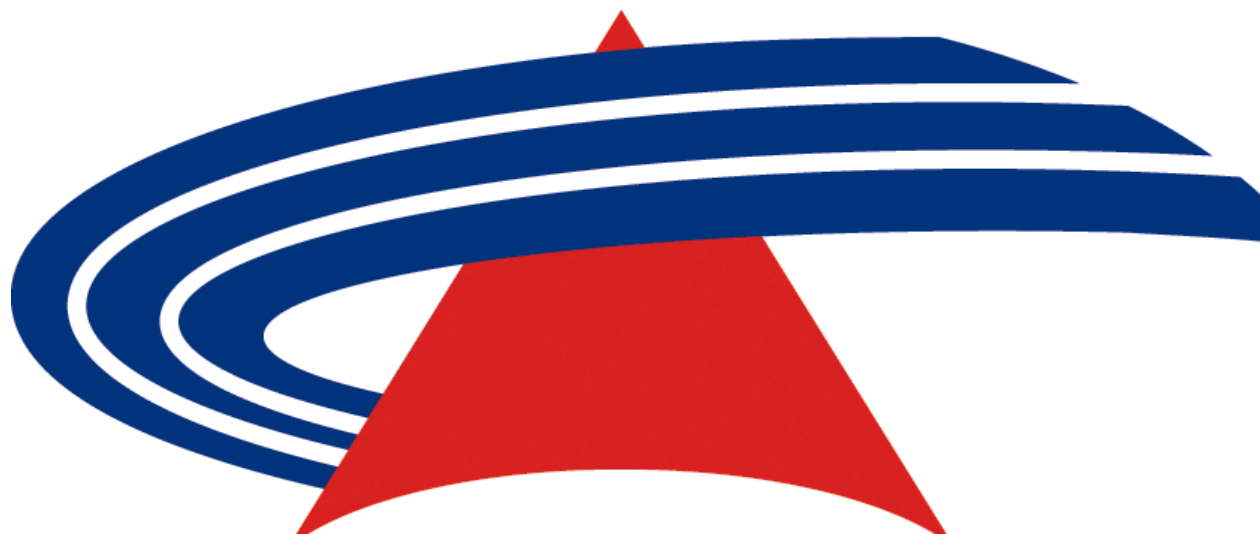


**POWERLINK QUEENSLAND**

RESPONSE TO: AEMC REVIEW OF THE ELECTRICITY TRANSMISSION REVENUE  
AND PRICING RULES

REVENUE REQUIREMENTS: ISSUES PAPER

16 November 2005



## Introduction

Powerlink provides this response to the AEMC's Issues Paper on Review of the Electricity Transmission Revenue and Pricing Rules, published for consultation in October 2005. It contains comments on the key themes and main aims of the review and provides answers to selected questions.

Powerlink has also contributed to a joint submission by Transmission Network Owners<sup>1</sup> (TNOs) in response to the Issues Paper. Our comments herein are in addition to that joint submission and are consistent with it.

### Fundamental Matter – Reliability

We strongly believe that the Issues Paper does not adequately consider the primacy of the mandated reliability obligations (and onerous sanctions) faced by transmission entities.

These mandated obligations, which are enshrined in instruments such as Electricity Acts, transmission licences, codes, connection agreements etc, drive almost all of a transmission entity's capital investment and operating costs, and are therefore a major driver of the regulated revenue requirement.

This, in turn, leads to the conclusion that the Rules must require the regulator to provide the entity with sufficient revenue to meet these mandated obligations.

In terms of alignment, this has created a strong, well-established (reliability-driven) alignment between the transmission entity and electricity consumers. The primacy of this alignment has been recognised and reinforced by a range of other policy settings, including:

- The NEL having a specific clause (35 (3)(a)) requiring the revenue Rules to provide revenue to meet such obligations;
- the Regulatory Test having a specific limb for reliability augmentations;
- the Ministerial Council on Energy (MCE), in its policy background on Regulatory Test dispute arrangements, stressing the importance of ensuring that delays as a result of disputes do not compromise security and reliability of supply; and
- the Queensland government (after the Somerville report) instituting similar mandated reliability requirements for the backbone of the distribution networks.

The AEMC should ensure that this review delivers outcomes which support, and not dilute, this fundamental reliability-driven alignment, and should ensure that any other alignments sought do not undermine this strong primary alignment.

<sup>1</sup> ElectraNet Pty Limited, Powerlink Queensland, SP AusNet, Transend Networks Pty Ltd and TransGrid.



## AEMC Review of Revenue and Pricing

Powerlink notes that the Issues Paper is part of the AEMC's consultation associated with the obligation in the National Electricity Law (NEL) to make rules in relation to the economic regulation of transmission systems. The AEMC has a legislative requirement to have rules in place by 30 June 2006. The obligation on the AEMC is specifically in relation to revenue and pricing associated with electricity transmission businesses.

The Rules prepared by the AEMC are to be assessed by the Rule Making test set out in the NEL relating to contribution to the national electricity market objective. In making its assessment the AEMC may give weight to aspects of the objective as it considers appropriate, having regard to any MCE statements of policy principles. In addition to the 'normal' rule making test sections 35 and 36 of the NEL contain more detailed requirements specifically in relation to economic regulation of electricity transmission. As such they are binding on the AEMC in its assessment of Rules both during this review and any further changes to the Rules proposed at any time in the future.

Section 35(3) is as follows:

- (3) Rules made as required by this section must—
  - (a) provide a reasonable opportunity for a regulated transmission system operator to recover the efficient costs of complying with a regulatory obligation; and
  - (b) provide effective incentives to a regulated transmission system operator to promote economic efficiency in the provision by it of services that are the subject of a transmission determination, including—
    - (i) the making of efficient investments in the transmission system owned, controlled or operated by it and used to provide services that are the subject of a transmission determination; and
    - (ii) the efficient provision by it of services that are the subject of a transmission determination; and
  - (c) require the AER, in making a transmission determination, to make allowance for the value of assets forming part of a transmission system owned, controlled or operated by a regulated transmission system operator, and the value of proposed new assets to form part of that transmission system, that are, or are to be, used to provide services that are the subject of a transmission determination; and
  - (d) require the AER to have regard to any valuation of assets forming part of a transmission system owned, controlled or operated by a regulated transmission system operator applied in any relevant determination or decision.
- (4) In this section—
 

**relevant determination or decision** means—

  - (a) any previous transmission determination; or
  - (b) a determination or decision under the National Electricity Code or jurisdictional electricity legislation regulating the revenue earned, or prices charged, by a regulated transmission system operator in respect of services provided by it that were regulated under the Code or that legislation.



The AEMC's Issues Paper makes reference to these obligations at various places throughout the document but does not discuss the interaction of these specific obligations with the rule making test. As these requirements are in the NEL they must be satisfied.

### Key Themes

The AEMC Issues Paper discusses two key themes that it considers will contribute to the achievement of the NEM objective. These are:

1. Aligning the long term incentives of transmission service providers with those of other market participants including end use customers.... ; and
2. Increasing the clarity, certainty and transparency of the regulatory approach....

It is notable by omission that these key themes are stated with reference only to the NEM objective and not the other NEL requirements in relation to economic regulation of electricity transmission systems (eg. section 35(3) of the NEL cited above).

### Alignment

The Issues Paper suggests that the emphasis in the NEL objective on efficiency for the long term benefit of consumers leads to an important theme for the Rules. That is, to facilitate efficient development and operation through effective incentives and processes. The Issues Paper then states that efficient incentives and processes should "work towards reducing or eliminating network constraints, where it is efficient to do so"<sup>2</sup>.

As noted above, this analysis of what should be one of the key themes for this review neglects discussion of the reason for nearly all investment in transmission – **keeping the lights on** – more technically referred to as "**reliability of supply**".

The MCE has recognised the primacy of investments for reliability purposes vs other reasons including reducing constraints. Its recently published Rule Change Application Reform of the Regulatory Test Principles<sup>3</sup> includes the following:

*"Most network investment is undertaken to maintain network performance requirements, including reliability standards."*

Powerlink has very clear, mandated (legally binding) reliability of supply obligations, including in its transmission licence.

*"The transmission entity must plan and develop its transmission grid in accordance with good electricity industry practice such that... the power transfer available through the power system will be adequate to supply the forecast peak demand during the most critical single network element outage."*

<sup>2</sup> AEMC Revenue Requirements: Issue Paper October 2005 p10.

<sup>3</sup> Letter from MCE Chair, The Hon Ian Macfarlane, to AEMC Chair, Dr J Tamblyn [www.aemc.gov.au](http://www.aemc.gov.au).



Powerlink's licence is a jurisdictional instrument with which Powerlink must comply. Failure to do so may result in loss of licence – a sanction Powerlink takes very seriously. Other TNSPs have similar obligations and in some cases even more onerous sanctions. These very clear obligations have ensured there is very strong alignment between Powerlink's actions and the interests of end use customers.

The MCE acknowledges that jurisdictional instruments place regulatory obligations on TNSPs in its stated policy intent in relation to the proposed Regulatory Test rule changes it recently sent to the AEMC is (emphasis added):

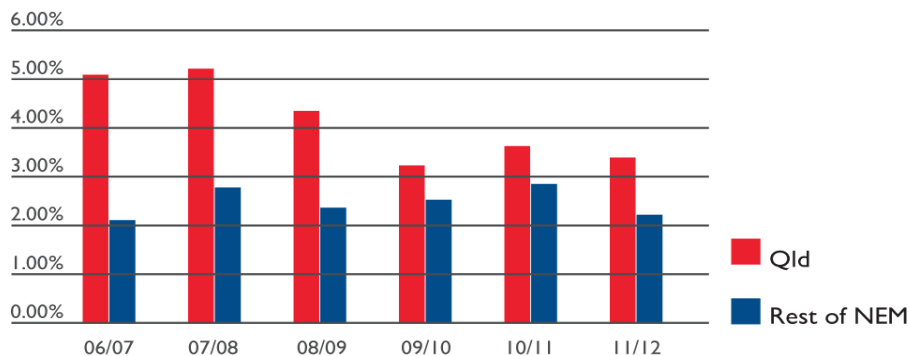
*“To allow NSPs to recover the efficient costs of maintaining a secure and reliable power system for end-users, the regulatory test must reflect the requirement for NSPs to meet network performance standards linked to the technical requirements of Schedule 5.1 of the Rules or **in applicable regulatory instruments**, while minimising the present value of the costs of meeting those requirements.”<sup>4</sup>*

The MCE also recognises the primacy of these reliability obligations in the policy background section of the proposed rule changes for Reform of the Dispute Resolution Process for the Regulatory Test (emphasis added):

*“Disputes concerning reliability augmentations are generally less complex, however **far more important to resolve quickly**. Delays in resolving disputes concerning reliability augmentations have the **potential to impact system security** if augmentations are not allowed to proceed when a need is identified.”<sup>5</sup>*

The magnitude of this issue for Powerlink can be demonstrated by reference to demand growth in Queensland which is higher than anywhere else in the NEM.

#### Peak demand growth rate



<sup>4</sup> Letter from MCE Chair, The Hon Ian Macfarlane, to AEMC Chair, Dr J Tamblyn [www.aemc.gov.au](http://www.aemc.gov.au)

<sup>5</sup> Letter from MCE Chair, The Hon Ian Macfarlane, to AEMC Chair, Dr J Tamblyn [www.aemc.gov.au](http://www.aemc.gov.au)



These realities are so pivotal that any consideration of the relevant Rules must take these things into account. Without the real world context of mandated reliability as the centrepiece of transmission operation and investment behaviour, many of the questions in the Issues Paper become either academic or are likely to lead to erroneous conclusions.

The difference in focus between reliability of supply and removal of constraints in the Australian NEM is epitomised by the difference in mandated obligations. In the case of reliability of supply, most jurisdictions have put in place legally binding arrangements for TNSPs to meet. By contrast, there are no arrangements in place which mandate or provide any deterministic guidance about the appropriate level of constraints in the NEM. Electricity market arrangements in Alberta provide an example of where such mandated constraint levels have been provided by policy makers. In the Australian NEM the appropriate level is effectively set by the Regulatory Test, a net market benefits test (very little investment in transmission has been realised under this limb of the test).

### **Certainty**

In response to the AEMC's Scoping Paper TNOs made a submission highlighting the need for certainty. The submission stated:

*"The first priority for TNOs in relation to the Australian Energy Market Commission (AEMC) review is ensuring regulatory certainty and stability for both investors and users of the transmission networks. In particular, TNOs believe that this can best be achieved by not re-opening the Statement of Regulatory Principles (SRP) and its supporting regulatory framework."*

The arrangements for regulation of transmission revenues has been in continual development and change since the start of the NEM in 1998. The National Electricity Code (now National Electricity Rules) included high level principles for the regulation of electricity transmission, leaving the detail to be filled in by the regulator (at the time the ACCC and now the AER).

The importance of a stable framework over time promoting efficient investment is recognised by the MCE. Its Rule Change Application Reform of the Regulatory Test Principles<sup>6</sup>, recently sent to the AEMC, includes the following:

*"The proposed Rule change will promote efficient investment because potential investment will be evaluated through a stable framework over time, which can only be changed through a consultative and transparent process."*

To assist with clarity the ACCC issued a Draft Statement of Regulatory Principles in May 1999. During 2002 and 2003 the ACCC sought to finalise its Statement of Regulatory Principles. Substantial changes were made to the arrangements during this process – most significantly to the capex incentive arrangements by replacing the ex post

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<sup>6</sup> Letter from MCE Chair, The Hon Ian Macfarlane, to AEMC Chair, Dr J Tamblyn [www.aemc.gov.au](http://www.aemc.gov.au).



assessment with ex ante, but also changing the incentive arrangements for opex, clarifying the asset base arrangements and fixing several parameters in the determination of the rate of return.

Notwithstanding that there were elements of the SRP which were regarded as suboptimal by some transmission entities, finalisation of the SRP was a lengthy but positive step and was welcomed by all transmission companies as providing greater certainty in the revenue regulation arrangements. Unfortunately, these changes occurred during TransGrid and Energy Australia's revenue determinations and resulted in substantial additional work for both transmission businesses and the ACCC plus considerable delays in reaching a decision. These businesses received their Final Decisions in April 2005, nine months after the start of their revenue periods and almost one full year later than required to determine TUOS prices. The change of arrangements during those determinations was also criticised by the EUAA in its submission to the AEMC Scoping Paper<sup>7</sup>.

Powerlink is now well advanced in preparing its revenue application for the 2007-2012 regulatory period. The application is to be submitted to the AER on 1 April 2006. The Rules and arrangements under which Powerlink's revenue application will be assessed should already be known – by Powerlink, by the AER, and by key stakeholders such as the EUAA. Unfortunately that is not the case. It is difficult to accept that regulatory best practice should include opportunities for the rules to be modified during a revenue determination.

It is acknowledged that the AER Statement of Regulatory Principles (SRP) is not binding on the AER and that under the current arrangements the AER has discretion to diverge from their own principles. It is also relevant that the SRP does not fully comply with the National Electricity Rules – a fact which the ACCC acknowledged in its December 2004 Decision<sup>8</sup>. Powerlink and most other transmission businesses considered that the ACCC should have developed principles within the Rules which applied to it at the time.

Powerlink considers that the appropriate balance between matters which rightfully remain at the discretion of the regulator and those which are not subject to discretion should be an important area of focus for the AEMC. A line in the sand must also be drawn after which time the arrangements for a revenue determination cannot be changed. Given the effort associated with a revenue determination (by the regulated business, the regulator, and the key stakeholders) the line should be 2½ years prior to the start of the new regulatory period. This would add to the efficiency of determining revenues by eliminating rework and avoiding unnecessary increases in the cost of revenue regulation which is ultimately passed through to electricity consumers.

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<sup>7</sup> EUAA Response to AEMC Review of the Electricity Transmission Revenue and Pricing Rules: Initial Consultation Scoping Paper, p2.

<sup>8</sup> ACCC Decision, Statement of principles for the regulation of electricity transmission revenues – background paper, 8 December 2004, p86.



While there are certain aspects of the SRP that Powerlink regarded as suboptimal and therefore argued against during the extensive consultation by the ACCC<sup>9</sup>, Powerlink considers that certainty of arrangements is more important than ongoing changes which may result in improvements (in the eyes of some parties) to the arrangements. This is a particular issue for Powerlink as the AEMC has not provided any comfort that either our current decision or imminent revenue determination process will be protected from any substantial changes to the Rules coming out of this review.

### **Conclusion**

The key theme of alignment must recognise the established strong alignment emanating from mandated reliability obligations on TNSPs, and the reinforcement of that alignment which is embedded in policy settings, the NEL, the Rules and other instruments.

The key theme of certainty is strongly supported in achieving outcomes that are in the long term interests of consumers. We support the EUAA position that the arrangements should not change during a revenue determination. The imminent Powerlink determination represents an ideal opportunity for the AEMC to promote certainty.

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<sup>9</sup> See Powerlink submissions on DRP [www.aer.gov.au](http://www.aer.gov.au)





**Answers to Selected Questions.**

Whilst Powerlink is a contributor to the joint response to the AEMC's Issues Paper by the TNOs, we have presented here responses to selected questions on topics which have a particular relevance to the Queensland situation, or which draw upon specific Powerlink experiences as the largest transmission investor in the NEM and the largest acquirer of non-network services. Whilst all matters pertaining to revenue regulation are important to Powerlink, we have not responded here to all questions as there is considerable overlap between the issues underpinning some of the questions.

**Q14. Operation of the revenue cap.**

An ex-post prudency capex model is more flexible and is intrinsically better suited to the circumstances such as Queensland where there is high load growth, increasing and volatile input costs, and changing environmental drivers which result in step changes in costs eg. more undergrounding. An ex-ante capex cap model is better suited to more "steady state" or low change environments.

**Q22. Services within the revenue cap.**

The existing delineation is appropriate. In Queensland, the legal obligations to develop the shared network (regulated) rest with Powerlink, together with clear accountability for reliability outcomes.

All connections established before 1 January 1995 (when the Qld Grid Code came into effect) are regulated and remain regulated. 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. These investments are regulated for both the TNSP and the DNSP.

In contrast, where the decision to connect to the grid is discretionary, the connecting party (usually a generator or large load) is free to choose who owns, develops and maintains those connection assets. Due to the different individual circumstances and commercial requirements of the connecting party, it is appropriate that these are negotiated (non-regulated) services. There have been a large number of new connections in Queensland established through direct negotiations with new generation or loads, and these invariably involve compressed timetables imposed by the connecting party. The delineation is based on whether or not there are mandated obligations on providing the services.

**Qs 23 – 28. Services outside the revenue cap.**

Between them, Powerlink and ElectraNet (in which Powerlink has an ownership interest) have negotiated and developed more than 90% of the new non-regulated connections in the NEM, mostly new generators. Our experience is that all new connecting parties have different technical and commercial requirements. A common feature is a desire for a "fast tracked" connection and an incentive model (penalty/bonus) to facilitate this. Our



experience in both Queensland and South Australia is that the outcomes have been more than satisfactory for all concerned.

Q29. Contestable services.

The current definition of prescribed services appears to contain some circularity and could be improved to reflect the practice described above.

Qs30 - 35. Prescribed and non-prescribed services.

Powerlink considers that the current arrangements work well for all concerned and should not be changed. Investments required to meet obligations are included in the revenue cap application submitted by the TNSP. There is no problem that needs to be addressed. Should difficulties arise, there are existing avenues of recourse. Powerlink has made more investments in assets outside the revenue cap than any other TNSP. None of these negotiated investments have resulted in a dispute being raised regarding the provision of services. All new connections have met the (compressed) timelines required by the connecting party.

Qs36-40. Service performance standards.

The regulatory framework must, first and foremost, support the mandated reliability obligations faced by transmission entities. That is, the revenue cap must provide adequate revenue for the transmission entity to meet its mandated obligations under the Rules and any other relevant legislation or instruments.

It is a fundamental principle that an entity can only be accountable for performance of matters which it can effectively control and manage. By way of example, since the transfer capability of the grid dynamically varies according to, inter alia, which generators are running at the time, it follows that a transmission entity cannot be accountable for the transfer capability. However, this does not preclude the entity from being incentivised to optimise the contribution it can effectively control. To do otherwise would require the entity to be rewarded by way of an additional risk premium on its return on investment.

Qs41-44. Capital expenditure

The Rules already require the transmission entities to publish an Annual Planning Report containing information about forecast constraints and reliability shortfalls, and to participate and co-operate with NEMMCO to produce the ANTS for the major national flow paths. All of this happens as intended.

The Rules already require proper consideration of non-network solutions. Powerlink spends more than \$14 million per year on non-network solutions.

The Rules already provide for funded augmentations – surely the funding is enough incentive? Other parties can already develop connection assets – the choice is made by the connecting party.



Q46. Regulated asset base.

During the extensive consultations associated with the ACCC's finalisation of the Statement of Regulatory Principles, Powerlink was neutral on whether sunk assets should be subject to a revaluation at some or all revenue determinations. Powerlink supports certainty in revenue arrangements and regards the adoption of the existing arrangements as a known package.

However, there is an argument that assets should be revalued at each reset to reflect modern day replacement costs, in order to ensure pricing equity. Transmission pricing uses a component of "cost reflective" pricing, which is derived from the value of the assets servicing the customers in an area. If the value of existing assets is "locked in" at old replacement costs, and new assets are rolled in at modern day replacement costs, then this anomaly will result in a distortion of the cost-reflective prices. This can be overcome by revaluing all assets at modern day replacement cost.

Qs.47-51. Capital expenditure

An ex-post prudency capex model is more flexible and intrinsically better suited to circumstances (such as Queensland) where there is high load growth, increasing and volatile input costs, and changing environmental drivers which result in step changes in costs eg. more undergrounding. An ex-ante capex cap is better suited to "steady state" or low change environments.

Q54-56. Performance incentive arrangements.

Irrespective of any incentive arrangements, the AER needs to provide the entity with adequate revenue to meet its mandated reliability obligations and the Rules should require the AER to do this.

Q59. Prior approval by regulator.

If such a mechanism were to be made available, it must be at the choice of the transmission entity. The Rules should not force the entity to take individual investments to the AER – to do so would introduce intolerable delays into the process, and potentially cause the entity to fail to meet its mandated reliability standards. It must be remembered that the main game is to keep the lights on. The MCE's policy position acknowledges the timing imperative associated with reliability augmentations. The recently published Rule Change Application Reform of the Dispute Process for the Regulatory Test<sup>10</sup> includes the following:

*"Delays in resolving disputes concerning reliability augmentations have the potential to impact system security if augmentations are not allowed to proceed when a need is identified."*

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<sup>10</sup> Letter from MCE Chair, The Hon Ian Macfarlane, to AEMC Chair, Dr J Tamblyn [www.aemc.gov.au](http://www.aemc.gov.au).



Qs66-68. Use of the Regulatory Test.

There are obvious problems in estimating the precise value of capital works, especially in the present environment of a seller's market for construction services. It needs to be recognised that the Regulatory Test is about ranking alternatives, and not about absolute costs. In addition, the Regulatory Test already requires the result to be sensitivity-tested against variations in capital cost.

Whilst the philosophy behind the question on reapplying the Regulatory Test is understandable, it must be recognised that keeping the lights on is critical. The Rules should not impose requirements which would delay an augmentation required to maintain reliability (as a re-run of the Test and all its consultation periods would entail). It would be better to have other non-delay approaches to testing the prudence of investments.

Q96. Objectives

The NEL contains the objectives for revenue determinations for electricity transmission businesses. These are the overall NEM objective plus the objectives clearly stated in S35(3) of the NEL. S36 of the NEL requires that rules associated with the regulation of revenue for transmission businesses always comply with these criteria. The current NER have many and varied objectives for revenue regulation and this confusion of overlapping and potentially conflicting objectives should be avoided by simply referring to the objectives established in the NEL.

Q120-121. Erring towards the investors proposals.

This question is best answered by a regulator. The Queensland Competition Authority, which undertook revenue determinations for DNSPs in April 2005, following a series of reliability failures, concluded :

*“It is clear that the community is not prepared to risk falling service quality and potential system failure in return for lower prices. On the contrary, there is an apparent expectation that service quality should increase and that system security should be paramount.”*

Q123. Transitional arrangements.

Existing revenue decisions should continue unaltered until the end of the designated periods for those decisions. It is our understanding that a key element of the recent MCE decision to transition the economic regulation of electricity distribution networks to the AER is that existing revenue determinations will continue unaltered until the end of the designated period.

Powerlink is already past the “point of no return” in preparing its next revenue application, which necessarily is based on the SRP. A proper derogation is required, not “perhaps transitional Rules”. We note that, in its submission on the scoping paper, the EUAA argued for advance certainty of regime.

