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Mr John Pierce
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Our Ref:

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Dear Mr Pierce

**DPI Submission to the AEMC Transmission Frameworks Review – Second Interim Report
EPR0019**

The Victorian Department of Primary Industries (DPI), as the portfolio agency responsible for energy market development in Victoria, is pleased to make this submission in response to the Australian Energy Market Commission's Second Interim Report for its review of the frameworks governing electricity transmission services in the National Electricity Market.

Any queries in relation to the submission should be directed to Raif Sarcich by email at raif.sarcich@dpi.vic.gov.au or by phone on (03) 9658 4160.

Yours sincerely

Mark Feather
Executive Director, Energy Sector Development



DPI Submission to the AEMC Transmission Frameworks Review – Second Interim Report

1. Introduction

The Victorian Department of Primary Industries (DPI), as the portfolio agency responsible for energy policy in Victoria, welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) Second Interim Report for the Transmission Frameworks Review.

DPI supports the objectives of the Transmission Frameworks Review to promote efficient investment and operational outcomes for generation and transmission over the long term and to best balance generation and transmission investment to minimise total system costs. In particular, DPI supports a better alignment of transmission frameworks to the needs of the wholesale market, both in terms of long term investments (i.e. ensuring that they are timely, in desired locations and responsive to potential significant changes in generation location and patterns) and in terms of short term network operation (i.e. maximising network availability and efficient management of congestion).

In support of these objectives the AEMC has developed significant reform proposals for the interface of generation and transmission including: how generators can gain access to the wholesale market via the transmission system; the way in which network congestion is managed; the charges generators face in relation to transmission; and how the transmission network is planned (for generator access and load requirements). It is appropriate that these boundaries continue to be tested and modified as the National Electricity Market (NEM) matures and as both market participants and regulatory arrangements become more sophisticated.

DPI welcomes the significant work that the AEMC has undertaken to further develop the design and detail of its reform proposals, particularly on the Optional Firm Access (OFA) model. DPI provides the following response from a perspective of exploring opportunities to achieve improved outcomes for consumers located in Victoria and nationally.

Key messages

Generator access

As indicated in previous submissions, DPI supports the introduction of a market-based system of financial transmission rights (FTRs). DPI considers that an FTR framework will deliver improved coordination of transmission and generation investment, provide a better basis for directing future transmission investment, address disorderly bidding, and provide generators with an ability to better manage market and investment risks.

However, before being able to support the specifics of the OFA model, DPI is seeking additional information and analysis from the AEMC as follows:

- *Overseas FTR experience:* To provide confidence in the design and workability of the OFA model, further information and analysis is sought to compare the OFA model with alternative FTR design options that have been applied in other countries. At present it is unclear how the AEMC has arrived at the OFA model design and the extent to which it has drawn on international experience. In this respect, DPI considers that there is merit in the AEMC obtaining an international expert or peer review of the OFA model so that it can be

properly evaluated against alternatives and so that the implications of the model can be fully understood based on international experience.

- *Effects and impacts of OFA:* DPI is seeking additional analysis of the effects and impacts of the OFA model, including on market behaviour, to get a better sense of the materiality of change and outcome from the OFA model. In particular, DPI wishes to understand the impacts of the model on generator behaviour and competition between generators. It will be important for the AEMC to ensure that the model does not distort competition between generators (including between new entrants and incumbents). DPI is also seeking further insights into the extent to which transmission investment is likely to be driven by generation needs rather than by load and reliability and hence the influence of the OFA on future network investment outcomes.
- *Impact of the OFA on Transmission Network Service Provider (TNSP) incentives:* TNSP incentives and in particular their incentives to efficiently operate and invest to meet the needs of the market and load are central to achieving the intended benefits of the Transmission Frameworks Review and the OFA. Under an OFA regime TNSPs would be required to progress from a low risk regulated environment, to an environment characterised by commercial contracts with generators, including significant financial penalties for non-compliance. DPI endorses the introduction of market-based incentives to drive transmission investment, but recognises that these reforms pose significant challenges for TNSPs. Further analysis is needed to ensure that there is confidence that the arrangements will sufficiently incentivise TNSPs to enter into access agreements and to operate and invest efficiently for all customer needs.

Transmission planning

DPI believes that the current planning arrangements in Victoria have been successful in delivering good results for the electricity market and for Victorian consumers. As outlined in our submission to the First Interim Report, the Victorian arrangements were developed in response to specific concerns regarding the risk of exercise of market power by monopoly businesses and the acknowledgement of the inherent limits of incentive-based regulation. Although no governance regime is perfect, DPI consider the current transmission planning and procurement model in Victoria has performed well in terms of achieving efficient investment outcomes and we do not believe that the AEMC has provided sufficient evidence to the contrary. Indeed, as noted later in this submission, there is a significant body of evidence to demonstrate the benefits of the Victorian planning model.

DPI however recognises that the OFA proposal will have fundamental implications for future generation led planning augmentations in Victoria. As noted above, DPI endorses a market-based FTR regime as offering a range of benefits in terms of improved transmission and market outcomes. There are reasonable arguments to suggest that, in respect of generation led network augmentations, the OFA model would be better supported by transmission planning and provision functions being undertaken within a single transmission entity thereby linking service accountability, risk management and reward and optimising both network investment and operation. It also appears problematic for AEMO as a not-for-profit entity to enter into such commercial agreements and to be exposed to commercial risks.

There are therefore sound arguments to suggest that planning for generation led augmentations would be better placed with SP AusNet. An alternative approach would be for AEMO to plan and procure the physical transfer capacity required. The operational incentives to support an OFA could be backed by a financially motivated TNSP or through a network service agreement. DPI would encourage the AEMC to consider further the most optimal planning framework under an OFA model.

It is important to note that the AEMC's First Interim Report represents an initial step in the policy development and that considerable policy analysis will be required on a suitable access and planning framework. In this respect, at this early stage, it is important that the AEMC considers all potential planning options and analyses them comprehensively to develop an optimal solution.

To the extent that the AEMC proposes changes to the Victorian planning arrangements, DPI considers that the following matters require consideration:

1. **Load driven network investment.** To the extent that load driven transmission investment continues to play an important role, the continuation of the not-for-profit Victorian planning framework is likely to be necessary given the substantial information asymmetries faced by the Australian Energy Regulator in assessing TNSP planning and given the problems associated with existing investment incentive frameworks as set out in DPI's previous submissions to the Transmission Frameworks Review. In this respect it is important to emphasise that the OFA framework will provide market signals only in respect of generation led investments. In this submission, DPI considers whether it is possible to establish a model under which generation led augmentations are managed by SP Ausnet and load based augmentations continue to be managed under the existing Victorian planning model.
2. **OFA model not implemented.** Similarly, if the OFA model is not implemented, DPI considers that insufficient evidence has been established to justify any major change to the existing Victorian planning arrangements. DPI does not consider that the AEMC has produced evidence to suggest that a TNSP led planning regime will represent an improvement on the existing independent not for profit based Victorian transmission planning framework. Further, DPI does not consider that the AEMC has adequately explained the nature of the conflicts that exist between the enhanced national transmission planner and AEMO as Victorian planner – in circumstances where the Victorian planner is a not for profit entity with no distortionary commercial incentives.
3. **TNSP incentives under an OFA framework.** In the event that OFA arrangements were established, it would be also critical to ensure that SP AusNet is provided with an effective incentive framework (based on risk and reward) to operate and invest efficiently to meet the needs of the market and load, both for services provided under access agreements and for services provided outside of these agreements. DPI considers that it is vital that the investment and operational incentives framework for TNSPs is considered holistically within the Transmission Frameworks Review process. DPI does not accept that the investment incentive design issues that are related to OFA are being addressed through the AER rule change process which is currently underway.

Connections frameworks

Connection process

DPI is concerned that the AEMC's proposals may not be sufficient to allay generator concerns that the TNSPs will manage the tendering and construction process in an efficient timely manner. As such, DPI remains supportive of contestable provision of connection assets, as is the case under the current Victorian arrangements.

Extensions

DPI will need to consider how these arrangements would best operate under its current planning framework or in the event of any changes to the institutional arrangements for transmission planning and procurement.

Proposed Rule changes

DPI is not proposing to offer comments on these Rule change proposals at this time but may do so once the Rule change proposals are further developed as part of the formal Rule change process.

2. Generator access models

2.1 DPI support market-based transmission rights

As indicated in previous submissions, DPI supports the introduction of a market-based system of financial transmission rights (FTRs) to provide generators with greater confidence of transmission access (where and when desired) and to inform future investment in the transmission network. DPI considers that improved signals for transmission planning and investment should facilitate more efficient network investment and operation, ensuring that consumers are paying no more than is necessary for the delivery of efficient and reliable network services. Easing the pressures on energy costs for households and businesses is a critical concern for DPI.

DPI supports a continuing AEMC-led program to develop a workable scheme of FTRs for the NEM. In this regard, DPI welcomes the significant work undertaken by the AEMC to develop the OFA model and its operational detail. We note that specific elements of the model as outlined in the First Interim Report have been improved including:

- The basis for access charging (DPI did not support the use of deep connection charging which is not being pursued)
- The period of access agreements (we note this is not fully resolved but issues and options around the access period have been raised)
- Interaction with a generator reliability standard (we note a generator reliability standard will not apply)
- Inclusion of TNSPs in the compensation arrangements where they scale back network availability (we note this is not resolved but a longer term financial incentive regime is proposed for resolution by the AER).

2.2 Additional information and analysis sought

However, before being able to support the specifics of the OFA model, DPI is seeking additional information and analysis from the AEMC as follows:

- To provide confidence in the design and workability of the OFA model, further information is sought on the viability of alternative FTR design options and international experience and how this has informed the design of the OFA.
- To go beyond asserting that the OFA will deliver the intended benefits, DPI is seeking additional analysis of the effects and impacts of the OFA model on participants' behaviours. This could be done by tracing the likely patterns of behaviour and the interaction of the NEM participants with OFA. For example, it will be important for the AEMC to understand whether the OFA arrangements would distort bidding behaviour amongst generators, as well as understanding their impacts on wholesale competition between generators (including between incumbents and new entrants).
- TNSP incentives to efficiently invest in and operate their systems to meet the needs of the market and load are central to achieving the intended benefits of the Transmission

Frameworks Review and the OFA. Further analysis is needed to ensure that there is confidence that the arrangements will sufficiently incentivise TNSPs as intended.

Each of these points is expanded below.

Alternative FTRs design and experience

A key concern for the DPI is that the AEMC does not appear to have undertaken sufficient analysis to understand alternative FTR models and their relative merits, to learn from the significant available international experience and to assess the likely applicability and performance of different approaches in the context of the NEM.

Drawing upon the lessons learned from overseas is likely to be highly beneficial, even where the local characteristics and design features of the NEM do not necessarily provide a close match to those in overseas jurisdictions. At a minimum, design elements will be relevant or yield insights, such as understanding the nature of the access contracts and negotiation processes, options for the definition of access rights, impacts on generator bidding and potential for strategic behaviour, settlement approaches, etc.

DPI acknowledges the wide-ranging options canvassed for the provision of generator firm access in the context of the First Interim Report and in subsequent submissions (i.e. open access with congestion pricing, generator transmission standards, regional optional firm access and national locational marginal pricing). A repetition of this work is not being sought. Rather, given the decision to pursue a model based on FTRs (which DPI supports), a logical step would be to obtain an in-depth understanding of the FTR design options available, to understand practical experience from elsewhere and consider how this should inform the design of FTRs in the NEM.

The AEMC seems to have taken this more systematic approach on the issue of transmission planning, at least in terms drawing on overseas experience. There is a noticeable difference in the transparency of the work done to draw on international experience and to understand the range of options in relation to the transmission planning arrangements (including the reports commissioned from NERA and Allens Linklaters) compared to the development of the OFA model.

Recommended further analysis

DPI therefore recommends that the following analysis be undertaken by the AEMC to provide confidence in the design and workability of the OFA model:

- *Understanding of alternative models:* DPI considers there is merit in the AEMC obtaining a peer review of the OFA model against other FTR models used internationally. This could usefully involve international experts and practitioners. In particular, DPI is concerned to understand the experience with defining FTRs as point-to-point (nodal) versus flowgate rights. Point-to-point FTRs are potentially more dynamic and provide a financial hedge against any relevant binding constraint. By contrast the OFA model seems to be assuming that flowgates can be identified in advance so as to deliver a targeted level of access over the entire period of the agreement, when in reality constraints change over time.
- *Lessons from international experience:* This should provide insights into the performance of different design elements, how market participants have responded and into settlement outcomes under different FTR models.
- *Apply this knowledge systematically in the context of the NEM:* This analysis would consider how alternative FTR models would be likely to function in the context of the NEM design including its regional design. This will ensure that transparent and balanced debate can

occur about the trade-offs under different designs and a clear understanding can emerge about why a particular design option has been favoured under the OFA.

Likely effects and impacts of OFA

DPI notes that the Second Interim Report provides qualitative analysis of the likely outcomes of the OFA in Chapter 4 of the Second Interim Report and Chapter 11 of the Technical Report. The analysis focuses on key beneficial outcomes that will change under the OFA model, but these are largely asserted rather than being demonstrated.

In our view the evidence about the benefits of the OFA model must come from adopting a forward looking approach that attempts to trace the likely patterns of behaviour and the likely interaction of the NEM participants. This would require careful analysis of the incentives each party faces and the nature of the market, including any strategic behaviour that may arise. This would connect the OFA to the anticipated outcomes via a chain of reasoning and logic that rests on a clear understanding of the incentives and objectives of the key participants. This would include an understanding of incentives that arise from the regulatory arrangements where appropriate as well as from market dynamics.

In particular, it will be critical for the AEMC to consider the impacts of OFAs on competition between generators, including new entrants and incumbents, as well as the extent (if any) to which the proposed arrangements may lead to distortionary bidding behaviour.

Recommended further analysis

At a minimum this analysis should encompass the following:

- *Take up of firm access by generators:* The Technical Report presents a greater depth and more useful analysis than the Second Interim Report on likely access procurement by generators. As the proposed transition arrangements means that most existing generators will start with a high level of firm access, as noted above more focus is needed on understanding the likely secondary trading of transitional access rights as well as future demand for access.

It will be important to understand the extent to which rights can be easily traded in the future or whether new entrants will face being in a position of having to pay for network augmentations, when purchasing existing rights may be more efficient. For example, it will be important to understand whether there are likely to be barriers to trading because the detailed terms and conditions governing the rights become too site specific (even though from a physical network perspective trading should be possible). DPI acknowledges that the tradability of rights will depend to some extent on their design. This is another aspect of the model that would benefit from an understanding of overseas experience.

- *Generator bidding:* The analysis, particularly in the Technical Report, adequately demonstrates how bidding incentives will change under the OFA model to reduce disorderly bidding. However, broader analysis is needed of likely bidding behaviour including strategic or inefficient bidding behaviour. We note that there has been some useful analysis of other forms of inefficient bidding that may arise (p. 53 of the Second Interim Report). While we agree with the general conclusions of this analysis it will be important that the AEMC is satisfied that this work has been done as thoroughly as possible to understand the bidding incentives of generators and how they are likely to be changed by the OFA model.
- *Optimisation of transmission and generation investment:* DPI understands that in principle OFA should drive improved optimisation of transmission and generation investment e.g. by

revealing transmission cost differences at different locations and having those costs reflected in generation location decisions. However, DPI is seeking further insights into the extent to which transmission investment is likely to be driven by generation needs rather than by load/reliability and hence the influence of the OFA on future network investment outcomes. DPI understands that this is a challenging question to answer and is driven by a number of factors including TNSP and generator incentives to enter access agreements, the definition of generator versus load-related network, etc. However, as we discuss in the context of the transmission planning arrangements, this question is central to understanding the extent to which the access agreements between TNSPs and generators are likely to displace the centrally planned and regulated network expansions with market-lead and commercially driven network expansion and funding. DPI notes that the AEMC has expressed a view that the OFA will substantially drive transmission expansion and investment.

*"In particular, the optional firm access model would fundamentally shift the driver of much transmission investment away from decisions made by transmission planners to commercial agreements between generators and TNSPs."*¹

TNSP incentives

TNSP incentives will in large part determine whether the review objectives are achieved i.e. to best balance generation and transmission investment to minimise total system costs and to better align transmission network operation and investment to the needs of the wholesale market (including encouraging timely investment).

DPI has significant concerns about the ability of the reform package (incorporating the OFA and the transmission planning proposals) to substantially improve the efficiency of transmission investment and operational outcomes and, in particular, to incentivise the TNSPs to deliver efficient levels of investment in a timely manner. DPI considers that further analysis is needed regarding TNSP incentives to ensure that there is confidence that the arrangements will sufficiently incentivise TNSPs as intended.

At present, the AEMC has indicated that consideration of the efficiency of financial incentives on TNSPs is outside the scope of the Transmission Frameworks Review (as indicated on p. 59 of the Second Interim Report). An effective consideration of these incentives needs to form part of the TFR. Alternatively, the AEMC needs to set out how the rule changes it is proposing in response to the AER's rule change request align the incentives of the TNSPs to the requirements of the wholesale market as signalled through the OFAs.

Further explanation of DPI's concerns in relation to TNSP incentives to enter access agreements and to operate and invest efficiently follows.

Incentives to enter access agreements

The success of the OFA model requires that TNSPs are adequately incentivised to enter access agreements and have the skills and personnel to fulfil these new roles and functions. The OFA model will significantly change the nature of TNSPs' businesses, introducing new commercial obligations and business risks that they must manage. The overall incentive regime must encourage TNSPs to willingly enter into OFA agreements and to effectively manage the financial risks associated with these commercial contracts.

¹ Australian Energy Market Commission (2012), *Second Interim Report, Transmission Frameworks Review*, p.2.

DPI notes that the proposed transitional arrangements would effectively require the TNSPs to enter access agreements to the limit of existing capacity.² Going forward, the incentives facing TNSPs to enter access agreements will be a function of the interaction between access and reliability revenues and regulation, reward being commensurate with their obligations to the generators, any penalties imposed for failing to enter into agreements or to meet access terms, TNSPs practical ability to manage risk and meet their obligations, etc. Taking these factors into account, is there enough in the incentive arrangements to encourage TNSPs to respond to requests for access agreements or to negotiate in a timely manner?

This core issue needs to be comprehensively understood and tested otherwise the considerable effort and expense of the OFA arrangements may not result in the anticipated benefits materialising. DPI therefore asks that this issue receives more serious attention in the next phase of analysis.

Incentives to invest and operate efficiently

The extent to which the OFA will drive efficient transmission operational and investment outcomes will be a function of:

- TNSP incentives to enter into access agreements – as discussed above DPI is concerned that there may be weak incentives to enter access agreements.
- TNSP incentives to meet the terms of their access agreements, including the extent to which TNSPs should be financially rewarded for timely and efficient investment and operation in response to market signals, and conversely, penalised for failing to act efficiently (e.g. failing to deliver network capacity in the agreed timeframe). DPI would support the development of appropriate reward and risk frameworks and consideration of whether a centrally determined risk/reward framework is required.
- The extent of TNSPs activities that are covered by the access agreements including:
 - the extent of new investment made under access agreements relative to investment driven by other load and non-firm generation investment
 - the extent to which network operations are covered by access agreements.

DPI considers that it will be important to ensure that TNSPs are appropriately rewarded for investing efficiently, as well as having risk exposure for a failure to act efficiently, both under the access agreements under the OFA model and under the broader regulatory framework. Ultimately, efficient network investment and operation should promote competition between generators and ensure that the most efficient forms of generation are able to access the wholesale market, in turn reducing pressures on prices for consumers.

2.3 Non-firm access model

While DPI considers that there is further work to be done, continuing to develop market-based transmission rights is supported. However, in the interim the current non-firm access arrangements

² Under the transitional access agreements:

- All generators would receive transitional firm access (to the extent possible given current network capacity)
- No access charge would apply
- This access would be sculpted back over time – although the time period is not nominated
- TNSPs would not incur penalties for breaches of the firm access standards under these agreements for a transitional period – at least for the remainder of their prevailing regulatory control period to a maximum of five years.

will continue to apply and the AEMC is seeking support to remove Clause 5.4A from the National Electricity Rules.

DPI agrees that this clause does not provide a workable arrangement for access provision and hence the clause is effectively redundant. On this basis, DPI would support the removal of this clause. Given that the existence of the clause has no real effect, its removal could be dealt with at any convenient time (e.g. in combination with other Rule changes) rather than as a matter of urgency.

While the current arrangements apply, progress should also be made on strengthening the positive incentives on the TSNPs under the planning and economic regulation frameworks to invest in a timely and efficient manner to meet both generation and reliability needs and to operate the networks with greater regard for the needs of the wholesale market. These issues are explored further below in our comments on the AEMC's transmission planning proposals.

3. Transmission planning

DPI endorses the proposal to move to a market-based FTR regime which we see as key to improved coordination of transmission and generation investment, providing a better basis for directing future transmission investment, addressing disorderly bidding, and providing generators with an ability to better manage market risks.

However, there are some significant implications for Victoria in fully subscribing to the AEMC proposals, most notably the proposal to reallocate transmission planning and procurement to SP AusNet. Although DPI accepts that under the OFA model there are reasons to suggest it is likely to be more efficient to follow this recommendation with respect to generation led augmentations, we have remaining reservations.

DPI's chief concern relates to the extent to which future transmission investment will be driven by OFA. If OFA has only a marginal influence on the total expenditure on transmission investment or if OFA is ultimately not implemented, it is difficult to justify (based on the evidence provided by the AEMC) a major change in the existing Victorian transmission planning arrangements. Indeed, in the absence of the OFA arrangements, DPI does not consider that the AEMC has produced evidence to suggest that a TNSP planning regime will represent an improvement on the existing Victorian planning framework that sufficiently aligns the incentives of for profit TNSPs with consumer interests.

The section outlines DPI's view and indicates where further analysis and advice is required in order to progress the consideration of the transmission planning options.

3.1 Implications of OFA for transmission planning arrangements

DPI believes that the current planning arrangements in Victoria have been successful in delivering good results for the electricity market and for Victorian consumers. As outlined in our submission to the First Interim Report, the Victorian arrangements were developed in response to specific concerns regarding the risk of exercise of market power by monopoly businesses and the acknowledgement of the inherent limits of incentive-based regulation. Although no governance regime is perfect, DPI consider the current transmission planning and procurement model in Victoria has performed well in terms of achieving efficient investment outcomes and we do not believe that the AEMC has provided sufficient evidence to the contrary.

In DPI's view there is a substantial body of evidence regarding relative TNSP performance which could be utilised to quantify the potential risks (or benefits) associated with the proposed planning

amendments. For example, the AER has highlighted that (excluding revenue increases due to the application of an easements tax), SP AusNet's maximum allowable revenue (MAR) increased 19 per cent. This is in contrast to TransGrid (31 per cent) and Powerlink (27 per cent).³ The AER also report that SP AusNet experienced an increase in capex of only 9 per cent in the five year period 2005-06 to 2009-10. In contrast, the AER report the other TNSPs each experienced increases ranging from approximately 17 per cent to 227 per cent in the same 5 year period.⁴ SP AusNet's capex to Regulatory Asset Base ratio is also reported as the lowest of the TNSPs.

Other examples could be presented to illustrate the superior performance of the Victorian governance arrangements. DPI refers the AEMC to submissions by AEMO on this issue for additional evidence.⁵ The point of referencing these data is to highlight that there is a substantial body of evidence to support the proposition that TNSPs do not have incentives to efficiently deliver transmission investment and that the regulator is seriously constrained in its ability to mitigate opportunistic behaviour.

However, DPI recognises that the OFA proposal will have fundamental implications for the operation and performance of the NEM that will need to be carefully considered in evaluating the appropriate form of future governance arrangements, particularly those that currently apply for transmission planning and procurement within Victoria. In particular, DPI considers:

- It appears that the OFA model would be better supported by all transmission planning for generation led augmentations being undertaken within a single entity thereby linking service accountability, risk management and reward. The internalisation of these interrelated functions will also allow the entity to optimise across all factors determining the delivery of transmission services that enable it to meet its firm access obligations and to effectively deal with market and system changes over time.
- Centralisation of transmission functions into the one entity will reduce the problems that are likely to arise from tripartite OFA negotiations between AEMO, SP AusNet and a generator.
- The OFA proposal includes potential financial penalties on the access provider for a failure to meet the terms of the access agreements. It appears problematic for AEMO as a not-for-profit entity to enter into such commercial agreements and to be exposed to commercial risks. Alternatively, a model that has AEMO accepting performance risks but separately contracting with the TNSP to bear the risks of underperformance would seem complex.
- A potential conflict of interest for AEMO may arise, since the constraint equations in the National Electricity Market Dispatch Engine (NEMDE) which are managed by AEMO will become central to the firm access arrangements, including market and access settlements. This would seem to require a higher level of transparency and the absence of real or perceived conflicts in order to promote participant confidence in the market operation.

Whilst further analysis would need to be undertaken, DPI accepts there are reasonable arguments to suggest that planning governing generation related augmentations would be better placed with SP AusNet.

However, as discussed below, obtaining a clear view on the overall merits of relocation of any planning functions to SP AusNet requires improved evidence from the AEMC to clarify the source, nature and materiality of AEMO's conflicts, as well as views on the efficacy of the TNSP incentive

³ Australian Energy Regulator (2012), *Transmission Network Service Providers Electricity Performance Report*, p. 25.

⁴ Australian Energy Regulator (2012), p. 57.

⁵ Australian Energy Market Operator (2012), *Electricity Network Regulation AEMO's response to the Productivity Commission Issues Paper*.

regime and the extent to which future transmission investment will be driven predominantly by generation/load or a combination of both.

As part of this analysis, an alternative approach could be considered for Victorian transmission planning under the OFA whereby AEMO plan and procure the physical transfer capacity required. The operational incentives to support an OFA could be backed by a financially motivated TNSP or through a network service agreement.

As well as requiring further evidence on which to base any decision, there are two important caveats to DPI's support for any changes to the planning arrangements in Victoria, in particular a move from AEMO to the TNSP.

The two caveats are:

- TNSPs must be appropriately incentivised to enter into OFA agreements with generators and to deliver efficient investment and operation in response to the market signals generated by OFAs
- Future transmission investment should be predominantly driven by generator demand rather than reliability and load considerations.

If TNSPs are not adequately rewarded for entering into OFA agreements and delivering efficient investment and operation in response to market signals then the proposal will not achieve the desired evolution of transmission investment driven by market forces. Further, if a substantial degree of transmission investment is driven by load patterns and growth, DPI considers that the Victorian independent planner will need to continue to play an important role, particularly given the information asymmetries associated with TNSP planning and deficiencies in the incentive regimes (as set out in DPI's previous submissions).

If the OFA regime does not become the dominant driver for transmission investment then DPI's concerns regarding the flaws in the current investment framework and the distortionary incentives for network investment remain unaddressed. In these circumstances, it would be difficult to recommend a move away from the current approach to transmission planning and procurement in Victoria. Further, if the OFA model is not implemented, DPI does not consider that the proposed new planning arrangements by themselves justify any fundamental change in the Victorian planning arrangements.

In order to advance consideration of the OFA proposal, it is therefore critical to obtain a better understanding about the likely importance and impact of OFA relative to load based investment.

Alternative option

An alternative option is to develop arrangements that provide for AEMO to transfer responsibility for planning and procuring augmentations related to generation firm access arrangements to SP AusNet, with responsibility for planning all other augmentations (those required to meet load reliability standards or provide economic benefits) remaining with AEMO. At a practical level the implications of this arrangement would be that the AEMO would be responsible for transmission planning consistent with the "baseline" expansion plan established for the purposes of estimating LRIC. SP AusNet would then be responsible for developing the "adjusted" expansion plan developed in response to firm access negotiations.

Splitting transmission planning in this way preserves the benefits of the not-for-profit arrangements for load related investment where incentive based regulation on for-profit TNSPs is arguably less effective, and provides for market-based investment where the disciplines for efficiency achieved through negotiation of commercial access agreements are stronger.

DPI would be willing to undertake further analysis to test this option.

3.2 Concerns regarding the AEMC's transmission planning proposals

DPI's concerns regarding the shortcomings of incentive based regulation apply more forcefully under the NFA model, where no additional market forces are introduced. DPI notes that improvements to the existing incentive arrangements are being pursued through the Economic Regulation of Network Service Providers rule change process. Although this activity may be beyond the scope of the AEMC investigations of transmission planning options, the outcomes of this work are central to forming a view as to whether the incentives framework is superior to the governance approach adopted by Victoria.

We expect the AEMC will need to draw on all the interrelated threads of these separate work programs to provide participants with the required level of assurance that TNSPs incentives will be adequately aligned to the needs of the wholesale market and deliver efficient investment outcomes.

3.3 Unclear materiality of AEMO's conflict in undertaking enhanced NTP role

The AEMC has identified possible conflicts relating to the proposed independent review function that arises under either the OFA or NFA model. The AEMC characterise the issue as:

"AEMO would essentially be providing a check and balance on its own work" p70.

The extent to which this potential conflict is actually material depends on the extent to which AEMO, in undertaking its role as planner in Victoria, is likely to overlook opportunities to strengthen the national transmission network. As DPI and AEMO have argued elsewhere, the not-for-profit status of AEMO means the organisation has no incentive to enhance the Victorian network at the expense of worthwhile investments elsewhere. Put another way, if the role of the NTP review processes is to correct a bias towards investment by a TNSP in its own network, then absent this bias within AEMO, the presence of a material conflict is arguable.

In their report prepared for the AEMC, NERA/Allens express the benefits of a separate national transmission planner as providing a 'tension' between the longer-term strategic planning function, and the shorter term, detailed project specific planning:

"As a consequence, there would be no independent check on the development of plans, and the benefit of incorporating alternative viewpoints would be lost"⁶

DPI does not regard this latter interpretation as necessarily representing a conflict of interest. A conflict arises when there is a risk that the core purpose of an agency will be unduly influenced by other secondary (and opposing) considerations. What NERA/Allens appear to refer to is the benefits of a different perspective, which arguably could easily be provided within the one organisation. The alternative views on the nature of the conflict discussed in the various papers, combined with uncertainty about the materiality of the problem, create doubts that the conflicts concerns discussed by AEMC in Section 5.7 of the Second Interim Report warrant the reallocation of planning roles to SP AusNet.

Obtaining a clear view on the overall merits of relocation of the planning functions to SP AusNet therefore requires a clear statement from the AEMC on the efficacy of the TNSP incentive regime, clarification of the source and nature of AEMO's conflict, and a view on its materiality.

⁶ NERA and Allens (2012) *Alternative Transmission Planning Arrangements: Ensuring Nationally Coordinated Decision-making*, p. 34.

3.4 Practical challenges for AEMO as NTP should be recognised

Finally, it is DPI's view that the AEMC needs to give greater consideration to the challenges that AEMO will face in exercising its "enhanced" role as the NTP. The AEMC points to the advisory role currently undertaken by AEMO in South Australia in support of their NTP proposal. However, the ability of AEMO to effectively perform this oversight and advisory role in South Australia is enhanced by the active planning role it currently undertakes in Victoria.

This current role yields knowledge and insights into the operation of networks and hence the opportunities that exist to optimise network performance through operational means as opposed to further network investment. DPI believe that the proposed arrangements to strip AEMO of planning functions will place some limits on the scope for AEMO to rigorously undertake this review and advisory role across the NEM.

Arms length governance arrangements that are designed to avoid perceptions of conflict potentially give rise to a new risk associated with the informational asymmetry problems between TNSPs and regulators. This risk should be taken into account in evaluating the effectiveness of the proposed governance regime.

4. Connection to network

DPI offers the following comments on the AEMC's proposals in relation to connection arrangements.

4.1 Connection process

In response to the First Interim Report DPI offered its broad support for proposals to strengthen the negotiating framework for connections (Proposal 2) and noted that AEMO's Connection Initiatives in Victoria implements some of the recommendations. DPI remains supportive of these proposals.

A key area of contention with the AEMC's proposals in the Second Interim Report, however, relates to the degree of contestability for managing construction of connection assets. The AEMC is proposing that construction management be limited to TNSPs, with the connecting parties getting greater access to the TNSPs' tendering process and information to provide assurance that the assets are being provided at efficient costs.

DPI considers that the proposals may not be sufficient to allay generator concerns that the TNSPs will manage the tendering and construction process in an efficient and timely manner. As such, DPI remains supportive of contestable provision of connection assets, as is the case under the current Victorian arrangements.

4.2 Extensions

The AEMC's second set of proposals relate to extensions, which is defined as the new transmission line between the connecting party's facilities (e.g. generator) to the boundary of the assets used to provide the connection service (e.g. substation).

The AEMC is seeking to clarify a number of ambiguities it has identified in the National Electricity Rules regarding extensions including contestability and regulation. Under the AEMC's proposals extensions will be able to be owned and controlled by the TNSP, the connecting party or a third party. However, when an extension is being established a connecting party will be able to require the local TNSP to provide the end-to-end service as a negotiated transmission service.

DPI will need to consider how these arrangements would best operate under its current planning framework or in the event of any changes to the institutional arrangements for transmission planning and procurement.

4.3 Proposed Rules changes

Regardless of policy changes that may be adopted, we note that the AEMC has also proposed a significant set of rule changes to clarify the arrangements relating to connections and extensions involving redrafting of Chapters 5, 6A and 10. The AEMC is seeking endorsement for a set of proposed principles to be reflected in the redrafted rules. This includes sixteen principles in total: seven principles for connection rules, four principles for service descriptions and five principles for charging.

In the time available to make this submission, the focus of DPIs attention has necessarily been on considering and understanding the significant reform proposals relating to generator access and transmission planning arrangements and the large amount of technical material associated with the Optional Firm Access model. Hence, DPI is not proposing to offer comments on these Rule change proposals at this time but may do so once the Rule change proposals are further developed as part of the formal Rule change process.