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31 May 2011

Mr John Pierce  
Chairman  
Australian Energy Market Commission  
PO Box A2449  
SYDNEY SOUTH NSW 1235

Dear Mr Pierce 

**Transmission Frameworks Review Directions Paper**

The Australian Energy Regulator (AER) welcomes the opportunity to respond to the AEMC's directions paper on the Transmission Frameworks Review. Please find attached our submission to the Directions Paper.

I would like to reiterate our support for the work being undertaken by the AEMC as part of this review. We would be happy to discuss any of the issues raised in this submission, or to contribute to the review in other ways in order to develop a transmission framework that promotes the long terms interests of electricity customers. If you have any queries or comments, please contact Mark Wilson on 08 8213 3419.

Yours sincerely



Michelle Groves  
**Chief Executive Officer**

## Transmission Frameworks Review Directions Paper

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The Australian Energy Regulator (AER) welcomes the opportunity to respond to the AEMC's directions paper on the Transmission Frameworks Review. We consider ourselves well placed to comment on the interplay between the competitive electricity market and the services provided by electricity transmission networks, particularly given our responsibility to report on significant market outcomes in the National Electricity Market.<sup>1</sup>

In its Directions Paper, the AEMC asked stakeholders to comment on the way it has framed the issues and whether this represents an appropriate structure going forward. In order to comment on whether the AEMC has framed the issues appropriately, it is necessary to have a clear understanding of what we are trying to achieve.

Accordingly, this submission:

- sets out, at a high level, the AER's view of a cohesive transmission framework, and
- comments on the proposed scope of the Transmission Frameworks Review as set out in the Directions Paper.

### 1 Developing a cohesive transmission framework

The AER supports the view that the regulatory regime, incentives, pricing and approvals processes should all work together with the overall planning and governance structures to achieve an economically efficient mix of generation and transmission investment.<sup>2</sup> An efficient mix of investment will provide the lowest sustainable cost of energy delivered to customers, whilst maintaining a reliable and secure power system. To achieve this, it is necessary to have:

- free flowing, high quality **information** concerning the costs and benefits associated with investment decisions at various points on the transmission network (this includes decisions by TNSPs, generators and users); and

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<sup>1</sup> Under clause 3.13.7(d) of the National Electricity Rules, the AER is required to publish a report whenever the electricity spot price exceeds \$5000/MWh.

<sup>2</sup> Energy Reform Implementation Group, *Energy Reform, The way forward for Australia: A Report to the Council of Australian Governments*, January 2007, page 143.

- **incentives** on key players to make efficient decisions through price signals and the regulatory regime.

In the AER's conception of an ideal transmission framework, a significant proportion of a TNSPs' remuneration would be based on the level of service they provide rather than the size of their investment programs. Both users and generators would pay cost reflective charges for the transmission services they receive, and the decisions made by users and generators in this environment would inform an integrated national planning process. TNSPs would have incentives to operate, maintain and upgrade their network in a manner that delivers an appropriate level of network capability for least sustainable cost.

To relate this high level concept to the issues being considered as part of the Transmission Frameworks Review, the AER supports:

- reforms to address problems arising as a result of network congestion and inefficient locational decisions by generators, including cost-reflective transmission access charges for generators and a congestion pricing mechanism
- further refinement of the planning arrangements,
- a substantive review of the connections regime which encompasses strategies to promote genuine contestability in transmission connections.

We recognise that each of these workstreams give rise to complex implementation issues and necessitate difficult trade-offs. However, we consider that the problems we have observed under the current framework are sufficiently material to justify the case for reform.

## **2 Scope of the Transmission Frameworks Review**

The AER broadly supports the position of the AEMC as set out in its Directions Paper. Each of the workstreams identified by the AEMC represent areas where further analysis and development is likely to be beneficial. To the extent that the AEMC has decided to omit certain workstreams from the review, we consider that these issues can be effectively considered elsewhere. This section considers each workstream identified by the AEMC.

### **2.1 Nature of access, network charging and congestion**

These issues are closely linked. The AER has set out on a number of occasions its support for reforms to address problems arising as a result of network congestion and inefficient locational decisions by generators. We agree that the lack of certainty for

generators over dispatch outcomes can impact financial markets in a way that ultimately results in higher prices to customers.<sup>3</sup>

To address this, we support the introduction of a transmission access charge on generators which reflects the long run incremental network costs associated with a given location. We also support further consideration of whether some form of transmission access right for generators is appropriate.

The AER supports the further development of mechanisms to manage congestion in the National Electricity Market, including through the adoption of a location-specific time-limited congestion pricing mechanism.<sup>4</sup> We also support the use of financial incentives to encourage TNSPs to take steps to maximise network capability. The potential for a “network capability incentive” is discussed further in section 2.5 of this document. While we do not yet have a firm view on the detail of this package of reforms, we would welcome the opportunity to contribute to the AEMC’s consideration of the issues.

The Directions Paper contains a clear discussion of the relevant arguments and we are confident that the AEMC has framed the issues appropriately. However, there is one aspect of the paper which gives rise to concerns. As highlighted by the discussion in Appendix 1 of the Directions Paper, it is extremely difficult to put a value on the costs arising as a result of congestion (or, for that matter, inefficient locational decisions by generators). The issues under consideration are highly complex and inextricably embedded within broader market processes. Any attempt to quantify costs will inevitably be contentious. Further, given the major changes to the pattern of investment in electricity infrastructure and associated changes in usage of the transmission network, there are inherent limitations in using an examination of historical costs as the basis for decisions on the future shape of the market.

The AER is concerned that, if there is an undue preoccupation with quantifying costs, genuine problems associated with the current regime will not be addressed merely because they are difficult to accurately quantify. The proposed reforms under consideration are not radical – they are in widespread use overseas. We note that the case for reform is disputed only by those with a vested interest in retaining the status quo. Accordingly we would encourage the AEMC to design reform packages based on available information rather than await an idealised study which is unlikely to materialise.

While we advocate realism about the potential to measure certain costs, the AER fully supports the use of evidence to make informed decisions. Consistent with our submission to the Issues Paper, the AER will continue to submit relevant information to support the Transmission Frameworks Review. This information is likely to take the form of specific examples of market outcomes that highlight various features of the current transmission framework.

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<sup>3</sup> AEMC, *Transmission Frameworks Review Directions Paper*, 14 April 2011, pg 23.

<sup>4</sup> For instance, see *AER Submission to the Review of Energy Market Frameworks in light of Climate Change Policies: Response to AEMC second interim report*, 3 August 2009.

## **2.2 Planning**

The AER considers that the recent reforms to the transmission planning arrangements should be given the opportunity to work. We support efforts to make full use of the new planning regime. The AER is considering how to derive maximum benefit from the work of the National Transmission Planner in terms of our revenue reset process.

However, to the extent that there are clearly identified problems with the planning framework, further refinements may be beneficial. In particular, there may be merit in considering whether the AER could provide further information for stakeholders and their advisers on the process for considering market benefits as part of RIT-T assessments. While quantification of market benefits will always be a complex process, further information for stakeholders may promote more transparent and consistent consideration of market benefits in more RIT-T assessments.

## **2.3 Connections**

The AER supports the AEMC's conclusion that there is a need for further detailed exploration of the connections arrangements.

The problems in the connections market stem from the unequal relationship between the connection applicant and the TNSP. The connection applicant has no choice but to deal with the TNSP and there are information asymmetries since the TNSP holds crucial information such as data relating to existing network capabilities. The AER supports consideration of whether there is scope to promote contestability in transmission connections services. A competitive market has been established for connections to electricity distribution networks in NSW, and we would be interested in exploring whether there are any useful lessons for transmission.

The AER notes the AEMC's finding in relation to the interactions between the connections arrangements of Chapter 5 and the provisions of Chapter 6A. Some of the ancillary documents that are relevant to the connections regime fall within the remit of the AER, in particular the negotiated transmission service criteria. To the extent that the problems can be addressed via the negotiating framework in Chapter 6A, the AER would be happy to work with the AEMC to improve the effectiveness of the connections regime.

## **2.4 Economic regulation**

The AER notes that the AEMC has decided not to progress issues related to economic regulation or network operations as discrete workstreams. The economic regulation arrangements are a fundamental part of the overall transmission framework, and a regime which places flawed incentives on TNSPs is unlikely to function effectively. That said, the economic regulation arrangements ought to play a supporting role – they should give effect to the overarching framework. Accordingly, the AER accepts that it is appropriate to exclude the economic regulation arrangements from the Transmission Frameworks Review.

We note that changes to the economic regulation arrangements may be required in order to give effect to other reforms arising from the Transmission Frameworks Review.

The AEMC will have a further opportunity to consider the economic regulation arrangements in addressing Rule change proposals arising from the AER review of Chapters 6 and 6A of the National Electricity Rules.

## **2.5 Network operations**

Similarly, while we consider that network operations is a crucial area, we are satisfied that many of the most important aspects of network operation will be considered in the context of the other Transmission Framework Review workstreams, and through the AER's review of the Service Target Performance Incentive Scheme, which is due to commence in the second half of 2011.

As part of the AER review, we propose to consider whether the scheme could be extended to enhance the incentives on TNSPs to operate their networks in a manner that best meets the needs of the market as a whole. This could be achieved through some form of network capability incentive.

There are a range of very technical transmission network factors that can affect the efficient dispatch of generation in the market. The TNSPs have significant discretion in making decisions which affect these technical factors. However, there is very little in the revenue regulation framework which requires TNSPs to assess market consequences when making these operational decisions.<sup>5</sup> The AER has observed a number of market outcomes which suggest that the operational decisions taken by TNSPs can have adverse impacts on the wholesale energy market.

A network capability incentive would encourage TNSPs to devote resources to maintaining the capability of their existing network rather than focusing on large new investments. TNSPs would be rewarded for improving the capability of existing infrastructure, and penalised for allowing network capability to deteriorate. Depending on the findings of our review of the Service Target Performance Incentive Scheme, we may decide to put forward a Rule change proposal to the AEMC.

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<sup>5</sup> The market impact parameter of the Service Target Performance Incentive Scheme seeks to incentivise TNSPs to consider the market impact of their operational decisions, but it only applies to outages, not normal operation.