

ELECTRICITY TRANSMISSION NETWORK owners forum

4 May 2006

John Tamblyn
Chairman
Australian Energy Market Commission
PO Box H166
Australia Square, NSW 1215

By email: john.tamblyn@aemc.gov.au

Dear John,

Re: Supplementary Submission on AEMC Transmission Revenue Rule Proposal

The Electricity Transmission Network Owners Forum (ETNOF) provided a detailed submission in response to the AEMC Transmission Revenue Rule Proposal on 20 March 2006. Having reviewed submissions from other stakeholders, the purpose of this letter is to highlight and reiterate a number of key issues that we urge the AEMC to take into account in finalising its Draft Determination on the Rule Proposal.

Revenue Cap Re-openers and Contingent Projects

The ETNOF submission raised issues with the very high threshold proposed for re-openers (5% of RAB or in some cases as high as \$200m) and the requirement for projects to first be funded from savings on the capex program. We understand that these issues could potentially be overcome with changes to the proposed re-opener provision. However, there are important additional reasons for retaining contingent projects as part of the regulatory regime.

Most importantly transmission services need to be responsive to changing circumstances, including major new customer loads or other developments that deliver economic benefits to the market. At any time it is usual to have a significant number of connection enquiries from prospective customers and new loads. At the time of setting an ex-ante capex profile (once every five years) detailed information on the timing and scope of the eventual projects will not be available. Some of these loads will commit during a regulatory control period and must be supplied by the TNSP in accordance with its mandated reliability of supply obligations. Given the uncertainty about the scope and therefore cost of such projects (particularly in large geographic areas) it is impractical to make a justifiable provision for the associated capital cost of these projects at the time of a reset application. Each transmission owner can provide actual examples of this kind of situation if required.

A similar situation can arise for non-reliability augmentations that have not been through the regulatory test process at the time of a revenue cap application.



For example the Annual National Transmission Statement contains a number of possible future interconnection upgrades that may not pass the regulatory test at the time of any given revenue cap review but which may come to fruition during the subsequent regulatory control period. At our recent meeting with AEMC staff the potential QNI upgrade was cited as an example of this kind of project. The most recent upgrade of the Snowy to Victoria transmission capability would have been another example, but for the ex-post assessment regime that prevailed at the time.

In both cases it is in the interests of consumers that required transmission augmentations are not delayed because of commercial considerations of the relevant transmission owner arising from the regulatory incentive framework.

The regulatory framework should also allow a transmission network owner to meet its mandated obligations in a timely manner. Pre-consideration of projects through the contingent projects framework will assist with such timeliness.

A further reason for retaining the contingent projects framework is that at the time of a reset application, projects can be readily identified as being outside the main capital expenditure allowance. During a regulatory period a transmission owner will likely need to vary the projects actually implemented compared with their application, making it very difficult to distinguish between new requirements and those provided in the ex-ante capital expenditure allowance. This will be particularly problematic where capex forecasts are based on a probabilistic assessment of projects, making a direct comparison impossible. Pre-identification of contingent projects at the time of the revenue determination is essential in a probabilistic capex assessment.

An arrangement that requires a transmission network owner to fund this type of project from efficiency gains made elsewhere provides a dysfunctional incentive in that efficiency gains will inevitably be lost when an additional load has to be supplied. This requirement should be removed.

In summary, a contingent projects regime (a modified form of the model in the SRP) operating in tandem with the re-opener mechanism would address the problems outlined above and enhance the NEM Objective.

Ex-post Prudence Review

As discussed in the ETNOF submission, there is no justification for allowing the option of an ex-post prudence review for capital projects subject to the proposed ex-ante incentive. However, we now understand that a reason for the option of ex-post prudence review being included in the Rule Proposal was for regulatory assessment of projects not subject to the ex-ante incentive, i.e. those projects arising from a revenue cap reopening. We note too, that under the proposals in the ETNOF submission, the small number of contingent projects would not be included in the ex-ante incentive. Our conclusion is that, if an ex-post prudence review is to be retained, the Rules should explicitly limit its application to those projects not included in the main ex-ante incentive (i.e. those projects undertaken by way of the contingent projects or re-opener provisions).

As has been discussed with AEMC staff, a key consideration in relation to this matter is that having both an ex-ante framework and ex-post assessment creates a substantial administrative burden for the regulated businesses and the regulator. In an ex-post assessment framework, time consuming, forensic reviews are conducted 'after the event' but setting the original targets is relatively less resource intensive. In an ex-ante assessment framework the effort increases substantially at the time the ex-ante targets are established but the ex-post reviews are avoided. If both regimes operate together, a resource intensive process occurs at the start of the regulatory period to establish the

targets and at the conclusion of the regulatory period. Because of this it is clearly preferable to have either an ex-ante incentive regime or ex-post assessment regime - not both.

Expenditure 'Reasonable Estimate'

The ETNOF submission pointed out that the matters to which the AER is required to have regard to in assessing whether expenditure forecasts are 'reasonable' are overlapping, interrelated and contain matters of little or no relevance. In addition, these matters do not provide guidance on the weight to be applied to each factor. The submission argued that requiring the AER to have regard to such a list of factors is not regulatory best practice and that the list should be removed. However, if the AEMC considers that criteria are necessary, then the list needs to be reviewed and modified to ensure that the factors are additive and focus the AER on a fact based assessment rather than the ability to trade-off various factors. The ETNOF submission includes reference to such a list of factors.

A central consideration is the value of adopting 'good electricity industry practice' as a reference point for factual assessments of the reasonableness of proposed ex-ante capex and opex targets. This has distinct practical advantages for the regulator in that it can rely on expert assessments of the processes used by a regulated business in formulating their cost estimates. For example, it can be used to eliminate or substantiate the adoption of particular technologies or levels of redundancy in technical specifications. It also gives formal status to relevant Australian and International technical standards applying to the electricity transmission sector. In summary, it provides the assessment processes normally commissioned by regulators with a meaningful reference point for the conduct of such assessments. Accordingly, the transmission owners have proposed using 'good electricity industry practice' as a key criterion for determining whether proposed capex or opex estimates are 'reasonable'.

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A key positive aspect of the Rule proposal is the greater certainty and stability provided by adopting the input parameters and methodologies set out in the SRP for the initial 5-year period, which are the product of extensive consultation. However, the AEMC has correctly identified the need to reconsider the 'A' benchmark credit rating that has been used by the ACCC to determine the cost of debt. State regulators routinely adopt a rating of 'BBB+' and even the AER's own expert advice suggests 'A-' is more appropriate than 'A'. ETNOF has commissioned Jeff Balchin of the Allen Consulting Group to analyse and prepare a response to the paper prepared for the AER by Martin Lally. Work to date indicates significant support for the AEMC's position to move away from the A benchmark credit rating. We expect to forward the ACG report to the AEMC in the week commencing 8 May 2006.

Prescribed/Negotiable/Contestable Services

ETNOF welcomes the AEMC's acceptance that a "genuinely contestable service should not be subject to any form of price regulation, including a compulsory negotiate and arbitrate regime"¹.

Investments in the shared transmission network to meet mandated reliability of supply obligations and to deliver market benefits are regulated in all jurisdictions. New expansions between transmission and distribution are identified through joint planning (an obligation on both TNSPs and DNSPs in the NER) and the optimal solution is implemented. This includes both transmission shared network services and transmission connection services.

¹ AEMC Initial Position Paper on the "definition of prescribed services and the delineation from negotiated services", 10 April 2006.

be applicable and relevant in all cases. This level of clarity in the regime is appropriate and necessary.

Balance of Incentives

ETNOF notes the AER's suggestion that the AEMC be mindful of maintaining the mix and balance of regulatory incentives. The provision of effective and compatible incentives is also important to TNOs. Our preliminary view is that the proposed incentive regime does not materially affect the current mix and balance.

To provide greater clarity in relation to the various and mix of incentives, transmission network owners suggested that the Rules clarify the purpose of the service target performance incentive scheme. For example the current arrangements (notionally subject to the 1% cap in most jurisdictions) are complementary to mandated service (reliability) standards that drive most transmission investment. As such they are intended to encourage efficient operating practices rather than impacting on investment decisions. This should be clarified in the Rules.

Market Objective

Some submissions to the AEMC expressed a generic concern that the changes proposed to the Rules have not been explained in terms of satisfying the market objective. The TNOs have by and large supported the draft Rule Proposal, and have been mindful of the need for the Rules governing transmission revenues to enhance the market objective.

The TNOs believe that the draft Rule Proposal incorporates changes, which directly respond to the market objective. These were highlighted in this context in the TNO submission on the AEMC Issues Paper, as follows:

1. *"...the current Rules do not provide appropriate and unambiguous direction to the AER. Many of the current Rules are high-level principles that offer little guidance, contain contradictions and arguably also reduce the extent to which the new market objective clarifies the guidance to the AER".*
2. *"The TNOs consider that carefully designed rule-based measures would enhance the discipline on the AER to make high-quality and timely decisions. In turn, this would provide benefits to all stakeholders, and thus promote the market objective. In summarising the key features of the necessary requirements for good regulatory decision making, the MCE Standing Committee of Officials recently observed (emphasis added):*

Transparent, fair and reasonable decision-making that also produces economically efficient outcomes is a product of:

- i. Strong institutional structure of the decision-makers: eg. AER member appointments and external policy accountabilities, internal management, public reporting requirements and financial accountabilities;*
- ii. Role clarity for decision-makers within the energy sector via the statutory conferral of functions and powers;*
- iii. Clear and effective procedural and consultative requirements in the NEL and the NE Rules and in the Gas Pipelines Access Regime as to how the decision-makers will perform their economic functions;*

iv. Clear and effective rules for economic regulatory decision-making removing layers of inconsistent objectives and principles in favour of a body of rules designed to structure and guide the exercise of regulatory discretion;

v. An appropriate review mechanism for specified decisions". (p 42)

It is also important to recognise that the inclusion of the revenue setting requirements in the Rules enables subsequent changes to those Rules to be subject to the Rule making process, including an assessment of whether the proposed changes enhance the NEM Objective.

Please don't hesitate to contact me on (08) 8404 7983 if you would like to discuss or clarify any aspect of this submission.

Yours sincerely,



Rainer Korte
Chair of ETNOF Regulatory Managers Group