28 July 2015

Mr Craig Oakeshott
Director
Wholesale Markets Branch
Australian Energy Regulator
GPO Box 922
Adelaide SA 5001

By email: AERinquiry@aer.gov.au

Dear Craig

TNSP Service Target Performance Incentive Scheme review

The Major Energy Users (MEU) welcomes the opportunity to provide its comments regarding the draft Service Target Performance Incentive Scheme (STPIS) which applies to electricity transmission network service providers (TNSPs).

In its response to the AER Explanatory statement accompanying the draft of the proposed scheme the Major Energy Users (MEU) observes that the changes proposed will address a number of significant concerns the MEU has with the current form of the STPIS.

As a matter of principle, the MEU considers that:

- Rewards from the scheme should result from the actions undertaken by the TNSP but not from actions of others
- The STPIS rewards must not have a power greater or less than the other incentive schemes established by the AER, as this might result in perverse outcomes for consumers
- Consumers should not be providing funds (through opex and capex allowances) that enable the TNSP to generate rewards under the STPIS

The MEU also notes that the STPIS rewards are benefiting from a number of aspects that are not driven by the TNSPs, including:

- A significant reduction in overall demand followed by very low rates of increase which implicitly results in less congestion

- Proposals from TNSPs seeking (and gaining approval for) significant increases in replacement capex (repex) which should lead to an outcome of increased reliability with fewer and shorter outages.
- The increase in intermittent generation has resulted in significant amounts of transmission network connection assets which are not included in the transmission elements funded by consumers, but are integral to minimising the cost of delivered electricity to consumers.

What the MEU has also noted is that some networks are sometimes investing their own funds in order to gain a reward under the STPIS. The MEU strongly supports such moves and notes that there are still many networks that exhibit a strong preference for using consumer provided funds to generate rewards under the STPIS. The MEU urges the AER to be vigilant in this regard.

Overall, the MEU supports the changes made to the STPIS but has the following concerns.

1. As noted above, there is still the ability of networks to use the capex allowed for "maintaining reliability" to provide improved reliability. Therefore great care is needed to ensure that capex allowances are closely examined to ensure that consumers do not fund rewards under the STPIS. It was because of this that the MEU considered that rolling reliability targets should be introduced[1]. By not implementing rolling targets as proposed by the MEU, this provides a clear avenue for networks gaining unearned rewards because the allowed repex provided can result in improved reliability rather than just maintaining the reliability through incorrect alignment of repex and historic performance.

2. The MEU can understand why there is concern about transferring responsibility to contracted third parties for a loss in the market impact component (MIC) rewards calculation. Equally, the MEU is concerned that by excluding the third party outages from the MIC calculation, the network is incentivised to contract more to third parties to avoid the market impacts. On balance the MEU agrees with the AER that the third party caused impacts should be excluded as the resultant outcome will be specifically related to the network performance. However, the MEU requests that the AER monitors this aspect to identify whether networks are deliberately involving third parties in order to minimise their responsibilities to ensure the best outcome for consumers.

3. The MEU remains concerned that the core principle of the network component incentive scheme is not addressed by the draft STPIS. The concept of the NCIPAP is to incentivise low cost projects that deliver high consumer value (in relation to the cost) that would not otherwise occur.

   Unless this core principle is achieved, the MEU does not support the NCIPAP. The MEU considers that a maximum payback period must be

[1] The MEU notes that the AER has decided not to implement such a change at this time.

applied to deliver the core principle, so a firm payback period is a perquisite for continued MEU support of the program.

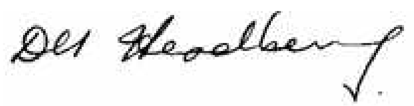
By not requiring a minimum payback on proposed projects, the AER is abrogating the rationale of the NCIPAP concept. The AER contemplates that by stipulating a firm payback period, projects that might provide value to consumers might be excluded. The MEU points out that such projects with a longer payback should have been addressed within the normal opex/capex allowances rather than being implemented by the NCIPAP process.

NCIPAP projects are, by their very definition, discretionary. The fact that they have not been addressed previously by the networks highlights that they are discretionary. This means these projects are "nice to have" but not essential in the delivery of the services. Discretionary projects have to "prove" that they are valuable and provide a rapid return of the investment. Firms in competition have established strong rules for such discretionary expenditure - that they return the outlay required in a very short time frame or they do not get funding, and this is only provided if there is funding available. As advised by the MEU, most firms have a 2-3 year payback for such discretionary projects but projects with up to 4 years have also been considered when funding is available. As regulation is a surrogate for competition, regulation should follow the tenets used by firms in competition.

To reflect the AER concern that otherwise valuable projects might not proceed, the MEU proposes that there be a target payback period of three years for NCIPAP projects, but there be discretion allowed to the AER to extend the payback period to no more than four years for certain projects, with the AER required to explain why a longer payback is in the long term interests of consumers and that otherwise the project would not be included in the normal opex/capex allowance.

Should you wish to discuss the MEU views expressed in this response in more detail please contact the undersigned at davidheadberry@bigpond.com or on (03) 5962 3225

Yours faithfully



David Headberry
Public Officer