

23 November 2012

Mr Philip Weickhardt  
Presiding Commissioner – Electricity Network Regulation Inquiry  
Productivity Commission  
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Canberra 2600

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Dear Mr Weickhardt

**Re: Draft Report - Inquiry into Energy Network Regulation**

SP AusNet welcomes the opportunity to make this submission in response to the Commission's draft report. The Commission's work is broad ranging and provides a valuable contribution into the discussion on broad aspects of reform under consideration in the electricity networks sector.

We support the recommendations of the Commission in relation to the appropriate use of benchmarking in setting network revenues. However, greater clarity is required in identifying when it may be feasible to progress to benchmark based revenue setting, and the model that should be applied. The draft report anticipates such a transition in the approach to revenue setting, which would be a significant change point, and the Commission should therefore consider the process that would be required to ensure stakeholder confidence.

The Commission articulates its views on preferable NEM-wide transmission arrangements to deliver an efficient level of transmission investment. The model preferred by the Commission involves separation of network planning and network operation responsibilities, by establishing the Australian Energy Markets Operator as a central national planner. The model was discussed at the stakeholder roundtable on 19 November and we appreciate the opportunity provided by the Commission to exchange views and explore the issues.

SP AusNet has some important points of difference on the Commission's conclusions on transmission arrangements, based on our experience with separated planning in Victoria over an 18 year period. It is important that the Commission note the realities of the Victorian experience and the shortcomings of the arrangements. Improvements would be necessary if transmission arrangements with separated responsibilities were to be contemplated for national application.

A particular point of difference is on the assignment of liability. The draft report states that a central planner (as established in Victoria) can be held liable for its failings, and in response to queries as to the validity of this the Commission has expressed the view that all liability is ultimately borne by consumers. This is a critical issue for future arrangements, where greater accountability should be a desirable outcome, and SP AusNet challenges the Commission's conclusions. As a private profit-motivated business we are acutely aware of how the prospect of liability can impact on business value and in turn is a key driver of prudent risk management and operating behaviour. The strong accountability to shareholders in turn reduces the costs to consumers.

Our detailed submission in response to the draft report is attached. We look forward to further engagement with the Commission on these important matters.

Yours Sincerely,

Charles Popple  
**Group General Manager, Network Strategy and Development Division**

**Attachment:**

Submission on Draft Report: Electricity Network Regulatory Frameworks

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## **Response to Productivity Commission Draft Report Economic Network Regulatory Frameworks**

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### **1. Introduction**

This submission responds to findings and recommendations of the Productivity Commission (the Commission) in its Draft Report on Electricity Network Regulation.

The terms of reference for the Commission's review focussed on the use of benchmarking in revenue setting and whether investment in interconnectors is efficient. In the course of its work the Commission has reviewed broad aspects of the electricity networks regulatory framework (in which benchmarking and interconnector services inter-relate with other parts of the overall 'system'). The Commission has made recommendations in many of these areas as well.

The Commission's draft conclusions and recommendations in several areas are of particular interest to SP AusNet, and our submission focusses on these:

- The challenge of protecting private sunk investment and encouraging essential on-going investment;
- The application of benchmarking as confidence develops; and
- The effectiveness of alternative transmission arrangements.

Comments on other recommendations are also included in the submission.

### **2. Protection of Private Sunk Investment**

A consistent theme in current phase of regulatory reform is the desirability of state government's divesting of their ownership of networks. It is also generally agreed that privately owned networks are efficiently operated and are compliant with service obligations and expectations.

The Commission discusses the lower cost of capital, and the resulting difference in investment incentives for state owned network businesses. The Commission concludes that a benchmark private network business is the appropriate benchmark, and the governance of the government businesses must recognise this inherent inequality and ensure effective neutrality arrangements are established to correct the investment incentive.

The effectiveness of the regulatory regime (to support the National Electricity Objective) then relies on such neutrality arrangements being established and maintained. However, to the extent that there is any doubt about the effectiveness of such arrangements there is the risk that the regulatory regime, and its implementation by the regulator, will evolve to compensate. Further pressure on the revenues of businesses subject to the regulatory framework would result.

In the scenario described it is private-investor owned networks that are impacted, providing discouraging signals for future privately funded investment.

It is essential that the regulatory regime is able to protect the sunk investment of private investors and provide the appropriate incentives and encouragement for future investment. Neither the Commission nor other recent regulatory framework reviews have given due regard to this important issue.

We provide further comment on following two aspects of the regulatory framework discussed by the Commission.

## **2.1 WACC Framework**

The approach proposed by the Commission is unduly prescriptive. It does not recognise that private firms must be able to attract and retain capital in a wide range of global economic environments and evolving circumstances.

**Draft recommendation 5.3** *Estimates of the debt risk premium and risk free rate used in the calculation of the weighted average cost of capital should be calculated using long-term trailing averages.*

The prescription of a return on debt methodology, such as the use of long-term trailing averages in the calculation of debt risk premium and risk free rate, may not be reflective of the efficient financing practices of the firm. A more permissive approach is necessary to suit the circumstances of particular network service providers.

Similarly, it is important that the Rules that govern the return on equity recognise the impact of actual equity market conditions. For example, in the current low interest rate environment, the evidence is clear that the true market risk premium has risen, to the extent that it more than offsets the reduction in the observed risk free rate. The Rules should not preclude the use of long run average real equity returns to set the benchmark return on equity. This approach is used internationally (for example in the UK and the US) and may offer a useful alternative to the current approaches used in Australia. To this end, references to prevailing conditions should not be absolute but rather should remain one of several considerations when setting the return on equity.

## **2.2 Limited Merits Review**

The regulatory system is composed of a number of components which all play their part and interrelate to make the overall system effective. The limited merits review regime is a critical component in the regulatory system.

An increasing degree of discretion being made available to the Australian Energy Regulator (AER) through recent regulatory reform, and supported in the Draft Report, which has the potential to reduce its accountability, make it more vulnerable to opportunistic behaviour, and erode the confidence of investors. As noted by the Expert Panel in their Final Report to SCER *“It is because the AER can exercise significant discretionary powers that merits review has such an important potential role to play”*<sup>1</sup>.

Whilst the Commission has examined many components of the system in terms of their effectiveness, such as the revenue setting, efficient pricing, reliability framework and customer advocacy, it has not so obviously provided an analytic treatment for the appeals mechanism. The Draft Report observes the work of the LMR regime review panel, and

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<sup>1</sup> Expert Panel, 30 September 2012, Review of the Limited Merits Review Regime, Stage Two Report, page 3

accordingly that *'The various progress reports by the limited merits review panel suggest that broader reforms to the processes are warranted'*<sup>2</sup>.

Having said that, we acknowledge the following important observation by the Commission:

*"Many of the limited merits reviews have focused on the WACC and have resulted in substantial increases in the revenue determinations (table 5.2). The figures should not be interpreted as necessarily indicative of inefficient increases in determinations, as the AER may well have underestimated the correct WACC in some instances. Regardless, they underline the financial importance of the limited merits review process"*<sup>3</sup>.

Further, the Commission has made recommendations around two aspects of the Limited Merits Review Regime that are most criticised, and which go a long way to addressing the deficiencies in the regime. These are the treatment of flow-on effects and consumer participation.

Conversely the Expert Panel's recommendations to completely overhaul the LMR regime are unwarranted, and indeed, counter-productive. Its recommendations do not deliver an appeal mechanism that is accessible to stakeholders, or which provides any confidence to stakeholders that error or unreasonableness in decision-making can be addressed. This is particularly important for investors, who commit funds to assets whose lives span 8 or more regulatory periods.

The Commission recommends that the Rules specify the inter-dependent nature of WACC parameters, as follows:

**Draft recommendation 5.2** *The Rules should specify the interdependent nature of the parameters used to estimate the weighted average cost of capital, and specify that any merits review must also consider the relevant rule in that light.*

We agree with the Commission's observation that the accounting for the interdependency of WACC parameters in decision-making is important, however it is unclear whether the recommendation is helpful as drafted. For the AER's primary revenue determination this level of direction should be unnecessary. In addition, the AER will be required to consider a range of approaches and no specific formulaic expression for the WACC will be promulgated. Interdependency of parameters will be self-evident from the approaches referenced.

For application to merits review, the recommendation appears fundamental, and if established for that purpose would also provide greater assurance that inter-relationships are adequately addressed in the primary decision-making. The improvement of primary decision making is an objective of the Limited Merits Review Regime.

However, the Rules are unlikely to be the appropriate instrument to provide direction into the appeals process. Rather, this would be the specification of the Limited Merits Review regime in the National Electricity Law.

Throughout the LMR review process the networks investment sector has advocated for the regime to be improved to ensure that the AER is required to bring inter-relational effects to

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<sup>2</sup> Productivity Commission 2012, *Electricity Network Regulatory Frameworks*, Draft Report, page 202

<sup>3</sup> *Ibid*, page 200

the attention of the appeal body (generic, rather than limited to WACC parameters). Yet this simple remedy to the greatest mystery in the conduct of the Limited Merits Review regime has been overlooked by the Expert Panel.

Finally we comment on the Commission's proposal for the establishment of a consumer advocacy body.

**Draft Recommendation 21.3** *There should be adequate ongoing funding of a single but broadly representative consumer body with expertise in economic regulation and relevant knowledge and understanding of energy markets. This body would:*

- *represent the interests of all consumers during energy market policy formation, regulatory and rule-making processes, merit reviews, and negotiations with providers of electricity networks and gas pipelines*
- ...

We acknowledge that there is significant scope and opportunity to improve the ability for consumers to participate in regulatory processes. Some progress has been made through decisions by the Australian Energy Markets Commission (AEMC), on the AER Rules Change Request, and the final determination on the distribution planning and expansion framework. New points of engagement between networks and consumers are established in the Rules arising from the AEMC's reviews. The Commission's proposals for a consumer body would facilitate the effectiveness of this relationship.

In submissions to the Expert Panel, SP AusNet and others, notably in a paper by Professor Alan Fells prepared for the Energy Networks Association, have proposed a funded consumer advocacy body. The establishment of such a body would appear to be instrumental in addressing concern regarding the balance achieved through the Limited Merits Review regime. Yet this simple remedy to the second key deficiency in the regime has been overlooked by the Expert Panel.

The Draft Report references the role of the consumer advocate in California. This includes the following text:

*"The DRA must 'represent and advocate on behalf of the interests of public utility customers and subscribers...to obtain the lowest possible rate for service consistent with reliable and safe service levels'"<sup>4</sup>*

This definition of the role for a consumer advocate in the context of the NEM would not be appropriate, as a 'lowest possible rate' objective for the body engenders a short term focus and would be in conflict with the National Electricity Objective which is appropriately phrased to be 'in the long term interests of consumers'. However, we acknowledge that the role as described for the DRA is one which may be attractive for consumer bodies in attracting attention to the immediate implications of revenue requirements proposals and decisions.

In tandem with the recommendation to establish a single, funded consumer body it would be timely to consider an appropriate charter for the body. This should identify with the NEO / NGO.

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<sup>4</sup> Ibid, page 289

### 3. Benchmark Based Revenue Setting

Benchmarking is an important element of the revenue setting process. The weight that can be applied to benchmarking depends upon its conformance with effectiveness criteria, in particular its robustness, consistency with the wider regulatory framework, transparency, promotion of efficiency, reasonableness of data requirements, adaptability and resource cost.<sup>5</sup>

Revenue setting principles established in the regulatory framework must form the basis for use of benchmarking, as for pure cost build-up based cost estimates. The principles provide important guidance and bounds on matters such as policy intentions on revenue adequacy and the criteria relevant to assessment of expenditure requirements. They include:

- National Electricity Law section 7A(2) Revenue and Pricing Principles  
Guidance that a network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing the regulated services; and
- National Electricity Rules clauses 6.5.6 (c)(2) and 6.5.7(c)(2)  
An expenditure assessment criterion being the costs that a prudent operator in the circumstances of the relevant business would require to achieve the capital and operating expenditure objectives.

We make specific comment on the implications of the following draft recommendation.

**Recommendation 8.5** *In any of the next rounds of regulatory determinations, the AER should not use aggregate benchmarking as the exclusive basis for making a determination. Instead, the AER should use such aggregate benchmarking results as a diagnostic tool in responding to business cost forecasts.*

The recommendation recognises that it is still early days in the benchmarking of Australian network businesses. The short term appropriate use of benchmarking in the revenue setting process is as a diagnostic tool until a much deeper understanding and confidence is gained in assessment of the performance of the networks using benchmark results. The Commission has made a number of recommendations in Chapter 8 that would facilitate the development of such understanding.

The subsequent part of the recommendation (not quoted above), is concerning. This appears to leave the decision as to when benchmarking is sufficiently robust for the AER's benchmark estimate to 'hold sway' to the judgement of the AER. This would risk a non-transparent, non-consultative transition to an alternate revenue setting paradigm. A formal Rules consultation process would be necessary at this turning point in the way expenditure allowances are determined, so that stakeholders are able to participate in the decision

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<sup>5</sup> These are criteria developed for Ofgem by Frontier Economics. SP AusNet's source is the Energy Networks Association submission to the Productivity Commission, 20 April 2012, Response to Productivity Commission Electricity Network Regulation Issues Paper, page 34

making process. This would provide improved confidence that the transition decision is entirely objective.

In addition, it is unclear from the recommendation whether the Commission intends that a benchmark outcome then apply at the expenditure component level or for the overall revenue path (noting the words '*...but if the overall proposal were divergent from the regulator's benchmarking estimate, the onus of proof would be for a network business ...*').

The recommendations should clarify that benchmarking would be applied at the expenditure component level. It would be more appropriate for benchmarking at the overall revenue level to be subject to further development of a model that would substitute for the 'building blocks' approach, and which would encompass the necessary protections to apply in the event that unsustainable outcomes were to eventuate. The Victorian Department of Primary Industry's Rule Change Proposal initiated in 2008, to introduce a TFP model, is an example of the formalisation of a model that would be required.

#### **4. Transmission Reliability**

The AEMC is separately conducting a review of transmission arrangements, through the Transmission Frameworks Review. In its Second Interim Report the AEMC has proposed arrangements which are quite different to the conclusions subsequently reached by the Commission. The AEMC has proposed national arrangements that most closely resemble the South Australian approach, and the Commission has opted for arrangements that most closely resemble the Victorian approach.

Consistency across the NEM for transmission planning and investments arrangements would be beneficial, in particular to facilitate progress toward firm access arrangements for generation and coordination of national flow path planning and investment. Both reviews recognise these benefits and so it seems clear that enhanced transmission arrangements will be recommended in both reviews.

SP AusNet has operated within the current Victorian framework for around 18 years. The arrangements, with separated planning and network operation / management functions, have operated reasonably well although SP AusNet has consistently observed that a number of modifications that would be necessary to streamline the approach if it were contemplated for national application. It should also be recognised that the separation of transmission functions in Victoria occurred at a time when no regulatory framework for the networks sector existed, and incentives on investment and accountability were accordingly not robust. The regulatory system is "one of the most highly regarded in the world"<sup>6</sup> and continues to evolve.

The prospect of change toward an integrated TNSP model has been raised by the AEMC in its Second Interim Report for the Transmission Frameworks Review. SP AusNet has advised that it could work under an integrated TNSP model, providing this was fully supported by other stakeholders and that the necessary parties could work constructively to make the change effectively. However we recognise that this would be contrary to the policy direction previously established by the Victorian Government and is counter to the direction that would be preferred by the Australian Energy Markets Operator (AEMO).

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<sup>6</sup> Expert Panel, 31 August 2012, Review of the Limited Merits Review Regime, Interim Stage Two Report, page 12



Consequently while accepting that this change may provide overall benefits SP AusNet is not advocating for such a change to occur.

The remainder of this section addresses aspects of transmission arrangements applicable to the Commission's preferred model, based on the Victorian experience with separated transmission responsibilities.

#### **4.1 Allocation of Responsibilities for Transmission Services**

The key feature of the Commission's preferred transmission model is the separation of planning and investment decision-making from the role of network operation, which is also the defining feature of the Victorian transmission arrangements. AEMO is shared network transmission service provider in Victoria, and procures services provided by transmission plant through contract.

Independent planning exists in a number of other jurisdictions. However the need that has led to this arrangement does not arise in the NEM. This is the concern of market power that can be exerted by vertically integrated structures with common ownership of generation and transmission. In this environment the planner is concerned with market outcomes. In the NEM this particular concern and planning interest does not exist, and the imposition of further pseudo regulatory functions through the activity of an independent planner would be an extremely heavy handed outcome for the industry. Further, as noted above, the absence of any regulatory framework, which led to the establishment of independent planning in Victoria, is no longer a factor. Therefore, a decision to extend separated planning throughout the NEM requires sound benefits analysis and comparison with the AEMC preferred model.

The following comments are submitted, having regard to the Victorian experience.

The Commission makes the following statement on risk and accountability:

*"SP AusNet is responsible for ensuring that reliability in the transmission network in Victoria is maintained, subject to the planning decisions made by AEMO. If a planning decision were found to be the cause of significant damage to a third party, AEMO could be liable if it had been negligent in carrying out its statutory planning functions."<sup>7</sup>*

Actual experience however is that it is extremely difficult to assign risk to the parties in rigorous contracts consistent with the intended allocation of responsibilities. This is because the separation effectively makes two separate entities responsible for the provision of transmission services, which is generally viewed as heavily integrated.

It is difficult to assign liability meaningfully to AEMO since it is not a commercial organisation, and can only pass-on its liabilities to consumers. The interdependence between functions is such that it is difficult to see how blame for any network service impact to consumers involving outage of plant would not be levelled at the operator (who's network caused the issue), regardless of the adequacy of network provided by the planner.

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<sup>7</sup> Productivity Commission 2012, *Electricity Network Regulatory Frameworks*, Draft Report, page 498

The arrangements are based on a contract for services between AEMO and SP AusNet. As discussed above, conferring appropriate risk allocation in these contracts is difficult. SP AusNet's experience is that the good operation of the transmission arrangements depends more on good will between the parties than on the contract. Attempts to improve clarity in the Network Agreement have failed in various attempts to do this over the years.

An independent planner does not hold the internal technical design, plant procurement and project management skills that are available to an integrated TNSP, and does not have full appreciation of these critical elements. While the planner can request information on these elements for a project they are not within the planner's governance oversight and full coordination of the end to end investment life cycle may potentially be compromised. The risk is that project lead time is absorbed by planning deliberations.

While the plans of a TNSP and independent planner are both published those of the independent planner are not as genuinely transparent and expertly scrutinised as a TNSP's plans. The TNSP is subject to AER revenue review oversight and continuous coordination with the planning functions of AEMO (as national transmission planner). SP AusNet's experience is that it is difficult to assess from AEMO's Victorian transmission plans whether network augmentation is always provided in a timely manner.

The Commission is dismissive of arguments that AEMO cannot bear liability, suggesting that ultimately it is consumers who bear all liability. This is fundamentally incorrect, especially for services provided by private networks.

In a profit motivated business risk to profit projections impacts the value of the business. This is most readily observable when publicly listed companies advise their profit projections to the Australian Securities Commission, or make disclosures on risks that may impact the business. This is equally true of regulated businesses and competitive market businesses. The business, both its shareholders and officers, are directly impacted by unforeseen liability. The function of the enterprise risk management framework is central to identifying and mitigating such risk and is subject to board oversight. There is a fundamental internal incentive for the profit motivated business to appropriately balance risk to maximise profit and build sustainability. The incentive is to outperform other businesses driven by the same motives.

The discipline on profit motivated businesses ensures two things. First, risks must be managed according to their consequences because they have the ability to severely impact the fortunes of the business. This is relevant to both under-investment and over-investment for regulated networks businesses. Secondly, a service management culture is developed that also minimises risk to customers.

Our conclusion is that incentives on the planner are poor, and disproportionate risk is likely borne by the network operator. Indeed, for its preferred model the Commission proposes that the AER would monitor AEMOs implementation of the planning process to ensure it is operating to good practice. This would be a problematic task for the AER, in the absence of a number of firms operating subject to strong governance arrangements and incentives where processes can be readily benchmarked. Neither the revenue regulation or compliance arms of the AER would be expected to have the inherent resource capability to fulfil this role meaningfully.

It is not clear from the Draft Report how the relationship between AEMO and transmission businesses would be established for the Commission's preferred model, or whether an allocation of risk is envisaged. The Commission should carefully consider and clarify its

intentions on this matter, to ensure that incentives for timely provision of services, risk allocation across the sector and commercial accountability are most effective.

A broad concern with the Commission's preferred approach is that there appear to be extremely limited, if any, incentives and rewards for transmission network business to strive for new levels of best practice that will lead to efficiency benefits which are passed on to consumers. Planning, investment decision making, project costing, direction to deliver the service, etc. are all within the control of AEMO. There is the potential danger that the relationship between the parties could drift toward heavy handed control, rather than the service partnership which the Commission may intend.

It is important that the Commission note the realities of the Victorian experience and the shortcomings of the arrangements. Improvements would be necessary if transmission arrangements with separated responsibilities were to be contemplated for national application.

We encourage the Commission to look more closely at the advantages of the AEMC's preferred model. The AEMC has proposed a model that would deliver the benefits of national planning oversight, capturing the main improvements sought by the Commission. An advantage of the AEMC's model is that it does not dilute the accountability of the transmission sector, and distorting effective and efficient risk allocation.

## **4.2 Network Connections**

The Commission's Draft Report does not discuss how the network connections process would be structured in its preferred model. The following comments are made based on experience with network connections in Victoria, in particular reflecting on the impact of separated transmission responsibilities. Approaches to effectively streamline connections, having regard to each party's legitimate business interests, should be identified and analysed if the Commission's preferred approach were to be adopted.

The negotiation of new connections to the transmission network is inherently complex in Victoria, because of the triangular contractual arrangements required, some confusion on responsibilities for the provision of new services and differing views on risk treatment. The complexity is illustrated by the number of deeds and agreements that amass between the parties. In one recent connection arrangement that has been negotiated to conclusion, mapping of the arrangements reveals 23 executed documents.

The negotiations can prove costly, because significant resources are tied up for a long period, including legal resources. A particular issue is the allocation of risk between the parties, and AEMO's inflexibility in negotiations, principally due to its inability to bear risk. This typically requires the incumbent network owner and connecting participant to negotiate on how the risk for the circumstances presented is allocated between them. Neither party may be satisfied with the negotiation and resulting connection arrangements. The direct flow on impacts are the extensive period required to reach agreement on the terms of connection, and the very high legal cost accruing to the parties, i.e. to the connection applicant and the incumbent network owner. As the costs may be substantial AEMO's legal costs are typically met by the connection applicant.

A new connection to the network will alter the configuration of the network, through additional switching points, and depending on how the new switching at the connection point is established this may impact the operational flexibility of the network. SP AusNet's experience is that new connections have been established where access to the network

for maintenance has been impacted by the connection configuration agreed by AEMO. Whilst AEMO takes SP AusNet's access requirements into account, the incentive is not as acute as it would be for SP AusNet, to directly explore alternatives with the connecting party that may result in arrangements better suiting the needs of both parties.

AEMO has undertaken, and recently concluded, a Connection Initiatives Project with the objective of improving the transparency, structure and timeliness in the connection process in Victoria. SP AusNet has supported the initiative and participated constructively in the project. However, our conclusion is that the inherent complexity of the structural arrangements this initiative has prevented the initiative from practically addressing the issues discussed in this section.

### **4.3 Service Provision Contestability**

The Commission has not included contestable service provision in its preferred model for transmission, observing that it is not clear that the benefits outweigh the costs. The Commission is seeking further information from stakeholders on this aspect.

SP AusNet has experience with contestable services provision in Victoria and provides the following comments.

The market for the contestable provision of services is very thin, particularly for the long term ownership of the assets. SP AusNet has been successful in all but two contestable transmission augmentation projects tendered by AEMO (and their predecessors) over the last 15 years. This raises questions as to whether or not the perceived cost savings arising in provision of these services has been actually delivered, particularly having regard to the administrative cost in undertaking the contestable process.

As a matter of course SP AusNet runs a competitive tendering process to ensure the most efficient service delivery. This is conducted in the deeper market for the provision of major plant items and construction services associated with new transmission projects.

In the Draft Report the Commission refers to the notion of 'contestable solutions'. This is not an accurate depiction of the process for transmission service augmentation. Typically a contestable augmentation is subject to a closely defined asset service, limiting the benefits of contestability. This approach is not surprising, as it would be difficult in a process operating to timely network management, for the tender process to make robust comparison between ultimate cost, relative benefits and risks of quite disparate solutions. The main benefits of contestability are achieved through the tendering out of the project construction, and these benefits are achieved without resorting to the high administrative costs of competitive service tendering.

We also note the following further points in relation to service contestability:

- detailed specification for the service requires the incumbent network owner to facilitate the process through provision of supporting technical information to AEMO, for use by competing tenderers. This approach raises questions regarding the transfer of intellectual property (conversely we also recognise this could be perceived as advantageous to SP AusNet in the tender process);
- the Commission has considered network effects in reaching its conclusions, pointing to the risk of coordination issues leading to 'cascade failure' (suggesting a single national planner is preferable). Potentially the proliferation of network

management interfaces that may arise through contestable service provision would be an instigator for a breakdown in coordination; and

- The Commission has noted the existence of contestable service provision models in the USA. The context for these is the resolution of market power issues arising from vertical integration in the industry, with common ownership of generation and transmission. Contestability does not have a proven track record and experience in Texas is that augmentation projects have been more costly than anticipated. Some ISOs have challenged FERC claiming it has not demonstrated the benefits.

#### **4.4 Firm Access**

The Commission's Draft Report supports the AEMC's proposal of Optional Firm Access for generators, set out in the Second Interim Report on the Transmission Frameworks Review (TFR). SP AusNet also supports progress in this direction.

However, the Commission has not discussed how well the alternative transmission models would facilitate the most effective firm access regime. This should be an important factor in consideration of the alternative approaches by the Commission. SP AusNet provides the following comments.

Firm access integrates transmission service provision with the wholesale market, transferring accountability for some risk from wholesale market participants to transmission entities. The 'Optional Firm Access' model being examined through the TFR proposes that the accountability mechanism would be financial incentives within the regulatory regime. Over time, or via other models that might be implemented, accountability could be via direct commercial exchange in the market settlement process.

Firm access models involving structural arrangements with the planner separated from the network operator may be plausible. However, the characteristics of the Victorian arrangements discussed in this submission would tend to mute the commercial accountabilities that could potentially be placed on the transmission sector. We recognise that this may have implications for the Victorian transmission arrangements if progress toward firm access occurs.

#### **4.5 Commission's 'Second Best' Model**

As SP AusNet understands this model, it involves the following elements:

- Investment decision making by TNSPs;
- Planning standards (hybrid) set by AEMO, planning process defined by AEMO;
- Current AEMO planning approach in Victoria retained; and
- AEMO recommended investment plan and costs as default, with onus of proof on TNSP to move away from that.

The Commission has not expounded the intended approach for Victoria. It is therefore only possible to make some broad comments.

The principal observation is that the model appears to be an extremely very heavy handed. While it has the appearance of an integrated planner model, on closer inspection

it is not clear that this is the case, or that it would be workable. For example, the final element of the approach as bulleted above indicates a significant degree of duplication between the parties, and potential disputation, inefficiency and delay.

The model also seems to further reduce the accountability on AEMO's planning functions, whilst it retains significant power of direction. The model risks projects stalling over debates on issues of varying materiality, with consequences for timely delivery of essential investment.

Such issues have been experienced in Victoria on a number of occasions. A comparable service area is transmission connection asset planning at distribution connection points, primarily the domain of the distribution businesses, but inter-acting with the transmission planning functions of AEMO. The distribution businesses and AEMO have held different views on various aspects of connection asset augmentation. An example of the disputation and potential for delay that can occur is discussed in a submission into the AEMC Transmission Frameworks Review by CitiPower and Powercor<sup>8</sup> in early 2012. The submission highlights issues with the planning process, classification of services and connection negotiations. The issues involved have proven to frustrate the smooth progress of network development activities.

Finally, and in common with the Commission's preferred approach there appear to be extremely limited, if any, incentives and rewards for transmission network businesses to strive for new levels of best practice that would lead to efficiency benefits. This does not appear to be a desirable solution for delivering services efficiently.

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<sup>8</sup> CitiPower and Powercor Australia submission to the Australian Energy Markets Commission, 27 January 2012, Transmission Frameworks Review