



Victorian Energy Networks Corporation

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Dr John Tamblyn
Chairman
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By Email: submissions@aemc.gov.au

Dear John

Submission on Revenue Requirements Issues Paper

VENCorp welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) Revenue Requirements Issues Paper (Issues Paper). VENCorp has the following comments to provide in response to the Issues Paper.

VENCorp and regulated revenue

As was raised in VENCorp's response to the AEMC's Scoping Paper, the issues identified by the AEMC in the Issues Paper are relevant to the operation and investment decisions of the asset owning Transmission Network Service Providers (TNSPs)¹. However, the Issues Paper has not considered the unique arrangements that apply in Victoria and VENCorp's functions as the independent, not-for-profit TNSP responsible for directing augmentations to Victoria's shared transmission network.

VENCorp notes that the Victorian derogations contain a number of modifications in relation to the operation of Chapter 6 of the National Electricity Rules (Rules) and, in particular, the revenue cap process that is to apply to VENCorp. These modifications are set out in clauses 9.8.4A to 9.8.4F of the Victorian Derogation (see attachment 1). In brief, the derogation provides that:

- Any transmission services provided by a regulated asset owner are subject to the revenue setting provisions in Chapter 6; and
- Any transmission services provided by VENCorp are subject to the revenue setting provisions of clauses 9.8.4A to 9.8.4F of the derogation.

In relation to the revenue setting process that applies to VENCorp, the derogation provides that VENCorp's revenues must not exceed VENCorp's statutory electricity transmission-related costs; and that the maximum allowable revenue must be determined on a full cost recovery but no operating surplus basis (clause 9.8.4C(a)).

¹ VENCorp, Submission on Scoping Paper – Electricity Transmission Revenue and Pricing Rules, 19 August 2005.

To facilitate the effective operation of this regime, the derogation also provides for VENCORP to seek, and for the Australian Energy Regulator (AER) to approve, an adjustment to its revenues during a regulatory control period (clause 9.8.4C(g)(2)).

VENCORP believes that the Victorian arrangements operate effectively and efficiently and strongly supports the retention of these provisions in the Rules.

The AER's Statement of Regulatory Principles

Given the extensive review conducted by the AER on revenue regulation for its Statement of Regulatory Principles (SRP), VENCORP supports the retention of the main principles set out in that document. In particular, it supports locking in the regulated asset base and the replacement of the ex-post regime for assessing capital expenditure (capex) with an ex-ante regime to provide regulatory certainty.

Asset revaluation

Once an investment is included in the regulated asset base it seems reasonable for the TNSP to be insulated from subsequent stranding risk. The current methodology in the Rules permitting periodical revaluation of "sunk" investment decisions provides considerable uncertainty to TNSPs and could potentially deter much needed investment.

Ex-ante vs Ex-post

VENCORP supports the replacement of the ex-post regime with the ex-ante regime. The rationale for moving to an ex-ante regime is that investment decisions can only be made on the basis of the information available at that time. It does not serve any purpose to reappraise an investment decision using new information, which only became available after the investment decision was made.

However, the ex-ante regime developed by the AER has low powered incentives and is not strongly linked to service quality. For example, even when a TNSP exceeds its capex allowance during a regulatory control period it is still able to roll in the actual expenditure into its asset base at the subsequent regulatory reset, losing only the return-on and return-of capital for that period. This regime may encourage over investment, particularly in the later part of a regulatory period, inefficient asset utilisation and a degradation of service quality. Consideration should be given to a regime with higher powered incentives which drives TNSPs to pursue the most appropriate solutions, whether they include generation or demand side support payments or transmission options.

Service Standards

For the regime to be effective the capex allowance must be linked to service levels. At present, there is no regulatory contract between the regulator and the TNSP whereby the TNSP specifies the bounds within which their network can and will operate in exchange for the revenue that it is being provided. The closest to this is perhaps the arrangements that apply in Victoria between VENCORP and the asset owning TNSPs where VENCORP enters into a network services agreement with the TNSPs specifying the technical operation of the network.

One approach to improve service quality may be to link transmission revenues to transmission asset ratings and capabilities. Therefore, in exchange for receiving revenues the TNSP would be required to define the continuous and short-term ratings of its network with suitable rewards and penalties for utilising the new and existing capacity more effectively.

Capex and Opex incentives

The SRP approach inconsistently treats incentives between capex and operating expenditure (opex). A low powered incentive on capex and a high power incentive on opex can encourage TNSPs to shift costs from opex to capex. VENCORP contends that the incentives should be consistent between the two.

Revenue cap re-openers

VENCORP believes this ex-ante regime would need to allow re-openers, during the regulatory control period, for pre-defined force majeure incidences that are beyond the control of the TNSP.

Regulatory Discretion

VENCORP supports embedding principles for regulation in the Rules as it will provide regulatory certainty and a consistent approach to revenue setting across all TNSPs. Over time amendments can be proposed to the Rules should they require refinement.

The role of the regulatory test

One issue that was left unresolved in the SRP is the role of the regulatory test in setting regulated revenues. While it was made explicit that projects defined as 'contingent' projects (i.e. sitting outside the cap) will be subject to a regulatory test assessment, in which the regulator would be involved, for those projects within the ex-ante cap its role is unclear.

One possibility raised by in the Issues Paper is for the costs used to justify a project under the regulatory test to be rolled into the regulated asset base. VENCORP believes that this introduces a number of issues. There tends not to be one cost used to assess the feasibility of a project, particularly when dealing with market benefit augmentations. Project costs are typically subjected to sensitivity testing to ensure that the results of the test are robust. By rolling in the value that is used to justify a project under the regulatory test TNSPs will have an incentive to over-inflate the expected cost of the project. If incentives are built around rolling in the cost of the project as justified under the regulatory test, whereby the TNSP gets to keep any underspend, the incentive for the TNSP to inflate the cost of the project is even stronger.

Alternatively, by allowing the actual expenditure to be rolled into the asset base reduces the incentive on the TNSP to manage the project effectively, potentially leading to increased cost overruns. Arguably, providing that the project satisfies the regulatory test, anything not exceeding the upper bound of the sensitivity testing on those costs could be rolled into the regulated asset base. It could equally be argued that providing the cost of the project did not exceed the benefits then any amount not exceeding the benefits should be rolled in to the asset base.

With any of these approaches, the regulator would effectively take over the role of the regulated business leading to an intrusive form of regulation. This was one of the justifications provided by the AER when it moved away from an ex-post regulatory regime.

VENCorp believes that these approaches are suboptimal and detract from the benefits of the ex-ante cap discussed earlier. In contrast, under a high powered ex-ante regime, TNSPs would have an incentive to invest in the most efficient option or adopt innovative solutions, such as generation or demand side options, control and wind monitoring schemes or even running the network harder during peak times. To this end a TNSP would have an incentive to consult on the options that it considers to be necessary and adopt the most appropriate solution subject to its overall revenue cap.

Consideration could, therefore, be given to changing the role of the regulatory test. For projects within the ex-ante allowance the role of the regulatory test could be changed from a revenue-setting instrument to a planning tool to aid decision making. TNSPs should still be required to consult on the technical aspects of all augmentations, with the method and length of consultation commensurate with the size and cost of the augmentation. This is the approach that is currently required of TNSPs when consulting on funded augmentations. Any disputes would then only be considered on technical grounds, not economic ones.

This approach is only appropriate in so far that TNSPs are responsible for maintaining their networks. This is not the case for interconnectors. Therefore, interconnectors would still need to be subject to the requirements of the market benefits assessment of the regulatory test.

Under this proposal, in Victoria, VENCorp would continue to consult on augmentations using an economic cost-benefit test, even for intra-regional augmentations, in line with good corporate practices.

Should you have any questions about these matters please do not hesitate to contact Louis Tirpcou on ☎(03) 8664 6615.

Yours sincerely



Matt Zema
Chief Executive Officer

Attachment 1 Victorian Transmission Services Derogation

9.8.4A Modification of Chapter 6 in its application to Victoria

The application of Chapter 6 in respect of the *Victorian Transmission Network* or a part of the *Victorian Transmission Network* is subject to the modifications set out in clauses 9.8.4B to 9.8.4F.

9.8.4B Transmission service revenues

- (a) Despite anything to the contrary in Chapter 6 or in this Chapter 9, the applicable *transmission* revenue regulatory regime for the regulation of *transmission service* revenues in respect of the *Victorian Transmission Network* or a part of the *Victorian Transmission Network* is:
- (1) in relation to any *transmission services* provided by a *Regulated owner*, the *transmission* revenue regulatory regime set out in Part B of Chapter 6 and, for that purpose, every reference in Part B of that Chapter to a *Transmission Network Service Provider* is to be read as a reference to a *Regulated owner*; and
 - (2) in relation to any *transmission services* provided by *VENCorp*, the *transmission* revenue regulatory regime set out in Part B of Chapter 6 as modified by clauses 9.8.4B to 9.8.4E, and for that purpose every reference in Part B of that Chapter to:
 - (i) a *Transmission Network Service Provider* is to be read as a reference to *VENCorp*;
 - (ii) a *revenue cap* is to be read as a reference to the *maximum allowable aggregate revenue*;
 - (iii) a *regulatory control period* is to be read as a reference to a *relevant regulatory period*; and
 - (iv) *prescribed transmission services* is to be read as a reference to services in respect of which *VENCorp* may determine *shared transmission network use charges*.
- (b) In clause 9.8.4B(a)(1), *transmission services* includes *shared network services*.

9.8.4C Transmission revenue regulatory regime for transmission services provided by VENCORP

- (a) The *transmission* revenue regulatory regime that applies to *VENCorp* must comply with the following principles:
- (1) the amount of *VENCorp's maximum allowable aggregate revenue* for a *relevant regulatory period* must not exceed *VENCorp's statutory electricity transmission-related costs*; and
 - (2) *VENCorp's maximum allowable aggregate revenue* must be determined on a full cost recovery but no operating surplus basis,

and clauses 6.2.2 and 6.2.3 do not apply in respect of *transmission services* provided by *VENCorp*.

(a1) Clause 6.2.4 does not apply in respect of *transmission services* provided by *VENCorp* with the exception of clause 6.2.4(d), (e) and (f). For the avoidance of doubt, for the purposes of clause 6.2.4(f), *transmission services* offered by *VENCorp* are not taken to be offered on a contestable basis by reason only of *VENCorp* having procured those services through a competitive tender or similar process.

(b) Not less than 7 months before the commencement of a *relevant regulatory period*, *VENCorp* must, for the purpose of enabling the AER to determine *VENCorp's maximum allowable aggregate revenue* for a *relevant regulatory period*, submit its revenue application for that *relevant regulatory period* to the AER that sets out:

(1) its proposed *maximum allowable aggregate revenue* for each *financial year* in that *relevant regulatory period*;

(2) its forecast *statutory electricity transmission-related costs* for each *financial year* in that *relevant regulatory period*; and

(3) **[Deleted]**

(4) a statement reconciling its most recent forecast of:

(i) the revenue that will be recovered by way of *shared transmission network use charges*; and

(ii) the *statutory electricity transmission-related costs*,

for the *relevant regulatory period* immediately preceding the *relevant regulatory period* to which the application relates.

(c) The application must be:

(1) consistent with the principles set out in clause 9.8.4C(a); and

(2) in a form that meets the *Information requirements guidelines* but only to the extent to which those guidelines are relevant and applicable to *VENCorp*.

(d) Subject to clause 9.8.4C(e), (f), (g), (g3) and (g4), the AER must determine *VENCorp's maximum allowable aggregate revenue* for a *relevant regulatory period*.

(e) A determination under clause 9.8.4C(d):

(1) must apply the principles set out in clause 9.8.4C(a);

(2) must comply with the requirements set out in clause 6.2.6(a) (and for that purpose, every reference to a *revenue cap* determination in that clause is to be read as a reference to a determination under clause 9.8.4C(d));

(3) must take into account:

- (i) *VENCorp's functions under the EI Act, the application of the Rules to VENC Corp and the conditions imposed on VENC Corp under its transmission licence; and*
 - (ii) **[Deleted]**
 - (iii) *the difference (if any) between the forecasts referred to in clause 9.8.4C(b)(4); and*
- (4) *must set out the maximum allowable aggregate revenue for each financial year in that relevant regulatory period.*
- (f) *If, after considering the application, the AER finds that there is a difference of the kind referred to in clause 9.8.4C(e)(3)(iii), the AER must apply that difference in any determination it makes under clause 9.8.4C(d).*
- (g) *If the AER does not make a determination under clause 9.8.4C(d) before the commencement of the relevant regulatory period in respect of which the application was made, the AER is to be taken to have made a determination as to VENC Corp's maximum allowable aggregate revenue in respect of each financial year in that relevant regulatory period on the same terms as the application.*
- (g1) *If, at any time during a relevant regulatory period, a Regulated owner proposes to send a notice to the AER which could have the effect (directly or indirectly) of varying a charge, or introducing a new charge, payable by VENC Corp to the Regulated owner during that relevant regulatory period for shared network services, the Regulated owner must first provide a copy of that notice to VENC Corp.*
- (g2) *If VENC Corp's statutory electricity transmission-related costs for a financial year have exceeded, or VENC Corp anticipates (as a result of receiving a notice from a Regulated owner under clause 9.8.4C(g1) or otherwise) that they will exceed, the amount of the statutory electricity transmission-related costs for that financial year assumed by the AER in making the determination of VENC Corp's maximum allowable aggregate revenue, VENC Corp may apply to the AER for an adjustment to the maximum allowable aggregate revenue for each affected financial year in the relevant regulatory period of an amount, set out in the application, equal to the amount required to ensure that the maximum allowable aggregate revenue complies with the principles in clause 9.8.4C(a).*
- (g3) *Following an application by VENC Corp under clause 9.8.4C(g2), the AER must determine the amount, if any, by which VENC Corp's maximum allowable aggregate revenue for each affected financial year in the relevant regulatory period is to be adjusted so that it complies with the principles in clause 9.8.4C(a).*
- (g4) *If the AER does not make a determination under clause 9.8.4C(g3) within 30 business days after the application by VENC Corp under clause 9.8.4C(g2), the AER is to be taken to have made a determination that VENC Corp's maximum allowable aggregate revenue for each affected financial year in the relevant regulatory period is to be adjusted by the amount set out in VENC Corp's application.*
- (h) **[Deleted]**

9.8.4D Information disclosure by VENCORP

For the purposes of clause 6.2.5:

- (a) clause 6.2.5(c) is to be read as if “clauses 6.2.2, 6.2.3 and 6.2.4” was substituted with “clause 9.8.4C”, and
- (b) VENCORP must comply with clause 6.2.5 but only to the extent to which it is relevant and applicable to VENCORP.

9.8.4E [Deleted]

9.8.4F Pricing for connection to and use of Victorian transmission network

- (a) The operation of Part C of Chapter 6, as it operates in respect the *Victorian Transmission Network* or a part of the *Victorian Transmission Network*, is modified by this clause 9.8.4F so that the allocation of the *aggregate annual revenue requirement* and its equivalent determined under clause 9.8.4C, and the allocation of transmission costs and the conversion of those allocated *transmission costs* to *transmission service prices* and charges as provided for under Part C of Chapter 6, reflects the arrangements in place in relation to the *Victorian Transmission Network* or a part of the *Victorian Transmission Network* under the *EI Act*, the *ESC Act* and the *Tariff Order*.
- (b) [Deleted]
- (c) Part C of Chapter 6 applies in respect of the *Victorian Transmission Network* or a part of the *Victorian Transmission Network* in the following manner:
 - (1) in clauses 6.3 and 6.4.1 and in the opening words of clause 6.5, every reference to *transmission services* is to be read as including *shared network services*;
 - (2) subject to clauses 9.8.4F(d) and (f), clause 6.3 applies to:
 - (i) where a provision of that clause relates to the provision of *transmission services* which are or form part of *transmission use of system services* or *common services*, a *Regulated owner* and VENCORP and, for that purpose, every reference in the provision to:
 - (A) a *Transmission Network Service Provider* is to be read as a reference to the *Regulated owner* or VENCORP (as the case requires); and
 - (B) *transmission use of system services* or *common services* is to be read as, in the case of a *Regulated owner*, a reference to *shared network services*; and
 - (C) the *aggregate annual revenue requirement* is to be read as, in the case of VENCORP, a reference to the *maximum allowable aggregate revenue* for the relevant *financial year*;
 - (ii) where a provision of that clause relates to the provision of *transmission services* which are or form part of *entry services* or *exit services*, a *Regulated owner* and, for that purpose, every reference in that provision to

a *Transmission Network Service Provider* is to be read as a reference to the *Regulated owner*;

(3) clause 6.4 (other than clause 6.4.1) and clause 6.5 apply to:

(i) where a provision of either clause relates to the provision of *transmission services* which are or form part of *entry services* or *exit services*, a *Regulated owner* and, for that purpose, every reference in that provision to a *Transmission Network Service Provider* is to be read as a reference to the *Regulated owner*; and

(ii) subject to clause 9.8.4F(h), where a provision of either clause relates to the provision of *transmission services* which are or form part of *transmission use of system services* or *common services*, *VENCorp* and, for that purpose, every reference in the provision to:

(A) a *Transmission Network Service Provider* is to be read as a reference to *VENCorp*;

(B) the *aggregate annual revenue requirement* is to be read as a reference to the *maximum allowable aggregate revenue* for the relevant *financial year*; and

(C) a *revenue cap* is to be read as a reference to the *maximum allowable aggregate revenue*.

(4) subject to clause 9.8.4F(d), clause 6.4.1 applies to:

(i) a *Regulated owner*, as if in that clause:

(A) for clause 6.4.1(a)(3) and (4), there were substituted: "(3) *shared network services assets*."; and

(B) a reference to a *Transmission Network Service Provider* were a reference to the *Regulated owner*; and

(ii) *VENCorp*, as if in that clause:

(A) clause 6.4.1(a)(1) and (2), were omitted; and

(B) a reference to a *Transmission Network Service Provider* were a reference to *VENCorp*; and

(C) a reference to *aggregate annual revenue requirement* were a reference to the *maximum allowable aggregate revenue* for the relevant *financial year*; and

(5) clauses 6.7 to 6.9 apply to:

(i) where a provision of any of these clauses relates to the provision of *transmission services* which are or form part of *entry services* or *exit services*, a *Regulated owner* and, for that purpose, every reference in that provision to a *Transmission Network Service Provider* is to be read as a reference to the *Regulated owner*;

- (ii) where a provision of any of these clauses relates to the provision of *transmission services* which are or form part of *transmission use of system services* or *common services*, *VENCorp* and, for that purpose, every reference in that provision to a *Transmission Network Service Provider* is to be read as a reference to *VENCorp*.
- (d) A *Regulated owner* must, on allocating its *aggregate annual revenue requirement* amongst all of its assets utilised in the provision of *shared network services*, immediately notify *VENCorp* of the actual amount of the *aggregate annual revenue requirement* allocated in respect of each of its assets utilised in the provision of those services.
- (e) In addition to the modifications set out in clause 9.8.4F(c)(3), clause 6.5 applies to a *Regulated owner* as if:
 - (1) in the opening words of that clause:
 - (i) for clause 6.5(a)(3) to (5), there were substituted: “(3) *shared network services cost*.”;
 - (ii) clause 6.5(b) were omitted; and
 - (2) after clause 6.5.1 there were inserted:

“6.5.1A Shared network services charge

The portion of the *aggregate annual revenue requirement* referable to *shared network services* is recoverable by a *Regulated owner* from *VENCorp*.”
- (f) *VENCorp* is to be taken to be:
 - (1) the *Co-ordinating Network Service Provider* appointed under clause 6.3.2 responsible for the allocation of all relevant *aggregate annual revenue requirements* relating to the provision of *transmission services* which are *transmission use of system services* or *common services* within the Victorian region in accordance with the relevant clauses of Part C of Chapter 6; and
 - (2) the *Transmission Network Service Provider* referred to in clause 6.3.3 which must liaise with *Network Service Providers* in other *interconnected regions* which are similarly responsible for the allocation of all relevant *aggregate annual revenue requirements* relating to the provision of *transmission services* which are *transmission use of system services* or *common services*.
- (g) **[Deleted]**
- (h) *VENCorp* must, in allocating the portion of its *shared transmission network use charges* that is to be recovered from each *Distributor* to which it provides *transmission use of system services* or *common services* in each *financial year* of a *relevant regulatory period*, adjust that portion in accordance with clause 9.8.4(a)(3).