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11 September 2006

Australian Energy Market Commission
PO Box H166
Australia Square NSW 1215

Dear Sir

Re: Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006: Supplementary Submission

The Tasmanian Government welcomes the opportunity to make a further submission in response to the above draft rule determination. It follows from and supports our earlier submission dated 21 April 2006, focusing on the Commission's proposed amendments to the 'safeharbour' provisions for Former Market Network Services (FMNS). It also reflects and elaborates upon discussions held with the AEMC Chairman, Mr John Tamblyn, in Sydney on 5 September 2006.

Summary of Key Points

- The Tasmanian Government is concerned that the provisions proposed to be introduced to the National Electricity Rules (NER) in relation to Former Market Network Services (FMNS) are inconsistent both with the regulatory framework under which entrepreneurial investments were made and with the principles applied in past regulatory determinations allowing entrepreneurial investments to become regulated investments, which were created specifically to provide access to a 'safe harbour' for such investments.
- The Tasmanian Government is concerned that the second draft Rules, Schedule 6A.2.1(e) with respect to FMNS, inappropriately seek to limit the market benefits allowable in the calculation of the regulated asset base (RAB) of a converting market transmission service to a subset of those that were taken into account by the ACCC and AER in the conversion of Murraylink and Directlink, and indeed to a subset of those that would be taken into account in establishing the regulated asset base of a prescribed service.
- The Tasmanian Government notes that the sole reason offered in the draft determination (p.99) for rejecting its submission is a concern to avoid "incentives which may otherwise exist for a MNSP to seek to bypass the Chapter 5 provisions", which we take to refer the standard regulatory test. However, the effect of the proposed Schedule is that it ensures

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that the regulatory test is bypassed, or at least not applied, in that a new and different test is instead required. The Tasmanian Government supports the AEMC's implicit objective that the current regulatory test should apply, and not be bypassed, but notes that the proposed Schedule does not deliver on this objective.

- The structure of draft Schedule is flawed in a number of ways:
 - first, in providing that a RAB be based on the *lesser* of the 'prudent and efficient value of the assets' (established with reference to the regulatory test) and an alternative test, whereas an equivalent prescribed service would have access to the regulatory test;
 - second, the alternative test is flawed in substituting for the concept of 'market benefit' a construct based on the net present value of expected *revenue* of an FMNS, plus the net present value of the market benefits to registered participants consequent upon conversion. Expected revenue is a poor proxy for market benefit and may contribute to perverse outcomes upon conversion due to contractual arrangements (which determine revenue) which may be out of line with (ie, higher or lower than) the net market benefits generated by the service;
 - third, conceptual as well as practical uncertainty is introduced into Schedule 6A.2.1(e)(2)(ii), by the opening clause of (B) allowing the expected market benefits consequent upon conversion only "to the extent that such market benefit is not included in the expected revenue referred to in subparagraph (A)". This extent is not determinable in any objective manner and therefore serves only to create uncertainty as to how both sub-clauses (A) and (B) should be applied.
- The draft Schedule breaches the level playing field condition between MNSPs and TNSPs, and creates a significant sovereign risk for Basslink as the largest single (and now sole remaining) MNSP in the NEM, in a manner inconsistent with the original intent of the safeharbour provisions.
- The draft Schedule breaches the clearly expressed policy of the Ministerial Council on Energy (MCE), in its December 2003 Report on Reform of Energy Markets, that code changes in this area should "...recognise and protect the rights of existing investors in market transmission services".
- If, despite this submission, the AEMC persists with its proposed rule change in this area, it is essential that Basslink be 'grandfathered' from this rule change to preserve the conditions created for such entrepreneurial investments when they were made. The process that was used for the Directlink conversion represents an appropriate process to grandfather for Basslink.

Policy Intent

Chapter 6 of the NER provides no specific guidance on the conversion of MNSPs. The ACCC, and subsequently the AER, have developed an approach based on their interpretation of the

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National Electricity Code¹ and specifically, in relation to the application of the Regulatory Test to conversion applications.

The conditions for conversion of entrepreneurial investments to regulated investments were in effect established by the NECA in its arrangements for including MNSPs in the NEM. These conditions were based on ensuring that market design risks did not inefficiently inhibit investment. These conditions are acknowledged by the AER in its Directlink Draft Decision of 8 November 2005 as follows:

“..the history and intent of the conversion provision remain relevant to the consideration of conversion applications. When Directlink and other entrepreneurial (unregulated) interconnectors were built, market network service providers (MNSP) were encouraged despite being considered somewhat experimental—as acknowledged in the National Electricity Code Administrator (NECA) working group’s review of arrangements for including MNSPs in the NEM. One means of encouraging these market based investments was to include a conversion provision to ensure market design risks did not inefficiently inhibit investment. In light of these matters, the ACCC, in its Murraylink decision, took a broad interpretation of the NECA working group’s intention and decided that it was appropriate to focus its assessment on whether the network service falls within the category of a prescribed service rather than a higher threshold.”

This position above is widely understood as the ‘safe harbour’ provisions.

The Ministerial Council of Energy (MCE) 11 December 2003 Report to the Council of Australian Governments (COAG) stated in this regard that:

“The MCE believes that the current arrangements for the coexistence of regulated and market provision of transmission have not resulted in optimal outcomes, and supports removal of biases towards unregulated investment. The MCE will develop code changes that establish a level playing field between regulated and market transmission for implementation in July 2004. The code changes would recognise and protect the rights of existing investors in market transmission services.”

The Tasmania Government cannot stress strongly enough the importance of the last sentence above. Future private investment in transmission services in the NEM – particularly in entrepreneurial interconnectors – would be seriously undermined by the realisation of sovereign risk as is here contemplated. This would run expressly contrary to the clear intent of the Prime Minister’s Energy Reform Implementation Group process, which has as one of its three major objectives:

Electricity Transmission: implementing the most suitable governance and transitional arrangements, having regard to COAG’s objective of achieving a truly national approach to the future development of the National Electricity Market (NEM) grid, the legitimate

¹ No conversions have been completed under the National Electricity Law (NEL) and National Electricity Rules. The conversion of Directlink was completed under the old National Electricity Code in line with Transitional Provisions of the NEL.

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commercial interests of asset owners, and the need to promote investment that supports the efficient provision of transmission services (Emphasis added)

Regulatory Framework

The proposed NER provisions in relation to FMNS are based around S6A.2.1(e) of the *Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006* of 25 July 2006. Through the ‘prudency and efficiency’ provision at S6A.2.2 of the draft rules, the FMNS provisions would be applied in conjunction with the Regulatory Test established under the NER.

The regulatory determinations that have allowed entrepreneurial investments to become regulated investments are:

- the Murraylink determination of the Australian Competition and Consumer Commission (ACCC) of 1 October 2003; and
- the Directlink determination of the Australian Energy Regulator (AER) of 3 March 2006².

Rule 2.5.2(c) of the NER allows for the conversion of an MNSP to provide prescribed services at the discretion of the AER, “*in which case the relevant revenue cap or price cap may be adjusted in accordance with Chapter 6.*”

Regulatory Determinations

The regulatory determinations allowing entrepreneurial investments to become regulated investments have relied upon the Regulatory Test established by the ACCC pursuant to section 5.6.5A of the NER. The relevant limb of the Regulatory Test applied in relation to the Murraylink and Directlink determinations is the economic limb (section (1)(b) of the test) which is focussed on maximising 1) the benefits to the electricity industry and 2) efficiency of investment in the industry. The economic limb of the test provides that:

- the most beneficial, efficient investment option is undertaken; or
- in the case of committed investments (such as FMNS), the capital costs allowed to be recovered by the committed investment are those of the most beneficial, efficient investment option.

As such, the outcomes of applying the Regulatory Test should be consistent with the relevant overarching provisions of chapter 6 of the NER ie:

- s6.2.2, ie, objectives of the existing NER; and

² However, the application of the Regulatory Test to Directlink is set out in the AERs Draft Decision of 8 November 2005 ie it is incorporated into the Final Decision of 3 March 2006 by cross-reference.

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- S6A.2.2, ie, the prudence and efficiency of capital investment provision NER revisions under the draft rules.

The application of the Regulatory Test - in the case of proposed investments, resulting in the most beneficial, efficient investment being undertaken and - in the case of committed investments, resulting in those investments only recovering the costs of the most beneficial, efficient investment option – by the relevant regulators under the following process (in this case, in application to a committed investment):

1. An investment passes the Regulatory Test where it maximises the net market benefits compared to a number of alternative investments and timings over a majority of reasonable scenarios. In that case, the RAB value to be recovered under the regulated tariffs of the investment concerned is the RAB of that investment.

The ACCC, and subsequently, the AER, have adopted a standardised approach to in relation to the market benefits to be used in such assessments. The gross market benefits used by the regulators can be generally characterised as:

- system augmentation deferral benefits;
- reduction of losses (efficiency benefits);
- availability of supply benefits
- competition benefits; and
- interregional benefits.

2. Where the investment concerned does not maximise the net market benefit under the Regulatory Test, and an alternative investment instead maximises the net market benefits over a number of timings and reasonable scenarios, the RAB value able to be recovered under the regulated tariffs of the investment concerned is the RAB of the optimal investment. In this way, the Regulatory Test result is consistent with the most beneficial, efficient investment having been undertaken.

The Murraylink conversion application was treated consistently with the process described above, in that the ACCC determined that Alternative 3 (Red Cliffs – Monash 220 kV AC) constituted the optimal investment, in that it maximised the net market benefits of the range of investment alternatives considered. Accordingly, the PV capital cost of Alternative 3 assessed by the ACCC was used as the RAB for Murraylink.

3. Where none of the investments considered (ie the investment concerned, or the alternative investments) passes the Regulatory Test over a number of timings and reasonable scenarios, the regulator is unable to follow the above Regulatory Test process to set the RAB and instead sets the RAB based on guidance from the general principles in chapter 6 of the NER.

The Directlink conversion application was treated consistently with this process, in that the AER, guided by the deprivation value principle in the current chapter 6 of the NER, set the RAB value for Directlink equal to the PV of the gross market benefits of Directlink, less the PV of forecast operating and maintenance costs (where such costs and benefits

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were determined consistently with the approach previously adopted by the ACCC in relation to Murraylink).

Provision on Former Market Network Services

The proposed FMNS provision in the NER is not consistent with the established Regulatory Test process above.

The provision determines the RAB for the investment concerned based on the *lesser* of the result of the application of the Regulatory Test or the result from applying a new measure as set out in (2)(ii) of that provision, as follows:

“(A) the net present value of the revenue that it is expected would be earned by the provider from the provision of those services, over the remaining life of the assets that are used by the provider to provide those services, if those services had not been determined to be *prescribed transmission services*; and

(B) to the extent that such market benefit is not included in the expected revenue referred to in subparagraph (A), the net present value of the market benefit to *Registered Participants* of the services being determined to be *prescribed transmission services* compared to being continued to be treated as services that are not *prescribed transmission services*,”

The new clauses measure different type of market benefit to that established and measured under the Regulatory Test. However, the established forms of market benefits are still required to be calculated under the Regulatory Test pursuant to clause (2)(i) of the draft FMNS provision.

The efficient result derived under the Regulatory Test would however obviate the need for a further, different test of efficiency in determining an appropriate RAB value. In any event, the test applied by the relevant regulators as described above would appear to cover all eventualities in terms of relative benefits and efficiency of the particular investment being assessed (noting however, that the deprival value concept would appear to be removed from s6 of the NER under the draft rules).

The additional and untested criteria in clause (2)(ii) of the draft FMNS provision would add uncertainty to any future conversion process. The introduction of such changes to an established conversion process may have the effect of inefficiently inhibiting future investment in entrepreneurial interconnectors, contrary to the objectives of the NECA, ERIG, MCE and to the broader objectives of the NER.

Grandfathering Provisions

Should the AEMC persist with its draft Schedule 6A.2.1(e), the Tasmanian Government strongly believes that any future conversion application with respect to the Basslink interconnector must be subject to a grandfathering provision to preserve the conditions created for such entrepreneurial investments which applied at the time such investments were made. This approach would be consistent with the above-cited policy intent of the MCE that changes to the

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rules should recognise and protect the rights of existing investors in market transmission services.

Given the lack of codification in the current Rules of the principles applied in the regulatory determinations on the previous conversion applications, it is recognised that such 'grandfathering' may require some codification of the approach that would apply with respect to Basslink. As noted above, the Tasmanian Government believes that the approach codified should be that followed by the AER in the Directlink case (which agreed conceptually with the earlier approach of the ACCC with respect to Murraylink).

I would welcome the opportunity to discuss these issues with you again before your final determination.

Yours faithfully

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