

**“The Group” Comments to Scoping Paper: The Australian Energy
Market Commission (AEMC) Review of the Electricity Transmission
Revenue and Pricing Rules**

This submission represents the views of the following companies, “The Group”:

- TRUenergy
- International Power
- Loy Yang Marketing Management Co.
- NRG Flinders.

The Group owns the majority of Victorian and South Australian generation capacity and will be approaching this review with prime consideration of the interface between the regulated transmission network and the competitive national electricity market.

1. Introduction

The Group’s supports the thrust of the AEMC’s scoping paper of “Review of the Electricity Transmission Revenue & Pricing Rules” for the following reasons:

- An independent review of the National Electricity Rules (NER) that apply to transmission by the rule making body (AEMC) has the potential to further refine the rules to better contribute to the achievement of the NEM objective – an efficient, safe, and reliable electricity system.
- The Group is aware that the ACCC has undertaken a comprehensive program to refine the electricity transmission rules in the past two years by
 - i. Implementing its Statement of Regulatory Principles (SRP), which refined the general approach to setting revenue caps to apply to transmission network owners (TNSPs) under the “Code”.
 - ii. Modifying the regulatory test, which included the commencement of a review of whether explicitly including ‘competition benefits’ in the test would further enhance efficient expansion of NEM investments.

Whilst The Group acknowledges the ACCC’s comprehensive effort in this regard, a review of the transmission rule making arrangements by a rule making body, independent of adjudicating on those rules (AER), will further improve the transmission regulatory arrangements.

Furthermore, the ACCC’s primary task in the NEM was the economic regulation of monopoly transmission assets. Because the ACCC did not have a direct responsibility for the efficiency of the competitive sectors of the NEM, we think it is now appropriate for the AEMC, which does have this responsibility, to consider broader competitive market aspects.

- The Group acknowledges the ACCC’s comprehensive contribution to the rules of transmission regulation. As such, The Group’s preferred approach is to limit the scope of this review to areas where it believes that there is room for the refinement-particularly those areas that affect competitive generation. The scope should be limited to a review of:
 - i. The current regulatory arrangements that give MNSPs the right to ‘convert’ to a ‘prescribed service’ under the ‘rules’.
 - ii. The regulatory arrangements that apply to ‘contingent projects’ under the capital expenditure framework in the SRP. Large projects that are likely to impact the competitive market (we suggest a capital value in excess of \$20M) should be subject to an independent ex-ante audit of the regulatory test applied to these projects by the AER.
 - iii. The compatibility of the current regulatory test horizons to the generation market and the inclusion of competition benefits applied under the regulatory test by TNSPs.
 - iv. The capital expenditure incentive framework. The effects of the re-opening provisions that apply to revenue caps have some similarities to rate of return regulation.
 - v. The current pricing arrangements for determining shared network usage charges for new transmission. Consideration should be given to generator contributions to shared transmission augmentations costs when generator locational or expansion decisions have created the need for it.
 - vi. The CRNP framework limited to demonstrated anomalies that can be relatively easily corrected to promote more efficient outcomes and incentives.

2. Key transmission areas the scope of this review should include.

2.1 The current regulatory arrangements that give MNSPs the right to convert to a ‘prescribed service’ under the ‘rules’.

The ‘Group’ believes the ACCC’s decision to allow MurrayLink to convert to a regulated status effectively allowed a stranded commercial investment to be underwritten by consumers. This was not the original intention of the NECA Working Group that developed the ‘conversion’ clause. It envisaged a MNSP would convert to a ‘prescribed service’ only when it faced additional risks related to ‘market design deficiencies.’ However, they did not explicitly define this term. The NECA Working Group noted:

“ The concept of a non regulated interconnector is still somewhat experimental. It might be argued that as well as the usual commercial risks, the proponent of a non-regulated interconnector may face additional risks related to market design deficiencies that may only become apparent once the first interconnectors become operational.

Providing a right to apply for regulated status may help ensure that investment is not inefficiently inhibited by such non-commercial market design risks. However, it is important that the conversion option should not shield the proponent from normal commercial risks. e.g. the risk of having over judged the future of demand for the inter-connection service. It is therefore essential that the regulated revenue entitlement is based on the assessed need for the facility at the time of the application rather than guaranteeing a return on the original capital cost. “

In The Group’s opinion, MurrayLink’s primary driver to convert to a ‘prescribed service’ under the ‘Rules’ occurred because the service did not attract the expected commercial interest and was becoming unprofitable. It did not stem from a market design deficiency.

The ability of a market-based investment to convert to a certain regulated income stream raises a question of its competitive neutrality with the generation sector. An MNSP’s right to convert to a ‘prescribed service’ effectively provides it with a ‘put -option’ if the investment turns out to be un-profitable. - This luxury does not exist for generators in the NEM. If such an option were to be retained, for the sake of competitive neutrality, it would seem necessary to extend it to other market based investments.

The group is not suggesting the right that allows a MNSPs to convert to a ‘prescribed service’ under the “rules ‘ be abolished. It simply requests that the provision be applied in accordance with the original intention of the NECA working group that developed it. That is, it should be applied to make

sure that it does not effectively have consumers underwrite a poor commercial investment gone wrong.

The Group considers the conversion option deserving of review.

2.2 The regulatory arrangements that apply to ‘contingent projects’ under the capital expenditure framework in the SRP. Large projects that are likely to impact the competitive market (we suggest a capital value in excess of \$20M) should be subject to an independent ex-ante audit of the regulatory test applied to these projects by the AER.

The SRP provided for capital expenditure to be reviewed on an “ex ante” basis at the beginning of the regulatory term with the threat of re-optimisation abolished. The amended incentive based regulatory regime under the SRP provided rewards for under spending relative to benchmarks and penalties for over spending during a regulatory period. Large projects were to be excluded from the “ex-ante” capital expenditure allowance and treated as ‘contingent projects’. The TNSPs would only get a return on ‘contingent projects’ when they had applied to the ACCC to undertake one of these projects during the regulatory term and the ACCC had approved this, given the project had passed the regulatory test.

The Group supports this approach, conditional that all significant investments that are likely to impact the competitive market and therefore generation investments have the regulatory test applied in accordance with the ‘rules.’ The simplest threshold for such investments is capital cost based figure. We suggest \$20m as a maximum, however \$10m would align the number with “large projects” threshold mentioned in the regulatory test. Projects of greater size should require an independent audit of the regulatory test from the AER. This position is consistent with Section 6.2.2 of the Rules.¹

We note the ACCC adopted this policy mechanism but instead based the criteria for excluding these “contingent projects” on a threshold on a +-10% error as applied to capital expenditure forecasts. That is, if a project were included in the capital expenditure forecast and it did not go ahead causing a distortion of +-10% to those forecasts, then it would be taken out of those forecasts and included in the ‘contingent projects’ provision. In practice this

¹ Section 6.2.2 of the “Rules” sets out a number of key issues that the AER is to have regards to when it sets a revenue cap. This includes the need to

- Provide TNSPs with incentives and opportunities to increase efficiency
- Create an environment in which generation, energy storage, demand side options and network augmentations are given due and reasonable consideration
- Take account of any agreement for the sharing of risk between TNSPs and users
- Provide a fair and reasonable risk adjusted rate of return to TNSPs on efficient investment given efficient operating and maintenance practices where assets are valued consistently with the principles set out in clause Sect. 6.2.3 (d) (4) (i) –(v)
- Provide consistency and certainty in outcomes of regulatory processes over time, having regard to the need to balance the interests of TNSPs and users, the capital-intensive nature of the business, the need to minimise regulatory costs, and any previous regulatory decisions, including decisions made by jurisdictional regulators.

results in considerably larger assets being treated as “contingent projects,” compared with the \$20M project threshold that the group proposes. In short, the ACCC approached the issue focussed upon minimising forecasting errors in capital expenditure forecasts rather than assisting market investor certainty.

The Group believes that whilst the incentive properties of the capital expenditure framework have been improved under the SRP, it requires further certainty that the regulatory test is applied independently and in accordance with the rules. Hence, it would support this issue being part of this review. Furthermore, it would also support the model being put forward for assessing efficient capital expenditure to be considered seriously by the AEMC if it decides to modify the approach in the SRP.

2.3 The compatibility of the current regulatory test horizons to the generation market and the inclusion of competition benefits applied under the regulatory test by TNSPs.

2.3.1 The current regulatory test horizons

The ACCC abolished the ‘market failure’ provision in its review of the regulatory test.² It argued interested parties in its review of the regulatory test misrepresented the market failure provisions. The Group believes that abolishing the market failure provisions will encourage the development of inefficient augmentations over longer time horizons crowding out unregulated investments such as generation. This is because through practical necessity generators do not commit to their investments at the last moment before construction. This was originally recognised by limiting the horizon for regulatory tests to no greater than 12 months, so that generation had sufficient time to commit prior to the test.

In terms of the market failure test, the ACCC has identified that the requirement within the Regulatory Test for an 18-month minimum period between announcement of the proposal and the commencement of construction has lead to unintended confusion. However, the ACCC removed the relevant provision in its entirety from the Test, effectively removing the market failure test altogether.

Given the removal of this clause, it would appear that a replacement clause is required to ensure that the original intent of the provision is met, and ensure

² In determining the market benefits, the proposed augmentation should not pre-empt or distort potential unregulated developments including network, generation and demand side developments. To this end:

- (a) a proposed augmentation must not be determined to satisfy this test more than 12 months before the start of the construction date
- (b) a proposed augmentation will cease to satisfy this test if it is not commenced by the 12 months after the commissioning date unless there has been a delay clearly due to unforeseen circumstances
- (c) unless there are exceptional circumstances, new interconnectors must not be determined to satisfy this test if start of construction is within 18 months of the project’s need being first identified in a network’s annual planning review of NEMMCO’s Statement of Opportunities

that regulated options do not unnecessarily pre-empt market driven capacity development. To this end, the AEMC may wish to reconsider the need for maximum lead-time between the commencement of the regulatory approval process and the timing of the underlying need being considered (e.g. 3-5 years). This will ensure that regulated developments continue to be undertaken only in instances where market driven solutions do not emerge in a sufficient timeframe.

In summary, the Group believes that this area of the Regulatory Test needs to be reviewed because

- The ACCC did not deal with the issue adequately in the review
- The removal of the maximum lead-time horizon erodes the competitive neutrality between investments in the NEM crowding out generation investments.
- The problem was not in the adoption of the lead-time in itself, but the way in which it has been expressed and applied.

2.3.2 The inclusion of competition benefits in the regulatory test

The ACCC undertook a comprehensive review of the regulatory test in the past 2 years. The review did consider whether competition benefits should be included in the calculation of the regulatory test. Whilst The Group commend the ACCC with its efforts in developing this facet of the regulatory test, more work is needed to complete the task that was started by the ACCC.

The Group believes there is a danger in TNSPs having too much discretion regarding what values may be attributed to competition benefits in applying the regulatory test. The concept of competition benefits is nebulous. Much more work is required in this area to clarify what level of competition benefits that TNSPs may claim in regulatory test applications. The AEMC is positioned well in this review to undertake that work and refine this process.

2.4 The capital expenditure incentive framework. The effect of the re-opening provisions that apply to revenue caps under the SRP is more consistent with rate of return regulation.

The AER has a responsibility to apply an incentive based regulatory regime in accordance with Section 6.2.2 of the “rules”. The Group believes that a more high-powered incentive regime would help to ensure that efficient transmission was built. The Group believes the incentive framework applied to capital expenditure under the SRP may be more consistent with rate of return regulation. ³

³ The right to re-open the revenue cap for contingent projects during a 5 year regulatory period combined with a TNSP’s asymmetric right to re-open the cap under Sect. 7.2 of the SRP (of which the legal right to do so is not included in the ‘rules’) guarantees returns for this additional capital expenditure not forecast in the “ex-ante” revenue cap and is more consistent with rate of return regulation.

The re-opening provisions that apply to the revenue cap are triggered too easily and asymmetrically. Only TNSPs have the right to re-open the revenue cap and there is no proposed limitation as to the nature of the event that could give rise to a re-opening of the cap.

Finally, the group also recognises the right to re-open the revenue cap forms part of the SRP under Section 7.2 of the SRP. However, no such right is included in the ‘rules’. As such, it also questions the legality of this policy. The AEMC should review the re-opening provisions that form part of the SRP in this context.

2.5 A review of the current pricing arrangements for determining shared network usage charges for new transmission. Consideration should be given to generator contributions to shared transmission augmentation costs when locational or expansion decisions have created the need for it.

We will limit our comments in this area to the issue of transmission pricing arrangements that apply to generators at this time.

The Group believes there are no efficiency gains to be made in re-allocating historic “sunk” transmission costs. Making incumbent generators pay for transmission does not provide any useful economic signal as it only increases fixed and variable costs and severely distorts the market (particularly in the case of low capacity factor plant). Regardless of questions of parity, any change will simply create a regulatory “shock” that will harm existing investors and create a perception of sovereign risk in the NEM.

We note that the AEMC has excluded from the scope of this review “issues such as whether there should be market-based transmission arrangements rather than a common carriage regime, and the appropriateness of the adoption of firm access rights (either physical or underpinned by a form of financial transmission rights).”

The group supports the limitation of the scope however we note that this limitation on the consideration of property rights (such as non firm access, firm access, physical access or financial transmission rights) will necessarily limit the considerations into the allocation of shared network costs between users of the transmission system.

However within this constraint we consider there are considerable efficiencies to be gained in restoring some locational incentives to new generators and providing existing generators some certainty that the access provided by the shared grid when they made their investments will be retained.

To that regard we recommend the AEMC include in the scope at least two key features of an efficient generator transmission access regime:

- A principle that generators should have their existing market access defined and retained; and
- Where shared transmission augmentations are required to retain that access, a principle that the funding of the augmentation come from the causer of the loss of access, e.g. a new generator locating in a congested area, or that the causer of the loss of access compensate the other generators for that loss of access. The latter approach is consistent with clause 5.5 of the Rules, but the rules need to be revised to make their application practical.

The AEMC should review the pricing principles that apply to TNSPs in chapter 6 as part of this review to enhance the efficiency of the pricing principles.

2.6 Addressing apparent anomalies and ambiguities in the application of the CRNP framework under the Rules, particularly in the application of Modified CRNP.

We believe any review of the application of the CRNP framework should be limited to demonstrated anomalies that can be relatively easily corrected to promote more efficient outcomes and incentives. Issues worthy of consideration include the lack of any ceiling in the level of individual TUOS Usage prices, particularly evident under the Modified CRNP framework (understood to be in use by only one TNSP) and the 2% limit on annual price movements, which not only restrains increases but perversely acts to prevent decreases also.

3. Conclusion

The Group supports the AEMC view that the review of the revenue and price regulation Rules for transmission raises complex issues that interact with the operation of the wholesale energy market. The review will need to take these into consideration while remaining focussed on the primary objective of improving the transmission regulation arrangements to better meet the NEM objectives.

In relation to the transmission revenue and pricing rules the group acknowledges the comprehensive contribution that the ACCC has made regarding transmission regulation in the NEM. Therefore the Group's preferred approach is to limit the scope of this review to areas where it believes that there is room for the refinement of the rules applied to transmission particularly those areas with an impact upon competitive generation. It hopes that the AEMC has been convinced of these arguments and looks forward to undertaking much more comprehensive analysis on the issues raised in this paper when the "Issues Paper" is released.

Yours Sincerely

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