

Defining revenue capped services

Preamble

The paper has been prepared by Transend Networks Pty Ltd (Transend) to facilitate discussion on the appropriate definition of revenue capped services for transmission network service providers.

In its 28 November 2003 submission to the Australian Competition and Consumer Commission's (ACCC's) Discussion Paper on its draft *Statement of Regulatory Principles*, Transend noted that this (further) paper would be forthcoming.

In providing this paper, Transend notes that:

- the ACCC's Discussion Paper on its draft *Statement of Regulatory Principles* does not address the issues of which services are to be revenue-capped and the form this revenue capping may take
- the Code does not provide much practical guidance in relation to defining revenue capped services
- in the absence of clear guidance, TNSPs may reasonably make different assumptions as to the definition of revenue capped services.

This paper seeks to interpret the Code provisions in a reasonable manner. Transend recognises that there may be other interpretations or applications of the Code provisions that are equally reasonable. It is ultimately a matter for the ACCC to clarify how the Code should be interpreted.

Transend considers that the *Statement of Regulatory Principles* should set out, where relevant, the ACCC's interpretation of the relevant provisions of Chapter 6 of the Code. Transend understands that such a statement would not be legally binding, but would give rise to "legitimate expectations". This would provide TNSPs - and other energy sector stakeholders - with greater certainty as to the scope and operation of revenue caps established by the ACCC.

1. Introduction

The effective regulation of electricity transmission revenue depends on appropriately defining those services that should be regulated. In principle, regulation is only desirable where competition proves to be an ineffective mechanism for setting prices and/or service levels.

Where a TNSP provides a mix of regulated and non-regulated services, the revenue from and the costs of providing these services need to be separately identified. For example, costs of providing “competitive” services should not be recovered through charges for regulated services. Similarly, the revenue from competitive services should not be swept into the definition of regulated revenue – and hence be regulated.

Given the basic nature of these issues, it is somewhat surprising that these matters have not yet been resolved, even four years after the publication of the ACCC's draft *Statement of Regulatory Principles*. This short note presents initial views on the following matters:

- Interpretation of the Code provisions, especially in the light of the ACCC's decision on Murraylink's application for regulated status;
- Issues to be resolved; and
- Suggested approach.

2. Interpreting the Code - Lessons from Murraylink

In considering Murraylink's application for regulated status, the ACCC analysed whether Murraylink exhibits characteristics that are consistent with the definition of a prescribed service. To address this issue, the ACCC looked to the definitions of prescribed services and other relevant terms in the NEC:

- *Prescribed Services* is defined as:

Transmission services provided by transmission network assets or associated connection assets to which the revenue cap applies.

- *Transmission services* is defined as:

The services provided by a *transmission system* associated with the conveyance of electricity which include *entry services*, *transmission use of system service*, and *exit services* and *new network services* which are being provided by part of a *transmission system*.

- *Revenue cap* (relating to transmission) is defined as:

In Parts B and C of Chapter 6, the maximum allowed revenue for a year determined by the Regulator for prescribed services applicable to a Transmission Network Owner.

The ACCC commented that these definitions do not explain which services are to be subject to a revenue cap and are therefore prescribed services. However, the ACCC noted that Part B of Chapter 6 sets out two circumstances where transmission services will be *excluded* from a revenue cap:

1. clause 6.2.3(c) provides that the Commission is responsible for determining whether sufficient competition exists to warrant the application of a regulatory approach which is more "light-handed" than revenue capping, and if so, the form of that regulation.; and
2. clause 6.2.4(f) provides that revenue caps set by the Commission are to apply only to those services, the provision of which in the opinion of the Commission are not reasonably expected to be offered on a contestable basis.

For Murraylink, the ACCC essentially treated 6.2.3(c) and 6.2.4(f) as two separate tests.

- (a) In the ACCC's view, insufficient competition exists to warrant a more light-handed approach than revenue capping as required by 6.2.3(c).
- (b) Therefore, the ACCC considered whether the services were expected to be offered on a contestable basis in accordance with 6.2.4(f).

In this regard, the ACCC noted that Chapter 10 defined *contestable* as:

a service which is permitted by the laws of the relevant participating jurisdiction to be provided by more than one Network Service Provider as a contestable or on a competitive basis.

The ACCC noted that the relevant jurisdictions (South Australia and Victoria) did not *explicitly specify* which services can be provided by more than one service provider. Therefore, the ACCC sought to reach its own view of "contestable". In doing so, the ACCC adopted the ESC's (Victoria) definition that:

"Contestability" describes a market that would be characterised by effective or potential competition.

The ACCC also followed the ESC's approach in assessing whether a market can be considered to be contestable. The first consideration is whether effective competition is present. If effective competition is not present, then the ESC examines whether there is potential competition.

Effective competition is assessed in terms of

- the number of competing providers;
- the degree of countervailing market power; and
- availability of substitutes.

The assessment of potential competition (if necessary) considers the nature and extent of barriers to entry.

To summarise, there are a number of important observations arising from the ACCC's final decision on Murraylink

- the NEC does not properly define which services are to be subject to a revenue cap and are therefore prescribed services;
- the NEC provides two mechanisms by which services fall outside the revenue cap:
 - clause 6.2.3(c) refers to “sufficient competition” for more light-handed regulation than revenue capping; and
 - clause 6.2.4(f) restricts revenue caps to only those services that are not reasonably expected to be offered on a contestable basis.
- the NEC defines *contestable* in an unhelpful way. The ACCC has taken the view that unless the relevant jurisdictions *explicitly specify* those services that can be provided on a contestable basis, the ACCC will reach its own view on whether a service is “contestable”; and
- the ACCC has adopted a fairly broad approach to defining “contestable” to include potential competition as per the ESC's definition. On the ACCC's interpretation of the Code, more services could fall outside the revenue cap by virtue of 6.2.4(f) compared to 6.2.3(c). This is because the latter clause depends on whether sufficient competition exists.

3. Issues to be resolved

The ACCC's analysis in its Murraylink decision provides a useful start in considering the question of what services ought to be regulated. However, from a TNSP's perspective, the Murraylink decision only addresses a subset of the relevant issues. This section seeks to identify these outstanding issues, before providing a suggested approach in section 4.

3.1. Can prescribed services be subject to lighter-handed forms of regulation?

As noted earlier, clause 6.2.4(c) provides for lighter-handed forms of regulation than revenue capping if there is sufficient competition. The ACCC's approach to Murraylink implies that a prescribed service could be subject to “lighter-handed” forms of regulation if sufficient competition exists. But, is this view correct?

As noted earlier:

Prescribed Services is defined as follows:

Transmission services provided by transmission network assets or associated connection assets to which the revenue cap applies.

This definition of prescribed services is only meaningful if all prescribed services are revenue capped. Similarly, clause 6.2.4(f) defines the coverage of the revenue cap in terms of those services that are not contestable:

Revenue caps set by the *ACCC* are to apply only to those services, the provision of which in the opinion of the *ACCC* are not reasonably expected to be offered on a *contestable* basis.

The definition of prescribed services together with clause 6.2.4(f) makes non-contestable services synonymous with prescribed services.

On this reading of the Code, lighter handed forms of regulation can only apply to those services that are not prescribed services. This is because the definition of prescribed services requires the form of regulation to be revenue capping. In effect, the lighter-handed forms of regulation can only apply to contestable services.

If prescribed services are in fact non-contestable services, the relationship between clauses 6.2.3(c) and 6.2.4(f) is different to that suggested by the ACCC in the Murraylink decision. The ACCC considered these clauses to provide two independent mechanisms by which services may fall outside the revenue cap:

1. Under clause 6.2.3(c) there might be sufficient competition for lighter handed forms of regulation to be applied; or
2. Under clause 6.2.4(f) contestable services fall outside the revenue cap.

The view expressed in this paper is that services can only be subject to lighter-handed forms of regulation if they are contestable. This means that it is impossible for a service to fall outside the revenue cap by virtue of clause 6.2.3(c) without also being excluded by the “contestability test” in clause 6.2.4(f).

To summarise:

- The Code could be reasonably interpreted as defining prescribed services as being synonymous with services that are not contestable
- On this reading, lighter-handed forms of regulation can only apply to contestable services. Prescribed services or non-contestable services must be revenue capped.
- If a service is contestable it must not be revenue capped. Whether the form of regulation is more light-handed than revenue capping (noting that other forms of control can be as “heavy-handed” as revenue capping), depends on whether the ACCC considers the extent of competition to be “sufficient”.

- The ACCC has interpreted contestable services to include potential competition, in cases where contestable services have not been explicitly specified by the jurisdiction.

3.2. Managing uncertainty

The discussion so far has concentrated on the detail of the Code provisions as they relate to defining services that are subject to revenue capping. Within this framework the issue is whether:

1. a service is non-contestable and therefore must be revenue capped; or
2. a service is contestable and therefore cannot be revenue capped (but may be subject to some other form of regulation).

However, even where it is clear that a service is non-contestable, further practical considerations arise in managing two types of uncertainty:

- What are the costs of providing the prescribed service?
- What is the quantum or scope of prescribed services required over the regulatory period?

In relation to the first question, pass-through rules manage uncertainty associated with unexpected events or cost items (such as insurance) which are difficult to forecast and outside the control of the TNSP. These pass-through rules are not considered further in this paper.

The second question relates to uncertainty as to the quantum of services required over the regulatory period. For example, the total costs of new connections will depend on investment decisions made by parties other than the TNSP. These costs are therefore difficult to predict and it is sensible to develop arrangements to manage this risk.

For example, revenue from connection charges could be allowed in addition to the revenue cap. Therefore, the TNSP would not be exposed to forecasting risk in relation to the quantum of new connections. At the next regulatory period, all existing connections could be included in the revenue cap. This approach deals with the uncertainty of forecasting new connections, within a revenue cap environment.

An alternative way of managing this type of forecasting risk is for new connections to be treated as contestable, and therefore outside the revenue cap. However, it seems inappropriate that contestability should be used as a mechanism for managing forecasting risk. In particular, where the TNSP cannot successfully argue that all new connections are contestable – the TNSP would be exposed to increased risk because of revenue capping. This seems to be perverse.

In summary:

- TNSPs should have a mechanism for managing forecasting risk within the confines of a revenue cap;
- It seems inappropriate to rely on being able to demonstrate that services are contestable in order to manage forecasting risk; and
- There is benefit in clearly separating the issue of whether a service is contestable from the issue of risk management within a revenue cap.

3.3. Negotiable services

Clause 6.5.9 of the NEC requires the TNSP to establish and *publish* a framework that complies with the requirements of the "*negotiating framework*" setting out the minimum requirements to be followed during negotiations with *Network Users* for *negotiable services*. The Code further defines negotiable services as:

- (a) an excluded service;
- (b) that part of a prescribed service which is to be provided to a standard which is higher or lower than any standard:
 - i. described in schedule 5.1
 - ii. outlined in the standards published in accordance with clause 6.5.7(b); or
 - iii. required by any regulatory regime administered by the ACCC;
- (c) connection services, use of system services and generator access provided to a Generator, for which charges are negotiated under clause 5.5;
- (d) connection services, use of system services and market network service provider access provided to a Market Network Service Provider, for which charges are negotiated under clause 5.5A; or
- (e) that part of a prescribed service which is to be provided at reduced Customer TUOS general charges or reduced common service charges (the "agreed reduced charges") under clause 6.5.8, and does not include a contestable service.

For negotiation to be meaningful from the TNSP's perspective, the outcome of the negotiation must affect the total allowed revenue. This implies that revenue from negotiable services should not be included in the revenue cap. However, as noted earlier it is important to distinguish between:

- those services that fall outside the revenue cap because they are contestable; and

- revenue that should be excluded from the revenue cap because of uncertainty regarding the appropriate revenue allowance.

It is noteworthy that the list of negotiable services is a mixture of these two cases. For example, excluded services fall within the definition of negotiable services, being defined as:

Transmission services the costs of and revenue for which are excluded from the revenue cap which applies to prescribed services.

This definition of excluded services therefore encompasses contestable services. However, negotiable services also include

- (b) that part of a prescribed service which is to be provided to a standard which is higher or lower than any standard:
 - i. described in schedule 5.1
 - ii. outlined in the standards published in accordance with clause 6.5.7(b); or
 - iii. required by any regulatory regime administered by the ACCC.

This mix of contestable services and prescribed services is confusing to some extent. It is especially confusing if we adopt the view that revenue can only fall outside the revenue cap if the service is contestable. As noted earlier, we recommend that this approach is not adopted. However, it is questionable whether the ACCC will accept this position – and therefore we need to be pragmatic.

A similar issue arises in relation to funded augmentations. Presumably, a funded augmentation (rather like a new connection) could in some circumstances be contestable, or non-contestable in other circumstances. However, given that the revenue from funded augmentations is hard to predict (whether or not it is considered to be contestable), it seems appropriate for revenue from these services to fall outside the price control.

Non-contestable funded augmentations would be rolled into the revenue cap at the next regulatory period, to reflect the charges agreed between the parties. Contestable funded augmentations would remain permanently outside the revenue cap.

This suggested approach is essentially an extension of SPI Powernet's proposed treatment of new connections, which has been endorsed by ACCC. Logically, negotiable services and funded augmentations are subject to similar uncertainties as new connections – and therefore a similar regulatory treatment is appropriate.

In summary:

- Negotiable services are a mixture of non-contestable and contestable services;

- It seems appropriate that all revenue from negotiable services should at least initially sit outside the revenue cap. This approach recognises that
 - negotiating services levels with customers should lead to different revenue outcomes for the TNSP;
 - it is difficult to forecast revenue from these services for a 5 year period; and
 - some negotiable services may be contestable, and therefore should sit outside the revenue cap permanently.
- Where a negotiable service is non-contestable, costs and revenues (as negotiated between the parties) for existing services will be included in the revenue cap at the next regulatory period; and
- A similar approach should be adopted with respect to funded augmentations.

3.4. Who pays?

There remains considerable confusion with regard to the relationship between “who pays” and “revenue setting”. One confusion is the argument that services which benefit generators should not be remunerated through the revenue cap. In a sense, the revenue cap is therefore considered only to relate to “load” services.

This adds a further dimension to the complexity that already exists in the Code. To some extent, the revenue cap can be defined in a number of different ways providing that services that fall outside the revenue cap can be remunerated. However, the risk with the “who pays” argument is that TNSPs will be prevented from including generation-related costs in the revenue cap, and not be provided with a mechanism for recovering these costs.

One concern is that allocating revenue on the basis of “who pays” will create problems in relation to shared network augmentations. As the allocation between generation and load will not be known in advance, it is not possible to set the “load-only” revenue cap accurately. This difficulty can be resolved by excluding all shared network augmentations from the revenue cap, and levying additional charges on load and generation as the cost allocation issue is resolved.

The conclusion is that developing a “load-only” revenue cap serves little purpose. Providing that the pricing arrangements appropriately allocate charges between load and generation, customers and generators will pay the right price. This can be achieved without attempting to develop a separate “load-only” revenue cap. In fact, the implication of a “load-only” revenue cap is that shared network augmentations cannot be included until the cost allocation is known. It is not clear that there are any benefits to this approach.

4. Suggested approach

In summary, the principal conclusions from this paper are:

- The Code is quite unclear on the definition of prescribed and contestable services, but it is possible to develop a reasonable working definition of these terms;
- There is some doubt as to whether the ACCC's interpretation of the Code is completely accurate. However, this does not appear to create any serious concerns at this stage;
- There is a tendency to believe that charges can only sit outside the revenue cap if they relate to contestable services. In our view, it is appropriate that revenue related to an uncertain quantum of services should also sit outside the revenue control, until the uncertainty is resolved. The ACCC, however, may not accept this approach – as noted in relation to Transend's fixed and variable approach to capital expenditure.
- Negotiable services and funded augmentations do not fall neatly into the category of contestable or prescribed services. However, there is a strong case that these should fall outside the revenue cap for a period (as noted above), and that contestable negotiable services should do so indefinitely.
- Where a negotiable service or funded augmentation is non-contestable, costs and revenues (as negotiated between the parties) for existing services will be included in the revenue cap at the next regulatory period.
- The suggested approach in this paper is essentially an extension of SPI Powernet's proposed treatment of new connections, which has been endorsed by ACCC. Logically, negotiable services and funded augmentations are subject to similar uncertainties as new connections – and therefore a similar regulatory treatment is appropriate.
- The “who pays” issue continues to create added complexity, and the question of “who pays” does not seem particularly relevant to the issues at hand. The principal issues are:
 - Contestable services should not be revenue capped;
 - Uncertainty regarding the quantum of some prescribed services needs to be sensibly managed within the revenue cap environment. This is best achieved by allowing revenue and costs to sit outside the revenue cap for an initial period.