatory Test.

Furthermore, much of the concern underlying the need for this power appears open to question. These appear to centre on the relative lack of incentives for transmission businesses to pursue interconnection projects compared with the reliability augmentations. To the extent that there are issues with the focus of transmission businesses on interconnection investment then this would suggest further examination of the investment incentive framework before invoking a central planning solution, such as the proposed LRPP.

Each of these issues is addressed in greater detail below.

2. A "Last Resort" Planning Mechanism

The Ministerial Council on Energy ('MCE') proposed that an LRPP, to be exercised by the AEMC, direct that options to address constraints affecting major national flows (between regional reference nodes) be subject to the *Regulatory Test* when:

> *"**normal market arrangements fail** to promote efficient and timely investments to address material congestion."* **[Emphasis added]**

In the case of regulated transmission businesses 'market failure' could, and should, include failure of the regulatory incentive framework under which transmission businesses operate. This is discussed further in Section 5 below.

The clear intent of the MCE proposed Rule change is that the LRPP should be limited to situations of "market failure" (and arguably failure of regulatory incentives). However, the draft Rule does not require the LRPP body to demonstrate (or even have regard to) whether normal market arrangements have, or are likely to, fail.

In fact, the only constraint to the exercise of the LRPP in the proposed Rule is that it must be consistent with the proposed purposed clause 5.6.4(c):

> *"The purpose of the last resort planning power is to ensure the timely and efficient inter-regional transmission investment for the long term interests of customers".*

TransGrid believes this purpose clause does goes somewhat beyond the stated intent of the MCE proposal and, in so doing, introduces an unnecessary degree of uncertainty for market participants. To address this, the draft Rule should incorporate a properly formulated trigger to ensure that the LLRP is only applied to situations of market failure, and not to all potential inter-regional transmission projects.

A simple requirement to demonstrate that the potential transmission project would *likely* result in a net economic benefit would limit the application of the LRPP to genuine potential transmission projects.

In this regard, TransGrid notes that inter-regional transmission investment generally has significant market implications, particularly to generators and retailers. As a result it is reasonably likely that some market participants will, from time to time, lobby for a particular transmission investment that advanced its interests, even if the likely *net* benefit may be negative. Pressure to invoke the operation of the LRPP would be one of the means by which such participants could effect this lobbying.

3. Due Process Requirements - Integrity of NEM Governance Arrangements

TransGrid also has concerns with the LRPP process advanced by the draft Rule. Under the draft Rule the AEMC would be responsible for:

- developing the LRPP Rule;
- drafting the LRPP Guidelines;
- identifying potential transmission project(s) or inter-regional constraints; and
- directing *Registered Participants* to undertake the *Regulatory Test.*

In other words, the current LRPP process would have the AEMC as the Rule and guideline drafter, project identifier and decision maker. TransGrid believes that the AEMC's decision to roll all these

functions into one body sits uncomfortably with the separation of powers envisaged by the recent MCE regulatory reforms.

TransGrid notes that in the draft determination the AEMC considers, and then dismisses, AGL's concerns regarding concentrating of the Rule Drafting and decision making powers with the AEMC. This is essentially on the basis that the NEL provides the AEMC with the appropriate powers in this regard.

Notwithstanding the legal arguments provided by the AEMC, TransGrid supports AGL's submission that a separation of powers would increase the transparency of the LRPP arrangements. AGL's submission would appear to have merit from the perspective of sound public policy and invites an open exchange between the AEMC and the MCE on this particular issue.

One possibility for overcoming these concerns in the final determination could be to vest the LRPP in the AER. Among other matters, this would complement the AER's other roles, such as the AER being the arbitrator of Regulatory Test disputes.

In this regard, it would also be reasonable to limit the operation of the LRPP to interconnection development options that have not already been dealt with, or are being dealt with, in a publicly available regulatory test. In this way, the operation of the regulatory test consultation process, including the dispute management process involving the AER, can be given the opportunity to operate before the test is invoked.

4. Due Process – The Obligations and Rights of Affected Parties

TransGrid submits that the current process would also be improved by requiring that *potential transmission projects* be sponsored by a party, other than the AEMC (for example a *Market Participant).*

As TransGrid has already noted transmission interconnection investments will have significant financial implications to some market participants. It is, therefore, not inconceivable that those market participants who are likely to 'win' from a particular transmission investment would seek to advocate the project to the LLRP body. However, the current process, whereby the AEMC proposes and directs the LRPP does not have adequate arrangements to constrain such advances, including the opportunity for parties that may be disadvantaged by a proposal to question the need for the invocation of this power in such circumstances.

To ensure that the process has sufficient transparency, TransGrid believes that *potential transmission projects* should be sponsored by a party, other than the AEMC (for example a *Market Participant).* The sponsor would be required to provide to the LRPP body a prima-facie case that the proposed project would pass the Regulatory Test, i.e. that the transmission project would *likely* result in a net economic benefit. The LRPP body should only be empowered to invoke the operation of the LRPP where there is a sponsor, and the sponsor has established there is a reasonable likelihood that the proposal is efficient, i.e. that it would produce net market benefits.

TransGrid notes that the AEMC is seeking comment on whether the LRPP should have the flexibility both to direct parties to undertake the Regulatory Test in relation to an identified project, and to direct parties to identify a project and then undertake the Regulatory Test. Under TransGrid's proposed approach the sponsor would be required to specify a particular project and, further, to demonstrate that there is a reasonable likelihood that the project in question would produce a net market benefit.

TransGrid's further submits that the current LRPP provides insufficient due process to directed parties even though it is those parties that carry the burden of undertaking the consequential regulatory test process. Under the draft Rule the AEMC would not be required to consult with the directed party (or parties) before directing them to undertake the Regulatory Test. In TransGrid's opinion this is a major shortcoming of the draft LRPP process and should be corrected.

The directed party (or parties) should have the ability to respond to a claim that there has been a "market failure" with respect to a *proposed transmission project*. The directed party may already have considered the proposed project and rejected (or deferred the project) for a number of valid reasons. For example, the directed party may have evidence that the proposed project fails to provide a net economic benefit, or that there is evidence the normal market arrangements will address the identified constraint.

With the information presented by the project sponsor, and the response provided by the directed party, the LRPP body, with the advice of the Reliability Panel, can determine whether there is sufficient cause to believe that normal market arrangements have failed, or will fail. Only if this threshold is established should the LRPP body be able to direct a party to undertake the Regulatory Test.

TransGrid notes that the AEMC is seeking comment from interested parties as to whether the Rules should also require the LRPP body to consult with NEMMCO in addition to the Reliability Panel. TransGrid believes that NEMMCO's membership on the Reliability Panel is sufficient to ensure that its opinions are heard by the LRPP body. Furthermore, our proposed LRPP process would allow NEMMCO to sponsor those proposed transmission projects that it believes have not been considered by TNSPs.

5. Adequate Compensation for Directed Parties

The draft determination states that:

> *"For a directed TNSP, these costs would be part of the ordinary operations of the business and could therefore be included in regulated revenue caps."*

TransGrid is concerned that this statement grossly oversimplifies the situation and, as a result, the draft Rule imposes a regulatory obligation on TNSPs to undertake a Regulatory Test but does not provide TNSPs with a reasonable opportunity to recover the efficient costs of complying with this obligation. Such an arrangement would be inconsistent with the requirements of Section 35(3)(a) of the NEL and therefore not lawful.

The costs involved are by no means trivial. For example, the cost, to date, of conducting the Regulatory Test analysis for the next upgrade of the Queensland to NSW Interconnection (QNI) by TransGrid and Powerlink, including both internal resources and external consultants, is estimated to total approximately $1 million. The costs associated with assessing the proposed interconnection between NSW and South Australia (SNI) were many times this amount.

To understand the operation of the revenue caps in relation to this matter, two basic scenarios need to be considered once the TNSP has completed the regulatory test assessment. These are that the proposed project will either pass or fail that assessment.

If the project passes the regulatory test then, assuming adequacy of regulated rates of return on investment, the project will be delivered and the total project cost, including the cost of the regulatory test, will be 'rolled' into the regulatory asset base at the end of the regulatory control period. If there is substantial expenditure within the TNSP's current regulatory control period then, under the ex-ante capex regulatory incentive scheme, the TNSP would forego returns on that expenditure. The only way that the TNSP could avoid most of this cost would be to defer expenditure on the project in question until the next regulatory control period, which would be inefficient under a range of plausible circumstances.

If the project fails the regulatory test, then the costs of carrying out the regulatory test are normally treated as operating costs incurred during the current regulatory control period. In this case, under the ex-ante operating expenditure regulatory incentive regime, the TNSP would forgo these costs, even though they were incurred as a result of meeting a regulatory obligation.

To address this TransGrid proposes that when, as a result of the operation of the LRPP, a project is identified as efficient then that project be deemed to be a 'contingent project' that has been triggered for the purposes of revenue cap regulation. Assuming the adequacy of the allowed rates of return, this would remove any incentive for the TNSP to defer the proposed transmission project.

In addition, TransGrid proposes that when, as a result of the operation of the LRPP, a project proposal is shown to be inefficient, then all expenditure required to carry out the relevant regulatory test process should be treated as prudent capital expenditure for regulatory purposes. In this way this expenditure would be rolled into the value of the regulatory asset base at the end of the current regulatory control period.

This would ensure that the TNSP can reasonably expect to recover LRPP imposed compliance costs.

6. Stated Need for the Last Resort Planning Power is Questionable

The need for the LRPP is largely based on concerns with the relative lack of incentives for transmission businesses to pursue interconnection projects compared with the reliability augmentations. For example the AEMC states the following on page 15:

> *"The Commission however does consider that under the current market arrangements there are few incentives for TNSP's to undertake efficient discretionary investments that are not related to reliability standards, but which could provide net market benefits through improved performance of the network. Indeed, where there is an investment that is not required for reliability reasons a TNSP has a financial disincentive to invest in the project."*

The Commission then dismisses the contingent project regime as an appropriate vehicle for addressing this concern. The Commission also dismisses the option of *"providing sufficient incentives for market participants to undertake infrastructure investment that is for market benefit, rather than introduce a LRPP".*

The need for the LRPP on the basis of these concerns is questionable for a range of reasons including the following:

- The AEMC has only just completed an extensive and detailed review of the framework for regulating transmission revenue caps which included, as the AEMC has noted, consideration of the need for providing adequate incentives for discretionary transmission investment.

- The key incentive for pursuing and undertaking regulated transmission investment is the rate of regulated return. The AEMC's statements on this matter therefore appear to raise doubts about whether the regulated rate of return parameters, recently included in the transmission revenue setting Rules, have been set high enough to provide TNSPs with adequate incentives to pursue discretionary investments. If this is an issue then this could be addressed simply by increasing these parameters.

- The evidence suggests that, by and large, that there are sufficient incentives for TNSPs to actively and co-operatively pursue discretionary investments. It is a matter of fact that transmission businesses have incurred, and are continuing to incur, considerable expenditure in seeking out interconnection investment opportunities. As noted earlier in this submission, TransGrid and Powerlink have already undertaken around $1million worth of expenditure on the investigation of future QNI upgrade options. In contrast, the AEMC has not provided any examples of prospective interconnection developments that are economic but are not proceeding because of lack of regulatory incentives.

- The invocation of the LRPP arrangement, per se, may help to inform the market of possible market or regulatory failure but it does not appear to alter the investment

incentives faced by regulated businesses. This shortcoming could be addressed, at least in part, by allowing a project that passes a regulatory test assessment, following the operation of the LRPP, to be treated as a contingent project for the purposes of transmission revenue cap regulation (as suggested above in section 5 of this submission).

In summary, the problem being addressed by the LRPP proposal appears to be one of inadequate incentives for TNSPs to undertake discretionary, but efficient, investments. Accordingly, it would appear preferable to develop the design of the regulatory incentives in lieu of implementing the LRPP, or at least complement the LRPP with adjustments to the incentive regime.

7. Proposed Approach

Concerns about market failure, and/or failure of regulatory incentives to encourage discretionary transmission investment, are best addressed by improving the market design and regulatory frameworks rather than by creating a process of bureaucratic intervention. This is particularly so where such intervention does not, of itself, address the investment incentive issues that appear to be of central concern.

Nevertheless, in the event that the AEMC is determined to establish LRPP Rules and Guidelines, these Rules and Guidelines should have the following features:

- *Registered Participants* can propose to the LRPP body a *potential transmission project*, that it reasonably believes has failed to be implemented by means of normal market arrangements and will *likely* result in a net economic benefit;
- the LRPP body would be required to consult with the *Reliability Panel* and the Directed Party (or Parties), to verify the reasonableness of the proposed project and whether there is evidence that normal market arrangements will address the identified inter-regional transmission constraint;
- the LRPP body could then, and only then, having regard for all the evidence provided, make the decision as to whether to direct one or more Registered Participants to apply the Regulatory Test; and
- the directed party (or parties) would be able to capitalise all the costs associated with the Regulatory Test and, where a project 'passes' that Regulatory Test, the directed party would be able to treat the associated project as a contingent project for transmission revenue regulation purposes.