Hydro Tasmania
the renewable energy business

18 July 2003

Mr Sebastian Roberts
General Manager
Regulatory Affairs – Electricity
Australian Competition and Consumer Commission
PO Box 1199
DICKSON ACT 2602

electricity.group@accc.gov.au

Dear Mr Roberts,

Draft Service Standards Guidelines
Hydro Tasmania Submission

Thank you for the opportunity to provide Hydro Tasmania's written submission on the Draft Service Standard Guidelines and our previous presentation at the Public Forum on 14 July in Canberra.

Introduction

As you may be aware, Hydro Tasmania provided some specific remarks on the service standards proposed under Transend's revenue reset application. We consider that these detailed comments may also be helpful as you finalise the Service Standard Guidelines.

Hydro Tasmania would also like to express its support for the ERAA/NGF proposals in respect of service standards. It is illustrative of the importance of this issue that these two organisations have been able to develop joint proposals. However, just as the Commission has acknowledged the existing service standard guidelines are a starting point, Hydro Tasmania considers that the ERAA/NGF proposals should be viewed as an first step to developing appropriate market-based incentives. This submission provides Hydro Tasmania's views where they go further than the ERAA/NGC proposals.

Hydro Tasmania's Approach

Figure 1 illustrates Hydro Tasmania's preferred approach to specifying transmission service. The remainder of the document largely follows this structure.

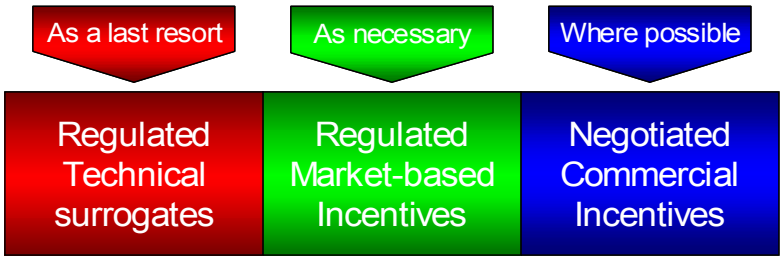

Figure 1 Preferred Approaches

- **The Current Proposal for Availability is flawed**

  As we state in Figure 1, technical surrogates for market impact should only be used as a last resort, and further should minimise as far as possible the potential for poor or perverse incentives. We consider that the current proposals for availability targets are technical surrogates and are flawed in three major respects:

  - An availability incentive does not provide an incentive to seek to increased capability from the existing asset base. As an absurd example, an asset could be down-rated to only 5% of its normal ratings. Under the proposed approach, as long as the asset was still in service, the availability incentive would be unaffected.
  - A general availability target treats all periods as having equal value. Clearly, the market value of transmission varies considerably across time , and yet this is not reflected in the availability incentive. Given the recent efforts of the TNSPs to carry out maintenance in off-peak periods (when overtime is incurred), they will now have a financial incentive to move this maintenance to peak periods (when overtime is not required). The ERAA/NGF proposal suggests distinguishing between peak and off-peak – another approach would be to use a price trigger.
  - A general availability target treats all circuits as being of equal importance. In practice, there are some key circuits which impact on the wider market much more significantly.

  In summary, if the Commission decided to accept a technical surrogate at this stage, the approach taken should be modified to ensure sensible incentives are provided to TNSPs.

- **Development of a market impact performance incentive scheme is essential, urgent but admittedly complex**

  We are pleased that the Commission recognises the desirability of a market-based incentive. We consider that the development of a scheme of this nature is essential to the development of the market. The first step is to clarify its fundamental design objectives. This would ensure that the wider market is clear about the intent of the scheme, and the likely direction of its development. At the moment there would appear to be some confusion about the objectives of a market-based scheme. In Attachment 1, we provide some initial thoughts.

Once these design objectives have been developed, and a clear view of the objective function is developed (overall market value, constraint costs, etc) a necessarily detailed process is required:

- To separate out those costs that the wider market is best placed to influence;
- To separate out the costs that TNSPs are best able to influence from those that NEMMCO is best able to influence; and
- To separate out the costs that each TNSP is best able to influence.

It is recognised that this potentially creates a substantial workload for the Commission. However, it is only by the Commission fully engaging in this process that any substantive progress will be made on this vital issue. The results of a similar scheme in the UK have been unquestionably beneficial[1].

- **Need to clarify Code arrangements for negotiated access**

  Even once the Commission has established a market-based incentive scheme, it would be preferable if market participants could negotiate their own preferred enhanced arrangements. Indeed, the Code clearly envisages that market participants should be able to negotiate enhanced access arrangements. However, the Code, as it stands, is unclear in how this would work in practice.

  Hydro Tasmania consider that, while not the primary focus of this consultation, there is a need for the Commission to develop guidelines (analogous with that for the framework for negotiating discounts) to clarify the arrangements for TNSPs and Market Participants who wish to establish individually negotiated enhanced access arrangements.

Conclusion

- The proposal for an availability incentive is flawed and should move to a more focused measure as a first step. (eg: peak times, key circuits)
- Development of market-based performance incentives is complex, urgent and essential.
- The ERAA/NGF proposals are a good start and should be seriously considered, particularly given the level of consensus achieved across the industry.
- There is a need to clarify the Code arrangements for negotiating enhanced access

Hydro Tasmania urges the Commission to seriously consider the above in deciding the next steps in this extremely important development process.

[1] We acknowledge that the UK only had to resolve the first and second issues in the list above. While the System Operator and Transmission Owner are the same organisation, the regulator was concerned that there should be no double counting between the normal revenue control and the transmission incentive scheme. The target setting process ensured, for example, that the market benefits from capex allowed under the main revenue control was not rewarded under the transmission incentive scheme.

If you wish to discuss any aspect of this note, please feel free to contact Greg Jones on 03 6230 5485,

Yours sincerely,

[Electronic Copy]

David Bowker
Manager Market Development

Attachment 1 Initial thoughts on market impact performance incentive design

- Market impact incentives should be based on market costs and not simply a percentage of the TNSP's Annual Allowed Revenue Requirement. (We note the requirement for sharing factors, caps and collars).
- Market based incentives do not require unique attribution of 'cause' or 'fault'. Rather, the incentive should be placed on the party who is best placed to manage risks and the impact of those risks. To illustrate this point, we turn to the example of the farmer who drives into a transmission tower[2] (used in the Discussion paper with the draft guidelines). By focusing the incentive on the party best placed to manage the risk, debates about fault are avoided. Say that the TNSP is provided with a market based incentive. In light of that incentive, the TNSP would carry out a risk assessment and if there were an ongoing risk of farmers driving into towers, the TNSP would implement systems to mitigate the risk – for example informing farmers or building high visibility reflectors on their towers. These measures and systems would be costed against the risk the TNSP faces. Absent the incentive on the TNSP, there would have to be some way for the market to conclude that farmers crashing into towers is adversely affecting the market and somehow sponsor a risk management programme.
- One of the attractions of the current technically based incentive schemes is that the Commission has been able to use historic data to base the targets on. However, for a market-based incentive scheme, the targets would need to be forward looking and seek to reflect the market dynamics expected over the period of the scheme. This has been the source of considerable debate between Ofgem and National Grid in the UK, and they have adopted various approaches to resolve their differences of opinion, including Ofgem offering National Grid schemes with different risk/reward profiles.
- Given the volatility of the market, the period of any market-based incentive scheme will probably have to be shorter than main revenue controls. For example, the longest incentive scheme run in the UK was 2 years.
- We recognise that both TNSPs and market participants are unclear about how a market-based incentive scheme would affect the market. It would be possible to establish a shadow scheme that could operate for a year to allow all the various parties to understand the effects of the scheme. It would also enable any design flaws to be resolved before there was significant revenue at stake. Even during the shadow operation phase the scheme would allow a focus on both NEMMCO and individual TNSP performance, which is not currently available.
- One scenario that is often raised is where a market participant takes a position in the market due to the timing of a particular outage, say taking

[2] For the purposes of argument, we are ignoring any safety implications, but clearly in practice these would be the main driver for the TNSPs behaviour in this example.

out a hedge. There is a perception that if a TNSP subsequently moved that outage, it would be unfair to the hedge holder. However, it is important to recognise that the market is dynamic, and all participants should react and anticipate other parties' behaviour. Once a market-based incentive scheme is in place, the market will find that TNSPs will react 'predictably' to market impacts. For example, if the TNSP expects the constraint cost of a particular outage to rise, then that outage will move – parties will hedge their positions with this effect in mind.

- It has been argued that TNSPs cannot influence broad market movements in price. This is clearly the case. However, for a market-based incentive scheme to work effectively, then the TNSPs most have some exposure to the market price. Their exposure to this risk can be managed through the target setting process, and through the setting of the caps and collars for the scheme.