

**TRUenergy's response to the Rule Proposal Report – Draft National Electricity
Amendment (Economic Regulation of Transmission Services
Rule) 2006**

I. Introduction

TRUenergy's supports the Australian Energy Market Commission (AEMC) Rule Proposal – Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006.

Let me outline the key reasons why:

1. The prescription of the revised regulatory approach provides a stable, more predictable, transparent regulatory environment that delivers benefits to investment in transmission in the long term.
2. The form of regulation applied to “negotiated services” is appropriate. It encourages the commercial negotiation of these services between the TNSP & customer. And, it provides pricing disputes be resolved in a timely manner through an independent dispute resolution panel.
3. The revised framework for approving forecast capital expenditure is appropriate. Under the ‘Propose–Respond’ model, the AER must approve forecast capital expenditure deemed a “reasonable estimate of forecasts”. However, the benchmark capital expenditure forecasts approved in the future need to be ‘efficient’. We would not expect the large current foreseen but uncertain contingent projects currently treated outside the current Statement of Regulatory Principles (SRP) Revenue Cap to form part of the up-front ex-ante capital expenditure forecasts under the current Rule proposal. Including these projects in the ex-ante cap would distort the incentive properties of the capital expenditure framework.
4. The policy to allow TNSPs to re-open their revenue cap for reliability augmentations (> 5%) of their regulated asset base (RAB) is appropriate. The philosophy underpinning the ‘re-opener,’ is it should only be re-triggered for legitimate but unforeseen capital expenditure. ¹ The ‘re-opener’ allows the revenue cap be re-opened for unforeseen and foreseen capital expenditure. Further relaxing the ‘re-opener’ will lead to outcomes more consistent with rate of return regulation. This will distort the incentive qualities of the regulatory regime on capital expenditure.

¹ Draft National Electricity Amendment (Economic Regulation Transmission Services) Rule 2006 p. 77” The Commission has sought to ensure that legitimate but unforeseen capital expenditure requirements relating to regulatory augmentations or emergencies can be addressed under the form of regulation. “

II. A prescriptive regulatory approach

We support the AEMC Rule proposal on the basis it provides greater clarity, certainty and transparency in regulatory processes. More prescriptive Rules reduce the AER's discretion when adjudicating on the Rules. Whilst discretion is an important component of any regulatory framework, it must be balanced with the need for certainty and clarity. Thus, we support the AEMC's attempts to provide a clearer framework for the making of Revenue Cap determinations for the AER.

III. The framework for negotiated services

The AEMC decision to treat

- a) Shared transmission services provided to above/below specified standard
- b) New connection services
- c) Use of system services relating to the augmentation or extension of the transmission network,

as "negotiated services" is appropriate. A commercial framework for negotiating these services, which includes a timely dispute resolution process for pricing disputes, represents the right form of regulation for these services.

1. We are satisfied with the AEMC's negotiate/arbitrate model represents the appropriate form of regulation to apply to these services. We believe it will lead to more commercial outcomes in providing these services. We agree the revised dispute resolution procedure improves the framework for settling pricing disputes in a timelier manner, in the event of a dispute.
2. We support the AEMC's position to set up a working group that improves the clarity of the definition of 'negotiable services' and have provided a generator representative. We agree with the AEMC that the current definitions of 'prescribed services' and 'negotiable services' are circular. This creates inconsistencies around how TNSPs in each jurisdiction treat these services. Clearer definitions will help resolve the circularity of the definitions of these services. As a consequence of this, it is our understanding that
 - a) 'Negotiated' services will be regulated through the negotiate/arbitrate model with a timelier dispute resolution process to apply in the event of pricing disputes.
 - b) Nothing within this model prevents a generator from building its own transmission line for an augmentation, or connection asset that further promote competition in providing these services.
3. We support the AEMC's decision to treat augmentations or extensions to the transmission network that connect remote generators as "negotiable services". However, where a TNSP builds a radial line to a remote generator as "negotiable service", the generator that pays for the extension has no guarantee that another party will not 'free ride' on it, which limits the funding generators use of it. Whilst the AEMC has stated it will not deal with property rights in the review, recognising some firmer form of access for these services through a high level principle in the 'Rules' is appropriate. The codification of the recognition of the principle of firmer service makes sense given commercial entities can enter into contracts that provide

some form of right through rebate schemes for extensions or augmentations of the transmission system that generators pay for.

4. Recognising some firmer form of access for these services through a high level principle does not constitute a firm transmission right. It simply provides more options for sensible investment in the transmission system. For example, the rebate schemes currently developing in the market recognise that extensions or augmentations developed and paid for generators would provide new entrants with access rights to these extensions, but they could not 'free ride'. They would compensate the generator for using that transmission line or the TNSP could provide the incumbent generator with a rebate. TRUenergy proposes the AEMC deliver and codify such a scheme (referred to above) in the 'Rules'.²

IV. The Propose/Respond Model

Some stakeholders suggest the propose/respond model of regulation leads to more favourable outcomes for TNSPs in Revenue Cap reviews. Our view is the propose/respond model will generally lead to similar outcomes to the current model.

1. The AER will still need to approve forecast capital expenditure deemed a "reasonable estimate of forecasts"³ under the propose/respond model. Benchmark capital expenditure forecasts approved in Revenue Cap reviews will still need to reflect an 'efficient level'.⁴
2. We would not expect the large current foreseen but uncertain contingent projects currently treated outside the current Statement of Regulatory Principles (SRP) Revenue Cap to form part of the up-front ex-ante capital

² TRUenergy notes that Vencorp has taken a similar approach to this in its Connection Augmentation Guidelines.

³ ³ Draft National Electricity Amendment (Economic Regulation Transmission Services) Rule 2006 Section 6.2.6 (B) (3) - " The AER must accept the forecast capital expenditure for each regulatory year as provided under clause 6.2.6 (a) if: (3) (vi) the total of the forecast capital expenditure for the regulatory period as provided under clause 6.2.6 (a) (being both capital expenditure referred to in clause 6.2.6 (b) (2) and all other capital expenditure referred to in clause 6.2.6 (b0) (2) and all other capital expenditure referred to in clause 6.2.6 (a) is determined by the AER to be a **reasonable estimate** of the Transmission Network Service Provider's required capital expenditure for the regulatory control period.

⁴ Draft National Electricity Amendment (Economic Regulation Transmission Services) Rule 2006 Section 6.2.6 (B) (3) (vi) - " The AER must accept the forecast capital expenditure for each regulatory year as provided under clause 6.2.6 (a) if: (3) (vi) the total of the forecast capital expenditure for the regulatory period as provided under clause 6.2.6 (a) (being both capital expenditure referred to in clause 6.2.6 (b) (2) and all other capital expenditure referred to in clause 6.2.6 (b0) (2) and all other capital expenditure referred to in clause 6.2.6 (a) is determined by the AER to be **a reasonable estimate** of the Transmission Network Service Provider's required capital expenditure for the regulatory control period taking into account: (vi) the reasonable estimates of the benchmark capital expenditure that would be incurred by **an efficient Transmission Network Service Provider** over the regulatory control period."

expenditure forecasts under the current Rule proposal.⁵ Including these projects in the ex-ante cap would distort the incentive properties of the capital expenditure framework.

V. The requirement to implement CPI-X regulation or a variant of the CPI-X form under Section 6.2.4 of the Rules and the need for consistency with the principles in Section 6.2.2 of the Rules.

The AEMC has proposed a low powered incentive regime on capital expenditure combined with a scheme that allows for un-restricted re-openings of the revenue cap (for unforeseen and foreseen reliability augmentations greater than 5% of the RAB). We believe;

1. The current threshold set for re-opening the Revenue Cap means it will effectively only be re-opened for only legitimate unforeseen/foreseen capital expenditure.
2. Further relaxing threshold for re-opening the Revenue Cap risks distorting the incentive qualities of the regulatory regime on capital expenditure. The danger is the low powered incentive scheme turns into a regime highlighted by frequent re-openings with characteristics more consistent with rate of return regulation.
3. Further relaxing the re-opening provisions in the revenue cap could lead to a breach of Section 6.2.4 & 6.2.2 (d) require the AEMC to implement;
 - a) A CPI-X regime or some incentive based variant of that scheme.⁶
 - b) The scheme must provide for an environment that delivers an efficient level of investment within the transmission sector.⁷

⁵ The ACCC excluded projects from the main ex-ante cap allowance if the expected error presented by the inclusion of that project in the main allowance quantified in terms of the revenue required to cover depreciation and the return on the investment on investment in that project – is equal to more than 10% of the revenue required to cover depreciation and return on investment of all projects included in the calculation of the main ex-ante capex allowance.

⁶ Section 6.2.4 (a) of the Rules state

“ Subject to clause 6.2.3 (c), the economic regulation applied to transmission services must be of the CPI - X form, or some incentive based variant of CPI - X form , and may take into account the performance of the relevant Transmission Network Service Provider under any prescribed transmission service standards imposed by the Rules or by any regulatory regime administered by the AER, provided it is consistent with the objectives and principles outlined in clauses 6.2.2 and 6.2.3.

⁷ Section 6.2.2 (b) of the Rules state

“ The transmission revenue regulatory regime to be administered by the AER under Part B of this Chapter must seek to achieve the following outcomes including an environment which fosters an efficient level of investment within the transmission sector, and up stream and down stream of the transmission sector.”

We previously raised concerns about the incentive properties on the capital expenditure framework under the Statement of Regulatory Principles (SRP) developed by the AER in the past. Specifically, we believed the combined impacts of

1. A generous regime that allowed TNSPs to re-open the revenue cap under certain restricted conditions (Off Ramp provision)
2. A generous pass through regime
3. A provision that allowed re-openings through contingent projects up front in the review process

raised serious question marks about whether the incentives for TNSPs to deliver an efficient level of transmission to the market were in place. We were concerned the regime would simply distort the incentive properties that applied to capital expenditure. However, we acknowledged that under the SRP, whilst the incentive regime on capital expenditure was low powered, it

1. Provided incentives to under spend relative forecast capital expenditure and penalised a TNSP for expenditure in excess of forecasts limited to the foregone return on the additional capital expenditure.
2. It provided a return of capital on forecast capital expenditure over the regulatory period. This created a further incentive to under-spend relative to forecast capital expenditure on depreciation. Also, a TNSP was not rewarded for depreciation on expenditure in excess of forecast capital expenditure.

The AER did attempt to protect the incentive properties of the low powered regime. However, this was lessened by the combination of contingent projects and a low powered regime on capital expenditure. A regime that adjusts revenues (allows consistent re-openings through contingent projects and rolls in the additional capital expenditure into RAB) in line with additional costs is more consistent with rate of return regimes.

We support re-openings provisions to form part of the ex-ante revenue cap. However, the re-opening provision should be designed carefully to protect the regime's incentive properties. As a result, re-openings should be limited to:

1. The event that triggered the re-opening would need to have a material impact on the need for transmission.
2. The event that could trigger the re-opening should be limited and clearly defined
3. Any re-openings for 'exogenous' capital expenditure should be used sparingly

Our position on the AEMC's current approach to re-opening provisions is;

1. The trigger for the re-opener is material and set at 5% of the value of the RAB for reliability augmentations.
2. The event that that triggers the re-opener is limited and clearly defined.
3. The 're-opener' for exogenous capital will be used sparingly.

By excluding corrections for most or all 'exogenous' factors the regulatory process becomes more streamlined and the regulated firm is forced to be accustomed to the realities of the market place. However, whilst this may be true, we support including corrections for relevant exogenous factors, so that the firm does not suffer or gain because of events beyond its control.

The characteristics of an event that triggers adjustments to the revenue cap include;

1. The event is truly exogenous. That is, it is truly beyond the control of management and its financial impact is beyond management's control.
2. The event has a pronounced magnitude, which will help to prevent excessive regulatory hearings.

If the re-opening regime is relaxed to allow the revenue cap to be re-opened more frequently during the regulatory period (perhaps through a lower threshold) , it will introduce some of the negative factors associated with rate of return regimes. If the ACCC choose to further relax the re-opening provision, then this might lead to

1. Frequently contentious re-openings.
2. Consumers rather than the regulated firm bearing much of the market risk.
3. A regime that provides limited incentives to deliver efficient transmissions in the NEM.

VI. Conclusion

1. We support a revised regulatory approach that provides a stable, more predictable, transparent regulatory environment.
2. We support the form of regulation applied to “negotiated services”⁸ which encourages the commercial negotiation of these services between the TNSP & customer and provides pricing disputes be resolved in a timely manner through an independent dispute resolution panel.
3. We support the re-opening provision that provides the revenue cap be re-opened for only legitimate but unforeseen/foreseen capital expenditure. However, the current model that allows the revenue cap be re-opened for reliability augmentations (>5% RAB for reliability augmentations for foreseen/unforeseen capital expenditure) should not be relaxed. Further relaxing the re-opening provision risks distorting the incentive properties of the capital expenditure framework.

Regards

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Manager Regulation (Access)

⁸ These services refer to

- i. Shared transmission services provided to above/below specified standard in Section 5.1 of the Rules
- ii. New connection services
- iii. Use of system services relating to the augmentation or extension of the transmission network