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Australian Energy Market Commission
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REVIEW OF ELECTRICITY TRANSMISSION REVENUE AND PRICING RULES

Origin Energy (Origin) appreciates this opportunity to provide a submission to the Australian Energy Markets Commission (AEMC) consultation, *Review of electricity transmission revenue and pricing rules*. We are a vertically integrated energy market player with substantial generation and retail interests and therefore strongly support the efficient operation and development of the transmission network. In particular we are concerned to see an effective incentive framework for transmission companies with a view to minimising the impact of transmission on market transactions and an effective regulatory investment framework which maximises the level of trade and competition across the network.

The issues paper covers a broad range of issues and Origin will focus only on those which it considers of most importance in achieving these outcomes. We also note that much of the subject matter has been extensively examined and consulted on previously by the Australian Competition and Consumer Commission (ACCC) and we therefore urge the AEMC to consider substantive changes only where necessary and in areas that have not already been the basis of extensive consultation.

More generally, we believe that as a consequence of the complexity and uncertainty of many of the variables which impact transmission regulatory decisions; that transparency, consistency and predictability should form the essential focus for any refinements to the transmission regulatory framework. It is with this underlying theme upper most in mind that we address the various issues in the discussion paper.

Form of regulation

As a consequence of the substantive natural monopoly characteristics and both positive and negative externalities inherent in transmission, regulation is likely to generate more efficient outcomes than the market. Origin further considers that the CPI-X building blocks approach currently applied to transmission companies reflects the best compromise available for encouraging efficiency gains while at the same time sharing some of those gains with users. In principle Origin would support setting regulated revenue with less reliance upon a transmission company's own costs and a greater focus on industry best practice and productivity trends (such as benchmarking or total factor

productivity). This would discourage gaming and provide strong incentives for cost reduction. However, there is considerable subjectivity and uncertainty inherent in such approaches applied to transmission and they appear to be as yet insufficiently developed to play a significant role in the current regulatory environment. Therefore, while it is appropriate for regulators to include benchmarking as an informal test of the validity of transmission companies' cost proposals we acknowledge that allowable revenues will continue to be primarily based on an assiduous evaluation of historic and forecast expenditure.

The AEMC presents price monitoring as an alternative model for consideration in regulating transmission revenues. While the least intrusive of the options presented Origin considers that the presence of substantive natural monopoly characteristics would make such a model unsuitable for application to transmission.

The scope of regulation

Origin is not convinced that there is any clear delineation possible between deemed contestable and non-contestable transmission services. The degree of market power transmission companies have does not vary with the service provided in our view. Origin's experience with some of the negotiable provisions in the rules has shown that as a consequence of information asymmetry and imbalance of negotiating power that it is very difficult to argue with a transmission company over price.

We consider that the distinction between contestable and non-contestable services is probably better made in terms of the practicality of which services are more readily brought under the regulatory cap and which are not; perhaps having regard to their ad-hoc nature or volume demanded (which might make such services particularly difficult for a transmission company forecast). While non-contestable services are currently subject to the negotiate-arbitrate provisions of the rules, we would support these also being exposed to some form of price monitoring, as this would force a greater level of transparency and subsequent discipline on the cost of service provision.

Performance obligations and incentives

Origin is increasing its generation interests and therefore has some concern over its level of access to the network. However, we recognise that level of externalities inherent in the network mean that transmission companies do not control all the variables that influence network access and that, as a consequence, they are not in a position to guarantee the firmness of such access.

Moreover, Origin does not accept like many others do that generators have implicit rights to the network, as the natural monopoly characteristics and externalities associated with transmission preclude such a right. Arguably, if natural monopoly transmission companies were allowed to offer firm access to customers and their revenues varied to reflect this (as it must) then this would surely increase the scope and incentive for discriminatory behaviour (for instance, a transmission company may refuse access, or increase the price of access, to some participants on the basis that they negatively impact the access of others it has contracts with). This would seriously undermine generator competition on the network. Access regulation of monopoly providers works best if the terms and conditions of access are standardised and made non-discriminatory among participants. Origin therefore strongly supports electricity network services being provided on a common carriage and open access basis.

In this regard we would much prefer to see the level of generator access improved through the implementation of incentives by the regulator focused on encouraging efficient operation of and investment in the network to the benefit of all users¹. We discuss each in turn.

Transmission operation

A key element in determining the level of generator access to market is the transmission capacity available at times of high demand. Origin therefore strongly supports the current work being undertaken by the Australian Competition and Consumer Commission (ACCC) to develop financial incentives for network owners to maximise the availability of the network. The ACCC's most recent revenue cap decisions for a number of transmission companies have included financial incentives to: encourage more appropriate timing of outages; minimise the duration of outages; and maximise the availability of transmission elements. Whilst this incentive framework is a substantive improvement on what has been in place historically, Origin does consider that the level of the incentive, ± 1 per cent of revenue, is probably insufficient to provide transmission companies with real discipline to meet the performance targets specified. We note that VENCORP in a separate contractual arrangement with SPI PowerNet has negotiated much stronger incentive of around 2.5 per cent.

Origin also considers that the current incentive framework provides insufficient focus on the market impacts of transmission operation and investment. Constraints (henceforth congestion) on the network arise largely out of the lack of availability and limitations of transmission capacity at critical times. While transmission companies do not control all of the factors causing congestion they can nevertheless do much to influence its incidence and impact on the energy market. Origin would therefore strongly support further development of incentives targeting network congestion. The key element of such an approach should be that the transmission company is able to retain a proportion of the savings in congestion costs it achieves, as this would provide a strong financial incentive for reducing congestion in innovative ways²

This approach would provide an important addition to the transmission investment framework. The current legislative rules only compel transmission companies to invest to meet customer reliability requirements. Most transmission investment to date has therefore occurred on this ground rather than on a net market benefits basis. An incentive framework which allowed transmission companies to retain a portion of the congestion savings they made would provide a powerful additional incentive for transmission companies to invest using both the net market benefits limb of the regulatory test and the funded augmentation provision of the rules. The latter provides for investment which may benefit particular users but not to the extent of passing the regulatory test.

Capital expenditure incentives

Transmission development provides considerable social benefits in terms reliability and competition benefits (of lower prices) to customers, as well as increasing the capacity for market participants to access the market, trade and compete. Given these benefits Origin is inclined to support a conservative approach to transmission investment (which is

¹ FIRECONE, "Regulatory and Institutional Framework for Transmission, November 2003

² Ibid

consistent with the recent Epic decision in relation to the Dampier to Bunbury pipeline as well as Productivity Commission recommendations for investment in gas pipelines).

In this context, the key benefit of an ex ante, as opposed to an ex post, approach to transmission investment is that transmission companies have an enhanced level of certainty with regard to the costs they are able to recover through the regulatory framework; regardless of whether market conditions change over the regulatory period in question. This should encourage transmission investment, particularly given the imprecision and subjectivity associated with hypothesising what an efficient level of transmission investment should have been under an ex post optimisation framework. Under an ex ante framework the transmission company avoids the regulatory risk that investments that seemed justified at the time could later be judged as imprudent simply because some of the uncertainty inherent in the initial investment decision has been resolved over time.

Efficiency is attended to in this framework through the setting of a cap and the ex ante evaluation by the regulator of forecast expenditure proposals to ensure they are prudent given the information available at the time. The difference to ex post optimisation is that the regulator is placed in the same position as the transmission company in terms of the information available to it when it decides upon proposed level of future investment.

A further key component of this approach is to allow the opportunity for significant and uncertain investments, or unforeseen investment requirements, to be included in the revenue cap at a later stage in the regulatory period. However such contingent investments must pass the regulatory test. Origin agrees that it is important to avoid large potential errors in the setting of the ex ante investment cap, which would lead to potentially large windfall gains or losses to transmission companies, while at the same time maintaining an efficiency driver on such investments through application of the regulatory test.

That being said, in order to maintain appropriate forecasting discipline on transmission companies any allowance for later reopening of the revenue cap should only be for events over which a transmission companies are deemed to have had no control. It is important the AER evaluates the extent to which underestimated capital expenditures are due to factors that transmission companies could reasonably have taken into account.

Operating expenditures

Origin supports incentive mechanisms that share the benefits of cost reductions between transmission service providers and users. However, there is some evidence that such mechanisms when formulated incorrectly can lead to inefficient cost shifting within regulatory periods. We therefore support the ACCC proposal for a carry-forward mechanism which allows transmission companies to retain the benefit of any savings for the same length of time regardless of when such savings are made. We consider that retainment of cost savings for 5 years before they are passed through to reductions in access prices provides a reasonable balance between incentives for transmission companies to reduce costs and the sharing of those cost savings with consumers.

Origin considers that benchmarking should inform but not exclusively determine the incentives framework for cost reduction. Regulators appear a long way from implementing a methodology that can reliably estimate efficient benchmarks for

transmission companies. Variations in environmental, geographic, demand and political/regulatory legacy factors make such benchmarking a highly complex exercise.

Consequently, in our view, setting regulated revenues or prices exclusively on the basis of external benchmarks is likely to create significant uncertainty and financial risk for transmission companies with the resulting potential for it to deteriorate network quality.

Rate of Return

Transmission companies should be able to earn an appropriate commercial return on their capital which promotes some certainty and predicability of revenue streams and encourages sufficient transmission investment in the NEM.

Consistent with our views on other areas of transmission regulation the uncertainty surrounding the correct value of key parameters underlying the appropriate rate of return for transmission companies means such parameters should be conservatively set. This should be done based on a mixture of historical precedent and market based measures and we consider the general approach taken by the ACCC to date has been reasonable. While we have some inclination to support the setting of a range rather than a point estimate for WACC, our concern is that this would present a considerable departure from historical precedent and well tested parameter values. On balance we consider that the extensive consultation and the appeal processes in the NEM regulatory framework provide sufficient scope for establishing a fair rate of return for transmission companies.

Extent of design and discretion in the rules

Predictability, consistency and transparency of the transmission regulatory regime are crucial for encouraging the efficient operation of and investment in the network. Consequently we consider that discretionary decision-making by the regulator should be minimised to the extent possible. A commonsense approach needs to be taken here however; some degree of discretion will be required for certain aspects of regulatory decision making which involve a high degree of uncertainty or are subject to regular revision or change. For instance, it may not be appropriate that the rules prescribe specific values for cost components underlying the WACC. While this may provide maximum predictability in terms of regulatory decisions, it would also significantly increase the chance of regulatory error over time as new information comes to light which as a result of prescriptive rules can not be readily incorporated into the regulatory decision making process.

Nonetheless, in general Origin considers that the rule change process in the electricity rules provides sufficient flexibility for accommodating appropriate changes in regulatory best practice over time.

Specifically, we consider that the form of regulation to be applied (CPI-X revenue cap for instance), the type of incentive regimes (for instance ex ante vs ex post investment framework), methodology of calculating allowable rate of return and other components underlying the calculation of allowable revenues should be prescribed in the rules where possible. However, any further detail below this should probably be left to regulatory discretion. Most of the content of the Statement of Regulatory Principles (SRP) should be elevated to the rules, since its current status as guidelines provides a significant level of

uncertainty for participants; as the AER can either change or seek to depart from the SRP as it sees fit. It is more appropriate that any changes or departures in approaches to revenue regulation undergo appropriate and comprehensive consultation under the rule change procedures.

Conclusion

Efficient operation and investment in transmission plays a critical role in energy markets by enhancing the reliability of supply, reducing risks of trade and enhancing competition. Transmission companies should therefore have strong incentives to take account of their impacts on the energy market and invest to a sufficient level in the network. An appropriately conceived incentive framework combined with a regulatory framework that provides certainty and consistency is crucial to achieving these outcomes. Origin considers that the ACCC has done much good work to date on addressing these issues, and it is important that this work it built upon and extended rather than significantly amended by the AEMC.

Please do not hesitate to contact Con van Kemenade on 02 8345 5278 in the first instance if you have any further questions.

Yours Sincerely,

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