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By email: submissions@aemc.gov.au

Re: Submission to Australian Energy Market Commission (AEMC) Draft Rule Determination-
Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006

"The Group" consists of

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

Dear John

The above group of participants "The Group" are pleased to comment on the AEMC's Draft Rule Determination – Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006. In general, we support the Draft Rule Determination subject to the comments included in the attached submission. Any comments or queries regarding this submission should be directed to Mr. Con Noutso: Manager Regulation (Access) at TRUenergy on Tel: 03 8628-1240.

Australian Energy Market Commission (AEMC) Draft Rule Determination Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006

A. Introduction

The Group supports the outcomes of the AEMC's Draft Rule determination (Economic Regulation of Transmission Services) Rule 2006.

Let me outline the key reasons why:

- The prescription of the revised regulatory approach provides a stable, more predictable transparent regulatory environment that delivers benefits to investment in transmission in the long term.

- The revised framework developed to improve the clarity of the definitions of the transmission services offered by TNSPs is appropriate. However, the AEMC's work in this regard is incomplete. The boundaries between "negotiable services" and "contestable services" are unclear. The AEMC needs to do more work to provide clear criteria on determining what constitutes a "contestable service". Some enhancements to strengthen the operation of the arbitration framework should also be considered.

- The inclusion of a provision that adjusts the price for a "negotiated service" where the assets are subsequently shared with another user is appropriate. The provision that prevents cost shifting from "prescribed services" to "negotiated services" is also supported. However, the treatment of grandfathered connection assets needs greater clarity, as does the treatment of increases in value of such assets.

- The introduction of a propose/respond model where the Australian Energy Regulator (AER) must approve forecast capital expenditure deemed a "reasonable estimate of forecasts" is appropriate. The AEMC has developed a list of factors that the AER must consider in Section 6.2.6 (b) of the Draft Rule in assessing the reasonableness of the TNSPs proposals. Adopting more specific criteria provides a clearer and more predictable set of criteria for the AER in assessing forecasts. However, the Expert Panel on energy pricing [1] argued the introduction of a propose/respond model created uncertainty given the term 'reasonable estimate' is a new concept. Accordingly, we support the AER's position that calls to substitute the term 'reasonable estimate' with the term 'have regard to' in assessing capital expenditure under the proposed/respond model.

- The introduction of 'contingent projects' in the regulatory regime subject to the condition that the threshold for triggering a contingent project is greater than 5% of the value of the regulated asset base is appropriate.

- The re-opening provision that provides that TNSPs can re-open their revenue cap is appropriate subject to the condition that re-openings will only apply to capital expenditure valued at 5% of the regulated asset base. Furthermore, the more stringent conditions applied to the re-opener will help maintain the incentive qualities of the regulatory regime, and prevents frequent re-openings.

- The Draft Rule seeks to insert principles for determining the regulated asset base (RAB) in the case of a conversion from an unregulated asset to regulated status. The practical implementation of these principles might be difficult. In determining the RAB, the AER should have regard to:

    - The value achieved by assessing the asset against the principles of the regulatory test
    - The Optimised Depreciated replacement value of the transmission asset

[1] Expert Panel on Energy Access Pricing, *Draft Report to the Ministerial Council of Energy*

B. Key Issues

(i) Greater prescription in the revised regulatory approach provides a stable, more predictable transparent regulatory environment

The Group supports the AEMC Rule proposal on the basis it provides greater clarity, certainty and transparency in regulatory processes. More prescriptive Rules reduce the AER's discretion when adjudicating on the Rules. Whilst discretion is an important component of any regulatory framework, it must be balanced with the need to provide certainty and clarity. Hence, we support the AEMC's attempts to provide a clearer framework for making Revenue Cap determinations for the AER.

(ii) The revised framework developed to improve the clarity of the definitions of the transmission services offered by TNSPs is appropriate. However, the AEMC needs to do more work to clearly differentiate between a 'negotiable service' and a 'contestable service', and to improve the dispute resolution process.

The Group supports an improved commercial framework for providing "negotiated services" that includes a timely dispute resolution process to apply to pricing disputes, and believes it represents the right form of regulation to apply to these services.

1. It is satisfied with the AEMC's negotiate/arbitrate model represents the appropriate form of regulation to apply to these services. It will lead to more commercial outcomes in providing these services. The revised dispute resolution procedure improves the framework for settling the pricing disputes in a timelier manner, in the event of a dispute.

2. It believes some refinement should be considered to ensure the effectiveness of the dispute process. In particular, we note that arbitration is limited to pricing matters. In addition, a TNSP is expressly not required to provide a negotiated transmission service - even though such a service is still considered a monopoly service under Chapter 6A. This may render the dispute mechanism ineffective if the NSP can simply refuse to provide the service at the arbitrated price. It is also conceivable that a TNSP dissatisfied with the pricing outcomes of a dispute process may simply seek to recover such costs through non-pricing terms (eg liability regime, payment terms, credit support, etc). The AEMC may therefore wish to reconsider the provision that an NSP can not be compelled to provide a negotiated transmission service - an NSP should arguably be bound to provide the services at a price determined through arbitration. Arbitration should also be available to resolve both pricing and non-pricing terms.

3. It agrees with the AEMC that the current definitions of "prescribed services" and "negotiable services" in the Rules [2] are circular. This creates inconsistencies around how TNSPs in each jurisdiction treat these services. Clearer definitions will help resolve the circularity of the definitions of these services.

4. It believes more work needs to be done to clarify the difference between a "negotiable service" and a "contestable service". The AEMC has stated that a service is genuinely competitive where both the TNSP and third parties can supply it in a practical and economic sense. We can see that disputes will arise in the future between TNSPs and generators over how some negotiated services will be treated in the future. For example, a small-scale augmentation undertaken by a remote generator to connect to the shared network could be treated as either a "negotiated service" or "contestable service" under the current Draft - Rule. TNSPs will argue the augmentation is capable of being supplied in a competitive market where as the remote generator will seek the protection of the "negotiated services" framework which will inevitably result in disputes. Accordingly, more work is required to develop a definition of " contestable services" to prevent future disputes about whether services might be considered either "negotiable" or "contestable". The Draft Rule should include a definition of a "contestable service" that provides services are only deemed contestable in a jurisdiction where they:

[2] National Electricity Rules

- satisfy the definition of a "negotiable service" and
- the relevant jurisdiction allows the service to be provided by more than one service provider
- the service can be practically and economically be provided by at least three service providers

This added clarity would prevent further disputes and ensure only genuinely contestable services are treated that way.

(iii) The Group support the inclusion of a provision that adjusts the price for a "negotiated service" where the assets are subsequently shared with another user, and the proposed provision that prevents shared network costs being re-allocated to "negotiated services". However, the AEMC needs to further clarify the implementation of these provisions.

The Group agrees with the AEMC that the arrangements for " negotiated services" should take account of the fact that assets which may be largely used by one user at a point in time maybe used by more than one user in the future. More specifically, where new users enter into agreements for "negotiated services" which are supplied using assets the costs of which are already being recovered from another user under an agreement for 'negotiated services", then the original user should be entitled to a reduction in charges.

Where a generator pays for an extension as a '"negotiated service" to transmit its capacity to the market, there is no certainty that another party will not subsequently seek connection with the effect of limiting that generator's access to that line. We understand that the AEMC has explicitly stated that the NEM asset design is not intended to provide firm access to generators. [3] However, the Draft Rule does provide a discount to the generator that built that asset where some other party begins to use it. This represents a step forward in providing more transmission user certainty.

The Group also support the principle that costs that have been allocated to "prescribed services" must not be reallocated to "negotiated services". This prevents costs that have been historically been associated with shared assets from being inefficiently reallocated to "negotiated services" (such as negotiated generator connection charges) as a consequence of network developments which are outside the control of the connected party.

However, we believe two specific aspects of these proposed arrangements should be clarified:

1. Pre-existing generator connection assets included in the RAB as of 9/2/06 are grandfathered as "prescribed services" (Rule 11.5.11). These 'legacy' connection costs are therefore denied the protection of the non-reallocation principle that applies to "negotiated services", and therefore face the risk of inefficient cost shifting from historically shared assets.

   The same principle should apply to generator connection costs regardless of how historically determined - shared network costs should not be reallocated to generator connection costs. The AEMC may therefore wish to consider suitable amendment of the Cost Allocation Principles in order to reflect this, and ensure consistent treatment of both grandfathered and negotiated generator connection costs.

2. As above, pre-existing generator connection assets included in the RAB as of 9/2/06 are deemed to be "prescribed services" under (Rule 11.5.11). However, if a TNSP modifies these grandfathered assets (eg via a network reconfiguration or refurbishment project) it is unclear whether such assets automatically continue to form part of the RAB, and if so whether any **increase** in asset value also forms part of the RAB, or would be deemed to be a "negotiated service".

   The treatment of increases in asset value should therefore be clarified. Any increase in asset value should not be allocated to existing generator connection services where such projects are initiated to benefit users

[3] Draft Rule Determination – Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 p. 29

generally. The AEMC may wish to consider suitable amendment of the Cost Allocation Principles and/or grandfathering Rule in order to reflect this.

(iv) The introduction of a proposed/respond model where the Australian Energy Regulator (AER) must approve forecast capital expenditure considered a "reasonable estimate" of forecasts is appropriate. However, we support the AER 's position that calls to substitute the term "reasonable estimate" with the term '"have regard to" in assessing capital expenditure under the proposed/respond model.

TRUenergy's submission to the Draft Rule Proposal supported the idea that the introduction of a proposed/respond model in the transmission regulation will lead to similar outcomes to current receive/determine model. The AER would still need to approve reasonable estimates of capital expenditure incurred by an efficient transmission network service provider under the propose/respond model developed by the AEMC as part of this Draft Rule. [4] The TNSP would still need to provide those prescribed transmission services in an efficient manner. [5] However, the AER and the Expert Panel on Access Pricing have raised some concerns about the propose/respond model developed for transmission by the AEMC. These concerns include:

1. That the term 'reasonable estimate' is a new concept that creates uncertainty. [6]
2. The term 'reasonable estimate' could open the way for further regulatory gaming. The propose/respond model may encourage TNSPs to test the limits of the definition of the term 'reasonable' rather than provide a genuine assessment of their forecasts.

The Group supports a regulatory regime that leads to the development of an efficient level of transmission in the market. As such, we support the AER's proposal to remove the requirement for the AER to accept " reasonable estimates" of capital expenditure given the potential risks associated with this term. Accordingly, the AER should simply "have regard to" the matters in Section 6A.67 (b) (3) of the Draft Rule in making a capital expenditure determination. This simple change should alleviate the potential risks associated with untested terms like "reasonable estimates."

(v) The introduction of 'contingent projects' in the regulatory regime subject to the condition that the threshold for triggering the contingent project is greater than 5% of the value of the regulated asset base is appropriate.

The AEMC has proposed a low powered incentive regime on capital expenditure. The regime includes a contingent projects concept developed by the AER that will be included in the 'Draft Rule'. The contingent projects concept is designed to cater for relatively large projects that address foreseen events but where the TNSP in uncertain as to whether the project will proceed. The contingent capital expenditure must be greater than 5% of the regulated asset base (RAB) to trigger a contingent project.

The Group support the contingent projects provision to form part of the ex-ante Revenue Cap. However, this support is subject to the condition that the contingent projects regime be designed carefully to protect regime's incentive properties. As a result, the contingent project provision should have the following characteristics:

1. The trigger for contingent projects needs to be material
2. The event that could trigger the contingent project should be limited and clearly defined
3. The contingent projects provision should be used sparingly

[4] Section 6A.6.7 (b) (3) (vii) Draft Rule Determination – Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006.

[5] Section 6A.6.7 (a) (1) (vii) Draft Rule Determination – Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006.

[6] Expert Panel on Energy Access Pricing, *Draft Report to the Ministerial Council of Energy*

The current threshold that provides that a contingent project will only be triggered where its value is greater than 5% of the RAB achieves this. Further relaxing the threshold applied to contingent projects risks distorting the incentive qualities of the regulatory regime on capital expenditure. The danger is the low powered incentive scheme turns into a regime highlighted by frequent re-openings with characteristic more consistent with rate of return regulation.

(vi) The inclusion of a re-opening provision to form part of the regulatory arrangements for transmission is appropriate subject to the condition that the threshold for triggering the re-opener is greater than 5% of the value of the regulated asset base.

The AEMC has proposed a low powered incentive regime on capital expenditure. The regime includes a re-opening provision developed by the AEMC to be included in the 'Draft Rule'. We are concerned the inclusion of a contingent projects regime combined with a re-opening provision (combined with the retention of pass throughs) may erode the incentive properties of the regime. TRUenergy's original submission to the Draft Rule Proposal supported a re-opening clause that would deal with foreseen/unforseen capital expenditure that could only be triggered where the contingent project's value was greater than 5% of the RAB.

The Group supports the AEMC's revised re-opening provision to form part of the ex-ante revenue cap because it can only be triggered in extreme circumstances. It is designed to protect the incentive properties of the regulatory regime. If the re-opener is relaxed to allow the revenue cap to be re-opened more frequently during the regulatory period (perhaps through a lower threshold) it will introduce some of the negative factors associated with rate of return regimes. Further relaxing the re-opening provision may lead to

1. Frequently contentious re-openings
2. Consumers rather than the regulated firm bearing much of the market risk
3. A regime that provides limited incentives to deliver efficient transmission investment in the NEM

(vii) The value of the Regulated Asset Base (RAB) for Market Network Service Providers (MNSPs) that convert to regulated status

The Draft Rule outlines some broad principles for determining the regulated asset base (RAB) in the case of a conversion from an unregulated asset to regulated status. [7] These principles represent a significant departure from the approach adopted in the Murray-Link and Direct-Link conversion determinations by the ACCC. We agree with the AER [8] that the practical implementation of the general principles adopted by the AEMC to value the opening RAB for MNSPs that convert to regulated status will prove difficult. For example:

1. This principle of projecting wholesale market prices or contract prices over the asset life to determine the market benefits is a complex exercise.
2. The general principles developed by the AEMC do not deal with the issue that unregulated links converting to regulated links can by pass the regulatory test.

The AEMC believes its approach is preferable to the approach adopted by the ACCC in the Murray-Link case because it ensures that the RAB relates specifically to the MNSP seeking conversion. It provides the MNSP recovers a return based on either its efficient costs or the benefits it provides to the market. In contrast, the ACCC's method guarantees the regulatory test is not by-passed by the converting MNSP. Accordingly, it creates the possibility that the asset can be valued on the basis of the costs of an alternative option rather than the asset itself.

[7] The AEMC's approach in the Rule Proposal was for the opening of the RAB for an MNSP to be determined by the lower of:

- The efficient capital costs of the investment
- The NPV of the incremental net benefit derived by the market from the MNSP converting to regulated status plus the NPV of the expected revenue the MNSP would earn if it did not convert, minus the NPV of the expected operating costs over the life of the asset

[8] AER submission to AEMC Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 – march 2006 P.20

The Group believe that where the AER decides to classify a MNSP a prescribed service by allowing conversion, then RAB should be valued in a manner that that achieves consistency with the valuation of prescribed services under the Rules. We are specifically concerned that the AEMC's methodology will allow the regulatory test to be by-passed. Accordingly, we support the AER's submission [9] that requires the following principles be applied in the conversion decision to determine the RAB. They include:

- The value that would be achieved by assessing the transmission system against the principles contained in the regulatory test.
- The economic life of the transmission asset
- The optimised depreciated replacement value of the transmission assert

However, the context of this discussion highlights the challenges of attempting to transfer a merchant invested asset into a part of a natural monopoly. TRUenergy reiterates its comments to the 'Issues paper" that the conversion option should be abolished as it has departed from its original intent by which MNSP investments were made. Abolishing the right of MNSP to convert to regulated status represents a simple resolution to this debate.

C. Conclusion

The Group support the AEMC's work in its endeavour to reform the regulatory arrangements that apply to governing the investment in, and the operation of the national electricity transmission grid that should contribute to the efficient operation of the NEM. It is imperative the regulatory arrangements that apply to transmission are consistently improved given the significance of the interactions of the transmission network with the competitive sectors of the electricity. Accordingly, this submission supports the work undertaken by the AEMC this review, and it provides some ideas on how to improve the arrangements that form part of the Draft Rule.

A key theme central to this submission is that the regulatory arrangements for transmission need to be effective in promoting the right incentives to provide an efficient level of transmission in the NEM. In this regard, we support the AEMC work on this Draft Rule Determination. Furthermore, we support its endeavours in undertaking other Rule changes aimed at facilitating the timely and efficient investment that are sufficient to meet future demand in the NEM. [10]

We appreciate the opportunity to participate in this review conducted by the AEMC. We hope that this submission has been helpful. For further information regarding this submission please contact Mr: Con Noutso : Manager Regulation (Access) TRUenergy on Tel: 03-8628-1240

[9] See Above

[10] MCE, Regulatory Test Principles Rule change proposal, 12 October 2005, and MCE, Last Resort Planning Power Rule change proposal, 12 October 2005.