

AEMC

Australian Energy Market Commission

Public Hearing:

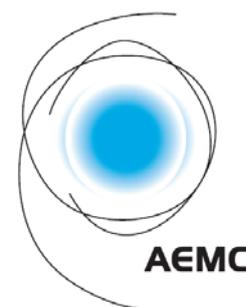
**Rule Proposal - Draft National Electricity
Amendment (Economic Regulation of
Transmission Services) Rule 2006**

Public Hearing: Transmission Revenue Regulation – Rule Proposal

Date: Wednesday 8 March 2005

Time: 9am to 1pm

Venue: Melbourne Airport Hilton



8:30 am

Registration (tea and coffee on arrival)

9.00 am

Welcome from the Chairman John Tamblyn

Overview of the Rule Proposal, Liza Carver, AEMC Commissioner

9:30 am

Gordon Jardine, CEO Powerlink (10-15 min)

Questions/Comments from the floor (10-15 min)

9:55 am

Con Hristodoulidis, Director Policy and Regulation, EUAA (10-15 min)

Questions/Comments from the floor (10-15 min)

10:20 am

Russell Skelton, Manager: Marketing and Trading, Macquarie Generation (10-15 min)

Questions/Comments from the floor (10-15 min)

10:45 am

Break

11:10 am

Comments from the Conference Chair, John Tamblyn, AEMC Commissioner

11:15 am

David Headberry, Public Officer, Major Energy Users Inc (10-15 min)

Questions/Comments from the floor (10-15 min)

11:40 am

Alex Cruickshank, Manager NEM Development, AGL (10-15 min)

Questions/Comments from the floor (10-15 min)

12:05 pm

Jim Wellsmore, Senior Policy Officer, Public Interest Advocacy Centre (10-15 min)

Questions/Comments from the floor (10-15 min)

12:30 pm

Rainer Korte, NEM Development and Regulation Manager, Electranet (10-15 min)

Questions/Comments from the floor (10-15 min)

12:55 pm

Concluding comments

Key Features of the Rule Proposal

In responding to the views put to the Commission by TNSPs and others, the Rule Proposal continues economic regulation (including a revenue cap approach) for Prescribed Transmission Services. However, while providing incentives for efficient investment in and operation of the shared network, the Proposal also provides incentives for the negotiated or competitive supply of services or, for pursuing non-network solutions where feasible.

The Rule Proposal has been substantially based on the current approach to transmission regulation set out in the Statement of Regulatory Principles (SRP). The Commission recognises the considerable work and consultation undertaken by the ACCC in developing the SRP and the widespread support in submissions for continuing that general approach to regulation.

In accordance with the views in many submissions, the Rule Proposal elevates key components of the SRP into the Rules. Where the SRP does not provide a complete framework for regulation, the Commission has provided greater clarity in the Rules or further guidance to the AER where regulatory discretion is appropriate.

The Proposal has also set out a clear and certain process for conducting regulatory reviews and making revenue cap determinations. This includes codification of a Propose-respond process, specification of a fixed timetable for regulatory decision-making and provision of guidance to be applied by the AER when exercising discretion including relevant consultation procedures.

In this respect, the Commission's approach in developing the Draft Rule is closer to the construction and approach of the current Gas Pipeline Access Code which is currently under review by the MCE. While differences remain between the two regulatory frameworks, the Draft Rule proposed by the Commission would result in greater alignment in the regulation of infrastructure access between the electricity and gas markets¹.

The greater clarity, certainty and transparency of regulatory processes and decision-making reflected in the Draft Rule means that it is necessarily more extensive and detailed than the current Rule. This Rule-based approach to energy regulation is consistent with the separation of Rule making and Rule administration which is a central feature of the new energy market institutional and governance arrangements established by the MCE in July 2005. It is also consistent with the view expressed in many submissions that greater regulatory clarity and certainty in the Rules would reduce the perception of regulatory risk and create a more certain environment for long-term investment in the transmission network.

Scope of regulation

The Commission believes that greater clarity is needed in the definition of transmission services that are subject to economic regulation. It believes that the lack of clarity in delineating between the types of transmission services that should be subject to a revenue cap determination under the current form of Chapter 6 of the NER and those that are subject to a less intrusive form of regulation, has resulted in an over-inclusion of services into the revenue cap. An over-inclusive approach to services that are subject to an intrusive form of economic regulation is undesirable. If the categories of services subject to a revenue cap are too broad, the cost of regulation is greater than optimal. In addition, over-inclusion of services within a revenue cap will distort market outcomes by crowding out the opportunities for competitive supply of services and commercial negotiations between TNSPs and users.

The current form of Chapter 6 of the NER also focuses on allocating costs on the basis of the assets of TNSPs rather than transmission services. The Commission has sought to develop a Rule

¹ Expert Panel Review of Revenue and Network Pricing across the Energy Market established by the MCE November 2005

Proposal which applies economic regulation to transmission services rather than transmission assets.

The Commission has adopted the following classifications of transmission services:

- Prescribed Transmission Services - use of system services supplied by the shared transmission network which meet (but do not exceed) the network performance requirements specified under any legislation of a participating jurisdiction (including instruments made or issued under such legislation eg., regulations, codes, licences) and the network performance requirements set out in Schedule 5.1 of the NER (prescribed transmission services do not include negotiated transmission services or market network services); and
- Negotiated Transmission Services - connection services (entry, exit and TNSP to TNSP connection services); use of system services supplied by the shared transmission network which exceed the network performance requirements specified under any legislation of a participating jurisdiction (including instruments made or issued under such legislation eg., regulations, codes, licences) or which are above or below the network performance requirements set out in Schedule 5.1 of the NER; and use of system services in respect of agreed transmission network augmentations or extensions for loads, generators and MNSPs (negotiated transmission services do not include market network services).

Services that fall outside the definitions of Prescribed and Negotiated Transmission Services, such as consultancy services, will not be subject to any form of regulation under Chapter 6 of the NER.

The Commission considers that there has been an over-reliance on traditional regulation for transmission services, and sees a greater role for commercial negotiation. The Rule Proposal applies a two part regulatory framework:

- Prescribed Transmission Services – are to be subject to a revenue cap - CPI-X building block approach form of regulation in a similar manner as currently applied by the AER; and
- Negotiated Transmission Services – are to be subject to a commercial negotiation regime.

The Rule Proposal includes a fundamental change in the definition of transmission services. In recognition of this and in order to allow for stakeholder input into this issue, the Commission is proposing to establish a Working Group. The Working Group will examine and provide advice on issues relating to the categorisation of transmission services. It is intended that the outcomes from the Working Group will be completed prior to the Commission's Draft Determination of the Rule Proposal.

The Rule Proposal establishes a new regime for the resolution of disputes about the price of Negotiated Transmission Services. The Commission wishes to encourage a clearer, more commercial and expedited process for dispute resolution than is currently provided for under Chapter 8 of the NER. Consequently, Chapter 6 of the NER will contain Rules for the negotiation and determination of price for Negotiated Transmission Services.

The Rule Proposal provides that only revenue from Prescribed Transmission Services is subject to a revenue cap. The revenues earned by TNSPs from Negotiated Transmission Services will only be subject to the commercial negotiation regime.

The Commission expects that over time, as a consequence of this Rule Proposal, more assets will be outside the regulatory asset base (RAB) than is currently the case. Further, that Negotiated Transmission Services will become subject to more competitive supply. In these circumstances the question of cost allocation (allocation of asset costs between Prescribed Transmission and Negotiated Transmission Services) will become a significant regulatory issue. Unless cost allocation is subject to regulatory oversight by the AER there is a risk that TNSPs may 'double dip'

by recovering costs through both the Prescribed Transmission Services' revenue and negotiated charges or engage in cross subsidisation of services.

The Rule Proposal provides a regime for AER oversight of cost allocation between different categories of services. In the future, assets will only be rolled into the RAB when the costs of those assets are appropriately allocated to Prescribed Transmission Services in accordance with AER cost allocation principles.

Regulated revenue for Prescribed Transmission Services

The Commission proposes that Chapter 6 of the NER contain a complete methodology for making a revenue cap determination for Prescribed Transmission Services – under a Propose-respond process. The Commission believes this approach will improve the predictability and transparency, and over time, consistency, of revenue cap determinations. The methodology set out in the Rule Proposal is based on the SRP.

The Rule Proposal provides for the revenue cap to be derived from a post-tax revenue model, based on a building block approach. The Draft Rule includes the following key elements:

- The calculation of the RAB on a 'locked-in' value of the assets.
- The locked-in value of the RAB will be adjusted for each year of the regulatory period by the AER approved forecast capital expenditure.
- The RAB will be adjusted using depreciation profiles proposed by the TNSP.
- The methodology for calculating the cost of capital (based on CAPM), and a number of the parameters, will be included in the Rules. The CAPM parameters are based on those in the SRP. The parameters will be subject to review by the AER every five years.
- Operating expenditure will be based on efficient forecasts on a firm-specific basis. An efficiency benefit scheme will apply.

The Rule Proposal provides for the AER to develop a post-tax revenue model, based on the principles in the Rules and subject to consultation. This model is to be used by the AER in making revenue cap determinations.

The Commission believes that, all other things being equal, it would be better to have a less intrusive regulatory approach rather than a more intrusive regulatory approach to determining the forecast capital and operating expenditure. While there is an incentive for TNSPs to seek to maximise their revenues through the regulatory process, there is also a risk of under-investment and insufficient operating expenditure if the determination by the Regulator is later found to be too low. The Commission has sought to balance these risks by providing that the AER must accept a TNSP's forecast expenditure if it is satisfied that the amount is a 'reasonable estimate' of the business' requirements having regard to a number of criteria including efficient costs, benchmark information and the regulatory obligations borne by the TNSP.

The regulatory period must not be less than five years but can be longer.

The Commission has not adopted the AER's 'contingent project' regime for capital expenditure, because it did not adequately address the potential need for necessary major capital projects that may have either have been unforeseen or, planned, but the timing was uncertain. Consequently the Rule Proposal provides that the revenue cap may be reopened in specified circumstances where a TNSP needs to undertake significant capital expenditure which was not provided at the commencement of the regulatory period. This will increase flexibility for infrastructure responses to market needs.

Transmission revenue is subject to adjustment in accordance with the operation of the applicable service target performance incentive scheme and cost pass throughs.

In addition to its existing guidelines on ring-fencing and annual certified accounts, the AER will consult, prepare and publish guidelines on information requirements for the transmission determination process, the public release of information, cost allocation methods, and the post-tax revenue model. Guidelines may be amended in accordance with the new consultation procedures which are set out in the Draft Rule.

Incentive mechanisms

There are essentially four incentive mechanisms in the package. These include mechanisms to encourage efficiency in capital; operating expenditure; improved reliability and availability of transmission services; and to provide incentives for better management of potential commercial stranding risk.

The Commission has continued the SRP's low powered incentive regime for capital expenditure. The actual capital expenditure of the TNSP will be rolled into the RAB at the commencement of the next regulatory period, subject to the AER's discretion to conduct efficiency and prudence reviews, in accordance with clear criteria set out in the Draft Rule. The TNSP will retain the benefit (or bear the cost) in relation to the return on capital allowed for in the revenue cap determination for any under- (over-) spend compared with forecast. In contrast to the SRP, depreciation will not form part of this incentive regime.

The details of the incentive regime for operating expenditure are to be developed by the AER but must provide a continuous incentive (equal in each year) to reduce operating expenditure below forecast levels. The principles for this incentive regime set out in the Draft Rule are consistent with the incentive mechanism set out in the SRP.

The incentive mechanisms for performance standards are to provide incentives for TNSPs to provide greater reliability of the system at times when the system is most valued and in relation to those elements that are most important to determining wholesale spot prices. The Commission believes requiring the AER to develop such an incentive mechanism will be an important evolution in the NEM. This development is consistent with the objective of the Review in aligning the operation of the transmission grid with the market incentives of the NEM.

The Commission proposes that the reward/penalty adjustments in the incentive mechanisms for performance standards should be capped at no more than +/-1% of the revenue cap. The Commission is seeking views on this proposed cap.

In line with the greater scope for commercial negotiation between TNSPs and users, it is proposed to establish a limited regime for managing the risks of potential commercial stranding. This is a departure from the SRP. The Commission wishes to adopt a regime for the economic regulation of transmission services which provides TNSPs with an incentive to negotiate with large end-users (whose future decisions may pose a commercial stranding risk in relation to dedicated assets) for an appropriate allocation of risk between them, and which provides an effective incentive for TNSPs to negotiate a prudent discount with users, when it is efficient to do so.

The Rule Proposal provides that the AER will have the power to remove assets from the RAB, which are the subject of commercial stranding, but only where the TNSP has *not* taken steps to either:

- enter into contractual arrangements with the user to manage stranding risk (for assets where construction is committed to after 16 February 2006); or
- to offer a prudent discount to such users in appropriate circumstances.

The ability of the AER to remove assets from the RAB is limited to assets that the AER determines are no longer contributing to the provision of Prescribed Transmission Services and where the current value of those assets exceeds a certain threshold. The Commission is proposing a threshold

of \$20m (in 2006 dollars) but would welcome views on other forms and levels of the potential commercial stranding threshold.

Regulatory procedures and approach

As noted earlier, the Commission proposes to codify a Propose-respond determination process to improve the transparency and predictability of the current determination procedures. The Commission proposes that:

- TNSPs will be required to submit a transmission revenue application to the AER. The TNSP revenue application must be no later than 13 months from the commencement of the proposed regulatory period for the transmission determination.
- The AER will be required to initially assess whether the TNSP's application complies with the information requirements.
- The AER will be required to publish guidelines setting out the information that must be provided with the TNSP's application and publish other instruments with which an application must comply including the post-tax revenue model to be applied by the AER, and guidelines in relation to cost allocation. The cost allocation method is to be prepared in accordance with the AER Guidelines.

Discretion is an important element of any regulatory framework, however it must be balanced with the need for certainty and clarity. While the Commission proposes to adopt a detailed framework for the making of revenue cap determinations by the AER there are a number of areas within that framework where it is appropriate for the AER to exercise discretion. These areas include the determination of forecast expenditure and the conduct of efficiency and prudence reviews. Where the Draft Rule provide for the exercise of discretion by the AER, criteria or principles are also set out to provide a framework for the AER in exercising those discretions.

The Commission believes that there are a number of areas in which the regulatory framework should be augmented with models or guidelines to be developed by the AER, these include: guidelines setting out the information that must be provided with the TNSPs' proposal; the post-tax revenue model to be applied by the AER; cost allocation principles and incentive regime mechanisms. Where the Rule Proposal provides for the development of guidelines and models by the AER the Rules require the AER to comply with a consultation process and also provide principles or criteria to guide the AER.

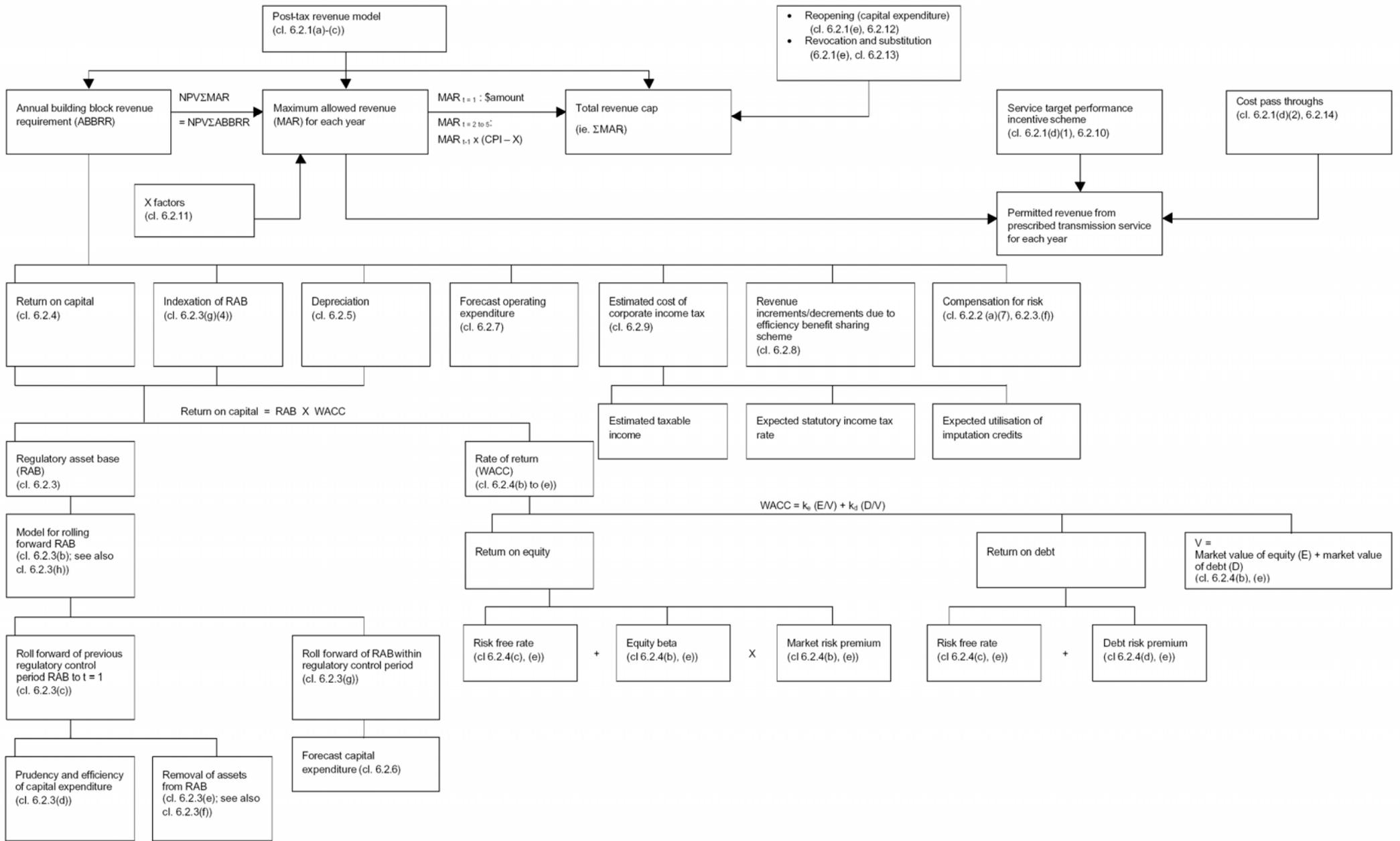
Savings and Transitionals

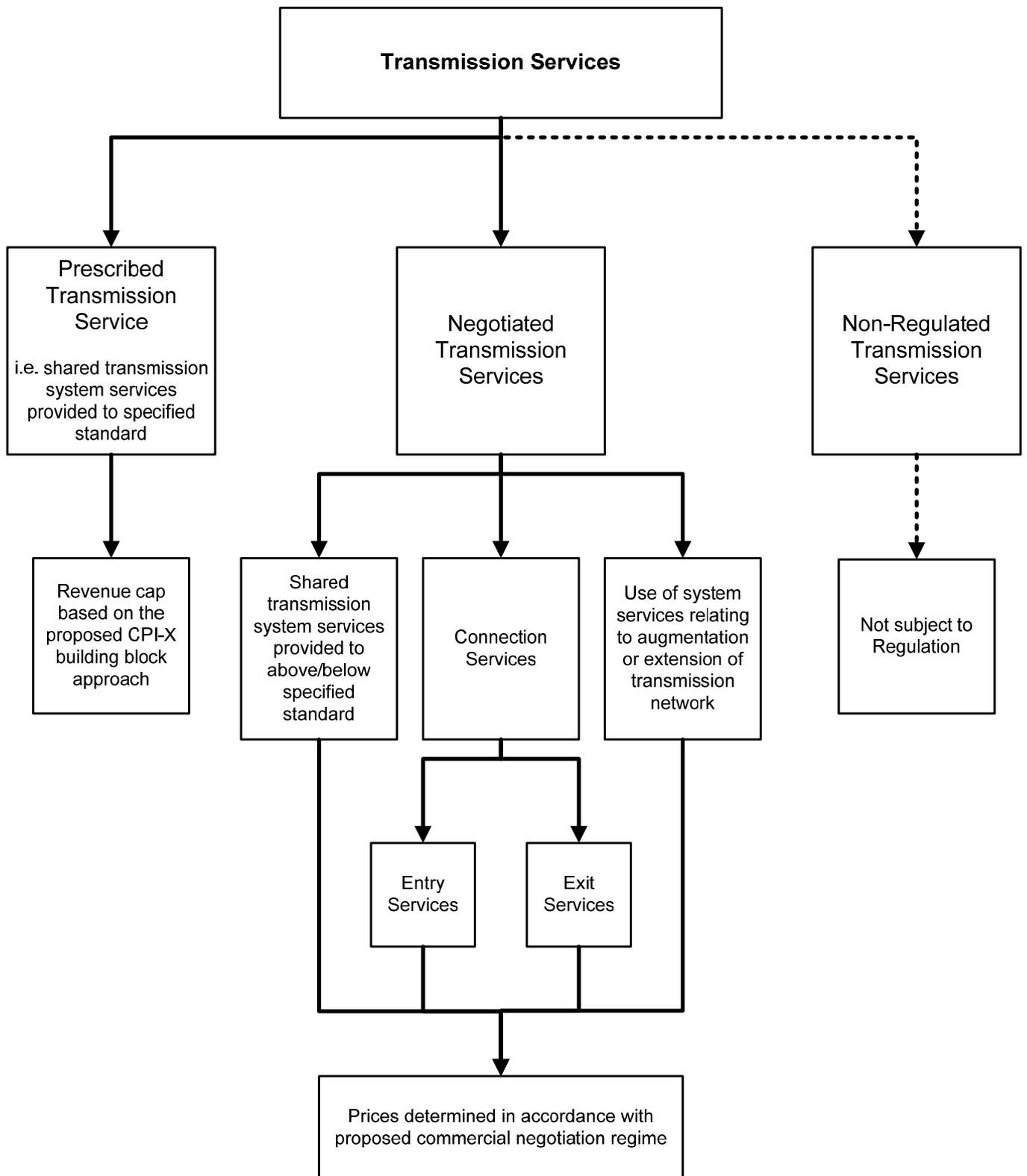
The Commission understands that savings and transitional Rules will be required in order to provide for:

- The saving of determinations by the ACCC;
- Transitional Rules to facilitate the making of a revenue cap determination in relation to Powerlink in a manner that minimises uncertainty and transitional costs for Powerlink and the AER in relation to the forthcoming revenue cap determination;
- Transitional Rules which 'grandfather' the treatment of assets which are used to provide services under long-term contracts by the TNSPs where those assets have traditionally been incorporated into the RAB but which may, under the Rule Proposal, be allocated to Negotiated Transmission Services; and
- The recognition of existing incentive mechanisms.

The Commission believes the development of savings and transitional Rules will be improved through close consultation with affected parties prior to releasing its Final Determination.

AEMC Public hearing handouts – Diagrammatic Overview of Draft Rule





AEMC Public hearing handouts – Timetable for Propose Respond Process

