



13 January 2011

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Australian Energy Market Commission
PO Box A2449
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Dear Commissioners,

ERC0100: National Electricity Amendment (Scale Efficient Network Extensions) Rule 2011- Draft Rule Determination

A: Background

The AEMC consulted with the market over a period of 18 months to change the connection framework to facilitate the more efficient connection of multiple generators seeking connection to the network in the same geographic region. Following the Energy Markets Frameworks Review,¹ the AEMC determined that it was likely that in response to the RERT, it could be that clusters of renewable generation develop in specific geographical regions. Therefore, without making the necessary changes to the connection framework, there was a real risk that renewable generators would duplicate network assets inefficiently in order to connect to the network. In addition, there would be delays in connection where network extensions could not be coordinated or built to an efficient scale in order to connect these renewable clusters of generation.

¹ Review of the Energy Market Frameworks in light of Climate Change Policies – Final Report : 30 September 2009

The MCE submitted a rule change request to the AEMC on 15 February 2010 to address this problem. In short, the rule change sought to revise the connection framework to ensure renewable clusters of generation would connect to the network in the same location in the most efficient manner. In addition, the rule change would allow generators located in a similar geographical location to connect to a SENE below their stand alone connection costs. Ultimately, the revised connection arrangements that allowed generators to connect SENEs below their stand alone costs would deliver renewable generators lower connection costs. In the long run, the benefits of these lower connection costs would be passed through as efficiency gains to consumers in the form of lower energy and renewable certificate prices. However, a key challenge in scaling up the size of a connection assets in order to build speculative capacity in anticipation of future connections was the risk of being unable to recover the potential costs incurred if the additional capacity was left unused.

The AEMC reviewed the MCE rule change submitted 15 February 2010 and rejected it. It rejected the current rule change request on the basis that it did not agree that consumers were the most appropriate party to assume the asset stranding risk associated with developing SENE. As we understand it, the AEMC was reluctant for consumers to underwrite any asset stranding risk in an environment where energy prices have been increasing rapidly as a result of increases in network charges. It is not clear on what basis the AEMC has now determined that this potential cost exceeds the savings to energy and renewable prices forecast in the Commissions earlier decision.

B: Key position

TRUenergy submits that the National Electricity Amendment (Scale Efficient Network Extensions) Rule 2011- Draft Rule Determination will not contribute to the National Electricity Objective (NEO) compared to the Ministerial Council of Energy (MCE) rule change.

The draft rule

- does not mitigate the asset standing risk associated with developing SENEs **for a TNSP** under the current framework in order for them to build these assets; therefore, SENEs will not get built and renewable generators will continue to inefficiently duplicate smaller stand alone assets in order to connect with resulting adverse impacts on energy and renewable certificate pricing;
- assumes a commercial entity will take on the asset stranding risk associated with a SENE on the assumption that it will receive a connection cost below its stand alone costs which is not realistic
- provides a regulatory decision that could not be predicted based on the earlier evidence presented by the AEMC following a lengthy consultation process;
- raises some interesting questions regarding the classification of a SENE as a transmission service and its treatment as part of the shared network; and
- does not deal with the issue of constrained off/on payments for the payment of privately funded connection assets like SENEs.

TRUenergy believes the MCE rule change submitted on 15 February 2010 will better contribute to the NEO. The rule change (as proposed) specifically addresses the key deficiencies in the current arrangements which do not provide the commercial incentive for network businesses to bear the risk of building assets to efficient scale in advance of future connection. In short, the MCR rule change addresses his lack of incentive and reduces the scope for inefficient duplication of assets and ensures that economies of scale are realised. Therefore, it is more likely to contribute to the National Electricity Objective (NEO) because it promotes efficient investment in electricity services.

TRUenergy submits its key concerns on the Draft Rule for the AEMC to consider in the rest of this submission.

C: Key issues

1 The draft rule does not mitigate the asset stranding risk associated with developing SENE for TNSPs under the current framework in order for them to build these assets. Therefore SENE will rarely get built.

TRUenergy remains concerned that the form of SENE proposed in the draft rule will not address the asset stranding risk associated with developing a SENE appropriately for a TNSP. As a consequence, SENE will rarely get built depriving the market of a wide range of efficiency benefits.

TNSPs identified the asset stranding risk associated with developing SENE as the major obstacle to building these assets. The MCE agreed with this observation in its proposed rule change.² As far as we can see, the SENE proposed in the draft rule - which provides for the commercial parties that fund the SENE to take on and allocate the risks associated with the SENE amongst themselves - fails to adequately mitigate this key risk for TNSPs. We believe the market based solution embedded in the draft rule does not adequately deal with what we regard as a major stumbling block in the workability of SENE. In our view, the current regulatory arrangements already provide for this solution in the current connection framework. In fact, there is nothing in the current connection framework that prevents a group of entities from paying for a SENE for other parties to connect too in the future. Therefore, because we have not seen any SENE been built under the current connection framework, we expect this will continue if the draft rule is accepted in its current form. In short, because the draft rule fails to realistically mitigate the asset stranding risk associated in developing a SENE for a TNSP, it runs the risk of being irrelevant. As a consequence, TNSPs will refrain from building SENE.

TRUenergy considers that the MCE's rule change proposal submitted on the 15 February 2010 provided the market with a reasonable approach to mitigating the asset stranding risk associated with a SENE. We believe that the rule change (as drafted) included certain design features that would address the issue of TNSPs' reluctance to build SENE. In short, the MCE rule change included a design feature for SENE where consumers would underwrite the asset stranding risk combined with a stronger regulatory oversight role for the AER. As we understand it, the MCE rule change submitted 15 February 2010 considered this to be a critical element of the SENE design.³ The AER would provide additional regulatory oversight in order to reduce the asset stranding risk for consumers. We believe that the combination of these two factors together would adequately mitigate the asset stranding risk associated with building a SENE. More importantly, the efficiency benefits associated with the development of SENE may actually be realised because it is likely that we may get some SENE built under this model.

2: The draft rule assumes a commercial entity will take on the asset stranding risk associated with a SENE on the assumption that it will receive a connection cost below its stand alone costs which is not realistic

TRUenergy disagrees with the proposition inherent in the draft rule that an entity (either individually or collectively) will fund a SENE in order to secure connection costs below their stand alone costs. The idea of underwriting the asset stranding risk of a SENE in order to secure connection costs below your stand alone connection costs adds a

² MCE Rule Change request – Scale Efficient Network Extensions

Implementation of the Rule change recommendations of the review of the Energy markets in light of Climate Change Policies undertaken by the Australian Energy Market Commission – Feb. 201. p. 4

“The existing framework does not provide network business with a commercial incentive to build network connections to an efficient scale to accommodate anticipated future connections. If the predicted generation does not eventuate, the network business would have a connection asset but no-one to recover the cost from, leaving it with a stranded asset.

³ MCE Rule Change request – Scale Efficient Network Extensions

Implementation of the Rule change recommendations of the review of the Energy markets in light of Climate Change Policies undertaken by the Australian Energy Market Commission – Feb. 201. p. 2

“The proposed rule introduced a new framework for planning, charging and revenue recovery of SENE and adjustments to the process of connections. An important element in this regard is a mechanism that minimises the risks to customers from SEN E assets being under utilised by generators. “

disproportional business risk that a rational entity (like a renewable generator) would most likely avoid in most cases. The MCE's rule change proposal submitted on the 15 February 2010 specifically outlined this concern.⁴ Therefore, we believe most renewable generators would be unwilling to take on this risk and add to the commercial risk of recovering the costs of its generation investment. In short, renewable generators are not the best entity placed to manage transmission risk.

TRUenergy considers that the current draft rule will make funding a SENE attractive in only a minority of situations. For example, in some circumstances, it could make sense for a range of renewable generators to negotiate together to have a SENE built in order to secure connection costs below their stand alone costs. However, we believe that this situation will be highly unlikely as the timing and cost risks associated with trying to negotiate a more complex connection arrangement for a connecting party will overcome any upside risks from sharing connection asset costs (one of the key reasons we have not seen examples of this in the past). By removing some of the basic design features of the SENE reflected in the MCE rule proposal brought 15 February 2010 (especially the requirement to underwrite the asset stranding risk) SENEs will seldom get built.

3. The predictability of the draft rule determination

TRUenergy submits that the outcome of the draft rule determination could not be predicted based on the evidence presented in a long consultation process.

TRUenergy regards the predictability of regulatory decisions as critical. As a result, we expect that any decision delivered by the AEMC will reflect the outcomes of the consultation process. As we understand it, regulators themselves regard the predictability of decisions to be a critical issue.⁵ In addition, the AEMC has reiterated the importance of a predictable regulatory environment in its publication of its "Strategic Priorities for Energy Market Development."⁶ Thus, to the extent that the draft rule delivers a solution that fails to address the original problem identified in the connection framework – that is the reluctance of TNSPs to build SENEs due to asset stranding risk – represents a surprise following the previous exhaustive consultation process.

TRUenergy submits that the AEMC regulatory decisions leading up to the MCE rule change provide clear evidence that the AEMC did identify a problem with the current connection framework that prevented SENEs from being built by TNSPs, as well as the desirability and potential benefits of that model. It was very clear, that under the current connection framework, TNSPs would not get any reward and incur potentially significant costs, for bearing the risk of

⁴ MCE Rule Change request – Scale Efficient Network Extensions

Implementation of the Rule change recommendations of the review of the Energy markets in light of Climate Change Policies undertaken by the Australian Energy Market Commission – Feb. 2011. p. 4

"It is also unlikely that the initial connecting party would be willing to pay for the excess connection capacity given it is likely to facilitate the future connection of a competitor. "

⁵ Developments in Best Practice regulation: Principles, Processes and Performance – Sanford Berg: 25-4-2000: p2

"Recently, Australia's Utility Regulators Forum (1999) generated a Discussion paper of "Best Practice Utility Regulation" prepared as part of a program to promote the exchange of ideas regarding regulatory activities. The authors identified Nine best practice principles:

1. Communication
2. Consultation
3. Consistency
4. **Predictability**
5. Flexibility
6. Independence
7. Effectiveness and Efficiency
8. Accountability
9. Transparency

⁶ AEMC: "Strategic priorities for Energy Market Development " Discussion paper 2011 p.6:

" We have identified three strategic priorities that will help us address these emerging challenges:

- **A predictable regulatory and market environment** for rewarding economically efficient investment
- Building the capability and capturing the value of flexible demand
- Ensuring the transmission frameworks delivers efficient and timely investment

building SENEs. After discovering this risk, the AEMC rigorously examined a wide range of options to address this problem in the current connection framework. In doing this, the AEMC:

- proposed a SENE model following The Energy Markets Framework Review second interim report ⁷ that required consumers to underwrite the asset standing risk of a SENE;
- reiterated this view in its final decision of its Energy Markets Framework Review ⁸ where it decided consumers were best placed to underwrite the asset standing risk of a SENE; and
- considered a range of alternative SENE options in the Options paper ⁹ as part of the consultation process to address this risk. Interestingly, 3 of the 5 SENE Options included design characteristics which required consumers to underwrite the asset stranding risk of the SENE. In the other two options, consumers actually paid for the SENE, which we regard as inappropriate.

As the Draft Determination is a significant departure from the direction indicated in the Options paper – which clearly focused on addressing the TNSPs reluctance to build SENEs – the ideal of regulatory predictability has not been met in this instance.

4. The AEMC's treatment of the SENE as part of the shared network

TRUenergy submits that the idea that a SENE is treated as a negotiated service or a non regulated service which forms part of the shared network represents a new idea.

Whilst we understand that the AEMC has assumed this position in order to ensure that third parties are able to connect to the SENE under open access, we are not so sure that this assumption is technically correct.

TRUenergy understands that Clause 6 of the original Competition Principles Agreement following the Hilmer Report required for governments to establish a regime for third party access to services provided by means of significant infrastructure facilities where:

- It would not be economically feasible to duplicate the facility;
- Access to the service was necessary in order to permit effective competition in a downstream market;
- The facility was of national significance having regard to the size of the facility, and its importance to the national economy; and
- The safe use of the facility could be ensured at an economically feasible cost.

But, clause 6 of the Competitions Principles Agreement provides that state and territory access regimes may apply to essential facilities (instead of the proposed access introduced under Part IIIA of the Trade Practices Act 1974) in certain circumstances. These circumstances applied when a state or territory access regime was certified as “effective”.

⁷ AEMC 2nd Interim Report – Review of the Energy Markets Frameworks in light of Climate change Policies. P.20

“The NER will require that prices for NERGs apply to the regulated rate of return and be set with the expectation that generators will pay for all the assets. Customers will be exposed to the costs of the NERG if generators arrive late or do not materialise, but will receive payments if generators arrive early or in excess of their forecasts”

⁸ Review of the Energy Market Frameworks in light of Climate Change Policies – Final Report: 30 September 2009. p.6

“In the context of the NEM, we are recommending changes to facilitate the efficient network investment in connection assets sized to allow for future generation connection. The change we recommend involves exposing customers to the costs of connection assets if the forecast new generation connections do not subsequently occur. To address this potential risk for customers, we propose that the Australian Energy Regulator, taking into consideration advice from AEMO, as the capacity to reject investment proposals.”

⁹ Options paper – National Electricity Amendment (Scale Efficient Network Extensions) Rule 2010 30 September, 2010.

The National Electricity Code was accepted under Part III A as an effective undertaking. Thus, we accept that the prescribed transmission services on the shared network are considered to have passed the national significance infrastructure facilities test; thus, they are regulated under a revenue cap and subject to an open access regime. However, we are not so sure that privately funded connection assets (like SENEs) have passed the national significance infrastructure test (referred to above) and should automatically be presumed to be subject to some form of open access.

Finally, as we have mentioned above, Grid Australia will most likely treat SENEs as connection assets (extensions), which they treat as non regulated transmission assets.¹⁰ In contrast AEMO, as Victorian NSP, will most likely treat a SENE as a negotiated service. Therefore, we are not sure how the AEMC can consider SENEs as part of the shared network, when they are not clearly treated that way by existing TNSPs.

Therefore, we request that the AEMC think much further about this issue before drawing this conclusion.

5: Constrained off payments for SENEs

TRUenergy remains disappointed that a party who chooses to fund a SENE does not receive some form of property right that entitles them to a form of constrained off payments where another third party connects to the SENE. Indeed it would appear that the AEMC has assumed that private entities will be prepared to take the stranding risk of building a SENE, on the basis they will subsequently profit from providing connection services to future connectors. In the absence of a property right that can be sold to future connectors, this assumption does not appear realistic. On the basis that a private party will end up paying for a SENE, we see no reason why they should not receive some form of property right in exchange for that investment. In addition, we are not convinced that these assets do form part of the shared network and are subject to open access. Therefore, we see no reason why the AEMC should not grant some form of property right in exchange for funding a SENE.

Currently, under the Rules, generators are free to connect to a connection asset which has been built for another generator. Where this occurs, the original proponent of the connection asset can apply for a tariff reduction from the TNSP. We have previously argued that we consider that these arrangements are inadequate and can be improved.

Generators should acquire some form of property right when they pay to connect to a SENE. They should get a tangible property right in exchange for their investment. Generators with firm right rights should get compensation when a new connection applicant connects and “constrains off” existing holders of a firm right on the SENE if the original generator pays for the SENE and takes on the asset stranding risk.

We submit that the revised approach embedded in the rule change brought by the AEMC on 15 February 2010 represented an improvement to the current approach to building connection assets. The introduction of some of right that provided for a constrained on/off payments for the party that finances a connection asset (like a SENE) addresses some of the deficiencies in the current approach. For example the original generator who took the risk of building the asset and funding it, would be able to enjoy the ongoing benefits of that investment while also allowing subsequent connectors to efficiently use any underutilised capacity to the benefit of the wider market.

C: Conclusion

TRU appreciates the opportunity to provide a submission to this Rule change.

The AEMC’s draft rule determination which requires commercial parties to negotiate and allocate the risks associated with a SENE amongst themselves does not address the original problem identified by the AEMC in the connection framework that causes TNSPs to be reluctant to build SENEs. The draft rule does not tackle the key

¹⁰ Categorisation of Transmission Services Guideline – August 2010: p.7 Section 3.2

“Where a Transmission Network User requires the construction of a new line and/or substation equipment beyond the transmission system (i.e. requires an extension beyond the boundary of the existing transmission system) this extension will generally be undertaken as non regulated transmission services.”

deficiencies in the current arrangements that the MCE rule change was trying to address in its rule change request to the AEMC on 15 February 2010. As a result, TNSPs will continue to refrain from building SENEs because they will still carry significant asset standing risk if they choose to build these connection assets. In addition, for the reasons articulated earlier in this paper, it appears unlikely that other commercial parties in the market will assume the asset stranding risk associated with the development of a SENE.

As we are all aware, the MCE proposed a rule change submitted on the 15 February 2010 to address the key deficiencies in the current arrangements which provided for a lack of commercial incentive for network businesses to bear the risk of building assets to efficient scale in advance of future connection. In short, overcoming this lack of incentive would reduce the scope for inefficient duplication of assets and ensures that economies of scale were realised. As a result, the MCE rule change was likely to contribute to the National Electricity Objective (NEO) because it would promote efficient investment in electricity services.

To the extent that the AEMC has delivered an alternative model proposed in this draft rule, we submit will not contribute to the NEO compared to the MCE rule change. In short, the draft rule

- does not mitigate the asset standing risk associated with developing SENEs for TNSPs under the current framework in order for them to build these assets; therefore, SENEs will not get built and renewable generators will continue to inefficiently duplicate smaller stand alone assets in order to connect;
- assumes a commercial entity will take on the asset stranding risk associated with a SENE on the assumption that it will receive a connection cost below its stand alone costs which is not realistic
- provides a regulatory decision that is not consistent with the ideal of regulatory predictability based on the evidence presented by the AEMC following a lengthy consultation process;
- raises some interesting questions regarding the classification of a SENE as a transmission service and its treatment as part of the shared network; and
- does not deal with the issue of constrained off/on payments for the payment of privately funded connection assets like SENEs.

Thus, we conclude that the draft rule as is unlikely to contribute to the achievement of the NEO and it will not promote efficient investment in electricity services.

Whilst we look forward to working with the AEMC in the Transmission frameworks Review (TFR) in order to deal with these issues, we request the AEMC revert to previously flagged options in order to address deficiencies identified in this paper to help make the SENE rule enhance the NEO. In particular, we believe that the asset stranding risk identified by the AEMC as a major stumbling block to TNSPs in building SENEs should be properly addressed. We do not believe that the draft rule in its current form deliver a SENE rule that will benefit consumers.

TRUenergy thanks the AEMC for its consideration of the issues that we have raised in response to the draft rule determination. If you have any enquiries regarding this submission, please feel free to contact Mr. Con Noutso - Regulatory Manager at TRUenergy on Tel: 03 8628 1240

Regards



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