

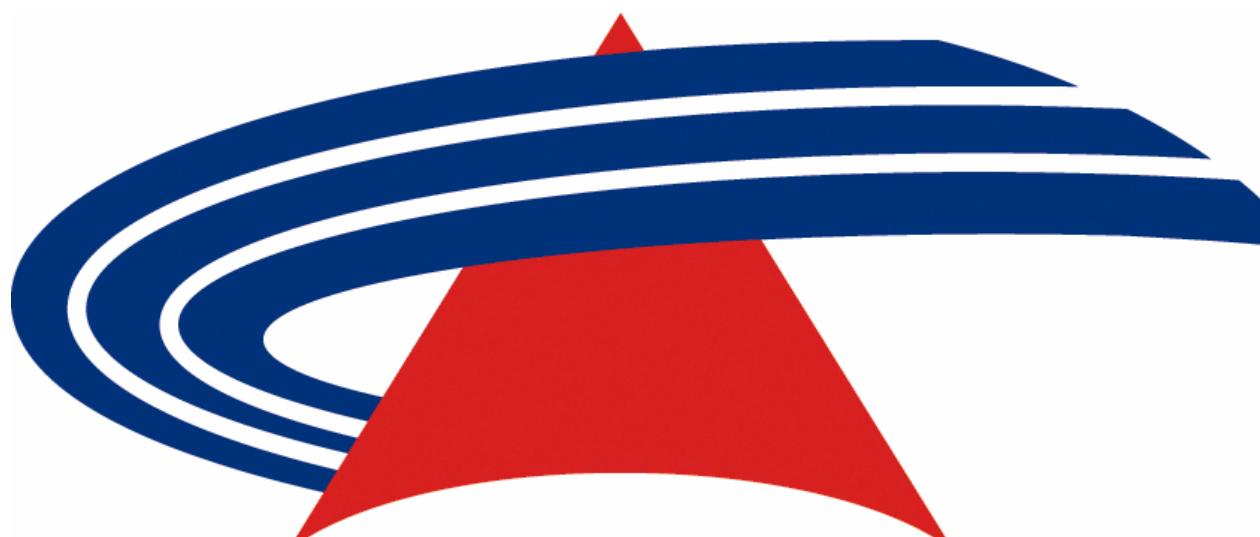


POWERLINK QUEENSLAND

RESPONSE TO: AEMC Draft Rule Determination

Draft National Electricity Amendment
(Economic Regulation of Transmission Services) Rule 2006

14 September 2006



Powerlink appreciates the opportunity to provide comments on the Draft Rule in relation to the economic regulation of transmission businesses issued by the AEMC on 26 July 2006. Powerlink supports the increased certainty provided to the revenue regulation framework provided by the Draft Rule and considers this will assist in delivery the investments required to maintain reliable supply of electricity transmission infrastructure, which is particularly important in the high demand growth environment of Queensland.

There are a small number of matters which Powerlink considers require reconsideration by the Commission to ensure the aims of the regulatory framework are achieved. These relate to:

- The contingent projects framework and the threshold \$ value
- AER assessment of reasonable estimates for capex and opex during a revenue determination
- Provisions for reopening of the revenue cap
- The cap on the service standards incentive scheme
- The definition of network support payment

Powerlink's comments and suggestions in regard to these matters are contained in this submission.

Powerlink is also reviewing the transitional provisions included in the Draft Rule and will provide comments and relevant revisions to the provisions shortly.

1. Contingent Projects and the Threshold – Working from a Philosophical Approach

The AEMC's draft rule introduces a contingent projects regime, which incorporates a \$ value threshold (of 5% of RAB).

This submission considers the \$ value threshold from a philosophical perspective of contingent projects in the regulatory framework first, and then considers some practical issues in arriving at an alternative proposal for the \$ threshold.

Characteristics of contingent projects

Contingent projects are investments which will be needed should a particular development (which is not included in the load forecasts used to determine the ex-ante capex allowance) become committed during the coming regulatory period.

An example from Powerlink's recent revenue submission to the AER is the Gold Coast water desalination plant, a substantial point load which has not been included in the load forecasts for the area, but which will, if it proceeds, require the network to be augmented. Powerlink has obligations to meet reliability of supply standards for the area should the plant proceed.



The key characteristics are;

- the increase in load is foreseeable
- the increase in load was not included in the load forecasts on which the ex-ante capex cap was based
- the increase in load will, should it occur, require a new large network augmentation
- whilst the timing is uncertain, it is plausible that it could happen in the coming regulatory period
- there is a pre-definable trigger (i.e. a commitment to proceed with the plant)
- the network owner must meet reliability standards in the area if this load occurs

Thus, there are a number of “non-financial” hurdles for a contingent project to be considered by the regulator at the time of the revenue application.

Overarching regulatory principles

There are two relevant principles to be considered:

- (a) the NEL requirement that the network owner be given a reasonable opportunity to obtain revenue for meeting its regulatory obligations, and
- (b) the design of the ex-ante capex cap, which includes an incentive for the network owner to invest less than the cap.

Implications for the \$ threshold for contingent projects

Because the network owner must meet reliability standards (for both the new load and the pre-existing load) if the contingent project proceeds, then the NEL requirement for revenue adequacy for meeting obligations can only be met if the \$ threshold is zero.

That is, if the regulator does not provide the network owner with revenue for contingent projects below a \$ threshold, then the regulator would appear to be contravening the NEL.

The suggestion that the network owner should meet the costs of below-threshold contingent projects from the ex-ante capex cap is also problematic in that it compromises the incentive regime inherent in the cap. In essence, it would penalise the network owner for matters outside its control. It must be noted that the new load which is driving the contingent project has specifically not been included in the load forecast on which the ex-ante capex cap is based.

It is also Powerlink’s recent experience that, in deriving the ex-ante capex allowance, the AER is undertaking a rigorous review of projects, and is not prepared to include in the cap a “miscellaneous” or “contingency allowance” provision that might cover, inter alia, below-threshold contingent projects.

In short, there is a compelling case, on philosophical grounds, for the \$ threshold to be zero.



Practical considerations

Notwithstanding the philosophical logic, it is recognised that it would be impractical to apply a \$ threshold of zero. It could potentially lead to a large number of contingent projects of low value, with associated transaction costs which would be high relative to the value of the project. Thus, there is a need for a \$ threshold on practical grounds.

Nonetheless, the logic suggests that the starting point for arriving at a threshold is zero.

The Rules already has an instance of a \$ threshold which may be useful in this regard – the \$ threshold for new large network assets (large augmentations) (currently \$10 million, but for which there may be a case for an increase at some time).

That \$ threshold would limit contingent projects in the revenue determination to large augmentations, and thus avoid the potential for a myriad of “rats and mice” projects.

On the other hand, it is not so far above zero as to give rise to practical problems with the NEL requirement for revenue adequacy, nor to distort the incentive design of the ex-ante capex allowance.

And it already exists in the Rules.

In contrast, there is no logical underpinning for a \$ threshold which is expressed as a % of RAB, or a % of capex. These are essentially arbitrary figures, designed to avoid the “rats and mice”, but have insufficient regard for the NEL requirement for revenue adequacy or the incentive design of the ex-ante cap.

Contingent projects \$ threshold

There is solid philosophical logic to support a \$ threshold of zero.

It is recognised that there is a practical basis for having a non-zero threshold.

It is suggested that a suitable non-zero threshold would be the already defined (in the Rules) threshold for a large augmentation (a new large network asset).

2. Reasonable Estimates Arrangements

Part of the regulatory regime contained in the Draft Rule involves assessment by the AER of “reasonable estimates” of both capital and operating expenditure proposed by a TNSP. The Draft Rule provides that the estimated expenditure allowances must enable a transmission business to:

- (a) efficiently meet the expected demand for prescribed services;
- (b) comply with all applicable regulatory obligations;
- (c) maintain the quality, reliability and security of supply; and
- (d) maintain the reliability, safety and security of the transmission system.



Consistent with the above, a TNSP will operate its business in a manner which is consistent with other similar electricity transmission businesses. This is important to ensure that the practices of the business can be defended, if necessary, through an objective legal test.

Sometimes these actions are associated with mitigating possible future risks. Taking reasonable care requires having regard to the degree of risk of an incident, the degree of loss or injury likely to result from such an incident, and the nature and extent of the remedial action involved. Courts are often also influenced by current national and international community standards when considering what amounts to reasonable care.

A relevant example (but by no means the only example) which Powerlink experiences regularly is associated with the selection and use of easements for the construction of transmission lines and prudence in the location of transmission lines in the community. It is appropriate for Powerlink to be prudent in the location of transmission lines. This includes having regard to reduced proximity to residential developments and, in particular, reduced proximity to the operation of premises within the community which are associated with children (for example, kindergartens, schools, playing fields, etc). Currently there are no Australian Standards or other binding statutory requirements to minimise the proximity of transmission lines to land associated with this kind of community activity. However, published guidelines associated with prudent avoidance of EMFs suggest that such precautionary measures should be undertaken at modest additional cost. These guidelines were first enunciated by former Chief Justice of the High Court, Sir Harry Gibbs, in 1991. Most, if not all, electricity transmission and distribution network businesses in Australia apply these guidelines when siting new lines.

It is important that transmission businesses continue this practice and that the regulatory arrangements recognise and provide for these matters as legitimate expenditure, the consideration of which must be included in the assessment of reasonable estimates for both capex and opex.

Powerlink therefore considers that the Rules should recognise the need for transmission businesses to act in a prudent manner in undertaking its activities by including an overarching requirement to do so in clauses 6A.6.6 and 6A.6.7 of the Draft Rule.

3. Reopening of the Revenue Cap

Clause 6A.7.1 allows for reopening of a revenue cap under certain limited circumstances. The AEMC's Draft Rule Determination states that the reopening provisions are to only apply to substantial, unforeseen expenditure obligations of a force majeure or 'shipwreck' nature¹. Consequently the threshold associated with reopening the revenue cap is set deliberately high – at 5% of RAB. The reopening provisions also contain several additional hurdles which must be met before a reopening can be invoked.

¹ AEMC Draft Rule Determination 26 July 2006, p73.



These include:

- that the total capital expenditure allowance is reasonably likely to be exceeded (i.e. the business must use up any efficiency savings made in the interim in implementing its capital investments);
- that the transmission business is not able to reduce capital expenditure in other areas without materially adversely affecting the reliability and security of the transmission system;
- a failure to rectify the adverse consequences of such an event would likely result in a material adverse impact on the reliability and security of the transmission system; and
- that the event not be a pass through event or contingent project.

These requirements are very onerous. The Electricity Transmission Network Owners Forum (ETNOF) submission² outlines that as currently drafted, the provisions would not be able to have practical effect and proposes amendments to address matters associated with the ability to foresee such events. Powerlink supports the suggested amendments to the drafting.

However, Powerlink also notes that the reopening clause appears to be the only element of the Draft Rule which includes reference to variations (particularly increases) in demand between that which the capital expenditure allowance was based on at the time of the revenue determination and the forecast during the regulatory period upon which actual investments are made. Under this provision, a transmission entity could reopen its revenue cap if the cumulative increase in demand during the regulatory control period resulted in additional capital expenditure above its allowance subject to all additional requirements listed above being satisfied.

For Powerlink, the 5% of RAB threshold equates to \$190 million at the start of its next regulatory control period. This is a very high level of additional investment due to demand growth above the forecast at the time of the revenue determination which Powerlink would have to fund under the proposed reopeners provisions. In addition, any efficiencies that Powerlink has already achieved during the regulatory period would have to be used up and other investments deferred or demonstrated that they cannot be deferred (in addition to demonstrating that the investments were required at the time of the revenue determination).

With demand levels in Queensland higher than in the entire NEM, Powerlink strongly believes that it is inappropriate for a regulated business to be financially disadvantaged as a result of higher than forecast demand. Increases in demand are clearly outside the control of a transmission business (except for demand side response which may be available to defer network investments). The regulatory framework requires that the Rules provide a reasonable opportunity for a TNSP to recover the efficient costs of complying with its regulatory obligations. The proposed framework for higher demand than was forecast at the time of a revenue determination is a disincentive on a business such as Powerlink which operates in a high demand growth environment. This is

² ETNOF (11 September 2006), Response to AEMC Draft Rule Determination.



because efficiencies must be exhausted before a reopen can be triggered and the threshold itself is extremely high.

Limitations and incentives on regulated businesses subject to a revenue cap framework were considered by the Independent Panel in the Electricity Distribution and Service Delivery Review in 2004. The Panel made the following observation:

"The Panel is of the view that if a revenue cap approach is to be used, it should be accompanied by other measures which allow the distributors, in cases where circumstances change significantly, to spend above the amounts included in their submissions without effectively being penalised.³"

One of the recommendations of the Independent Panel was increased certainty regarding investments made during a regulatory period, including:

"a flexible revenue cap based on variable demand levels⁴"

Arguably, there should be no threshold on reopening provisions associated with changes in demand. However, for pragmatic reasons Powerlink considers that the threshold for reopening a revenue cap should be substantially lower than that proposed in the Draft Rule. Powerlink also believes that the threshold should be linked to the capital expenditure allowance for the regulatory period rather than the RAB to capture the in-period nature of the funding program and because the threshold based on RAB will inappropriately become larger over time. Consequently, Powerlink proposes that the threshold for reopening a revenue determination be set at 2% of the capital expenditure allowance.

4. Service Standards

In determining the allowable cap for the service standards incentive scheme the AEMC appear to have given considerable weight to the proposition regarding the relativity of the various incentives put forward by the AER consultant Darryl Biggar.

The AER submission advocated 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 argued that this "order of magnitude" increase is better aligned with the economic loss that could arise from what Biggar labelled 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.

The following observations are relevant to considering this proposition:

- a) 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

³ Summary Report of the Independent Panel, Electricity Distribution and Service Delivery for the 21st Century, Queensland, July 2004, p10.

⁴Ibid, p29.

- 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.
- b) 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.
 - c) 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.

As per the 2002 ACCC Service Standards Guidelines decision, the service standards incentive scheme as originally intended by the ACCC was designed to incentivise transmission businesses to improve their operational behaviour:

“The ACCC’s performance-incentive scheme is designed to drive the TNSP’s operating decisions as opposed to its capital decisions.⁵”

The AEMC Draft Rule includes a cap on the service standards incentive set at 5% of MAR. It should be noted that 5% of MAR equates, in Powerlink’s case, to 25% 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.

In addition, the service standard targets are designed to reflect past performance. In the case of networks which are experiencing low growth and therefore low change, the past performance may reasonably be extrapolated to the future. On the other hand, for networks which are undergoing high growth and rapid change such extrapolation of past performance is much less robust and consequently more risky to the network business.

On the basis of the issues identified above Powerlink believes that the Rules should allow individual transmission businesses to propose the cap to apply to its service standard framework as part of the propose respond component of its Revenue Proposal.

5. Network Support Definition

The Draft Rule defines a network support payment as a payment by a TNSP to any Generator or Customer to enable the safe and reliable operation of the transmission system (both Generator and Customer are defined terms in the NER).

⁵ ACCC Decision Statement of principles for the regulation of transmission revenues: Service standards guidelines, 12 November 2003, p5.



Powerlink is the largest acquirer of network support in the NEM. Powerlink already has network support agreements with all four forms of network support – generators, co-generation (non-scheduled), a market network service provider and demand side management. The definition as drafted with capital G for generators and capital C for customers would not include all the network support providers Powerlink is already using or that are available to provide such services. The definition therefore should be broadened to ensure that transmission businesses can use any form of network support available which can economically defer investment in the transmission network. This will ensure that a simple definition does not restrict the implementation of economic outcomes.

Powerlink suggests that the definition could be redrafted as follows:

Network support payment means a payment by a network service provider (NSP) to any party providing network support services.

