



OFFICE OF THE CHIEF EXECUTIVE

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Ref. 06-GHJLtrAEMCDraftRulesTransRev1104

11 April, 2006

Australian Energy Market Commission
Attn: Dr John Tamblyn
Chairman
Level 16
1 Margaret Street
SYDNEY NSW 2000

Dear John,

Draft Rules – Transmission Revenue

Whilst there are several items in the AER's recent submission to the draft Rules for transmission revenue which will elicit detailed comment from the transmission network owners, I feel that there is one item which provides a seminal example which goes to the heart of the key issue facing you and your fellow commissioners viz. the extent to which the regulatory framework needs to be codified, and the extent to which the regulator should have discretion.

On one hand, as the AER points out, the regulatory arrangements need to be flexible enough to allow the regulator to take into account differences between networks. I would agree with the AER on that point. On the other hand, there are matters of a more universal nature where consistency is important, and where proposed major changes in the regulatory settings need to be exposed to a robust review process.

Seminal example - Service standards incentive

The AER, based on a report from its consultant (Biggar), is advocating that the cap on the service standard incentive be removed or at the very least increased from 1% of MAR to 10% of MAR. Biggar argues that this "order of magnitude" increase is better aligned with the economic loss that could arise from what Biggar labels as a "credible" loss of supply event in which 20% of the load in the largest energy consuming State was blacked out for 10 hours.

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One can make the following observations:

1. Biggar's "credible" event is very large – and rare. Events of this nature are invariably the result of multiple contingencies. The transmission network is generally planned around being able to cope with a single contingency (the N-1 criterion). The avoidance of large, multiple contingency events would require the network to be planned to N-2 or N-3, which would require an enormous capital investment program – many orders of magnitude above the levels of capex that have been thus far awarded by the ACCC/AER.
2. The existing service standards are based on typically much smaller, more frequent loss of supply events – such events can occur about 4 or 5 times a year. The avoidance/mitigation of these events is substantially managed via operational initiatives.
3. There is clearly a significant "logical disconnect" between the (relatively small) events being addressed by the present service standard targets, the (punitive) high 10% penalty being proposed by Biggar (based on extreme events), and the levels of capex being allowed in transmission regulatory revenue determinations.

Whilst the existence of such a major "logical disconnect" in the work of an ACCC/AER consultant is of concern, the real issue is whether there is a robust process which prevents fundamentally flawed propositions from being implemented.

It might be argued that the AER itself could run a process to logically consider these matters in a neutral manner. However, the AER's submission appears to enthusiastically embrace Biggar's proposal, without critical analysis. This raises questions about whether the AER would be perceived by stakeholders as a dispassionate reviewer or as having high "emotional ownership" of the proposal.

It should be noted that 10% of MAR equates, in Powerlink's case, to 50% of annual controllable opex. 1% of MAR equates to 5% of annual controllable opex. Even at 1% of MAR, the service standards incentive is much larger than the potential annual operational efficiencies which a network might be able to achieve, particularly in an environment of rising input costs.

The AEMC's proposal of enshrining the service standards cap in the Rules offers important safeguards against implementation of flawed propositions. A subsequent proposed change to this cap would:

- (a) expose the proposed change to the critical analysis which the above example has so far avoided;
- (b) involve the scrutiny of a "detached" entity, the AEMC, thereby lessening the risk of "motherhood-driven" agendas; and
- (c) expose the proposal to the test of meeting the NEM objective.



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This example suggests there is merit in codifying significant matters that have universal application, whilst leaving the regulator with sufficient discretion to deal with the inherent differences between networks.

Yours sincerely,

A handwritten signature in cursive script that reads "G. Jardine".

Gordon H. Jardine
CHIEF EXECUTIVE