

TRANSEND SUBMISSION ON ACCC'S DRAFT DECISION ON THE STATEMENT OF REGULATORY PRINCIPLES – EXCLUDED SERVICES PROPOSAL

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1 WHAT ARE THE ISSUES?

As previously discussed with the Commission's staff, Transend believes that there is considerable benefit in defining a set of 'excluded transmission services'. The costs and revenues of these excluded services would be (at least temporarily) outside the maximum allowed revenue established by the revenue cap.

The principal benefit of adopting an 'excluded service' approach is that customers and TNSPs will be less exposed to the risks of forecasting the quantum of these services that are to be provided over the regulatory period. Ideally, this lower risk can be attained without any off-setting 'cost'.

2 PRECONDITIONS

The purpose of the revenue cap is to provide the TNSP with a fixed¹ revenue for providing a relatively well-defined set of services, with penalty and bonus arrangements depending on cost and service performance. It is widely recognised that 'CPI-X' control has valuable incentive characteristics, as reflected in the Code requirements on the Commission to adopt 'incentive-based' regulation.

The use of 'excluded services' should not undermine the incentive properties or purpose of the revenue cap. On the contrary, the view expressed in this note is that excluded services can enhance the revenue-capping process by reducing the risk of forecasting error in setting the cap. In addition, it provides a mechanism for defining clearly which services are 'revenue-capped' and which ones are not. At present, the Commission itself has acknowledged that the definition of 'contestable services' is unclear – yet it continues to rely on this definition to determine which services are revenue capped.

It is important, therefore, that excluded services are defined in a manner that deals with the *uncertainty problem* (in relation to forecasting the quantum of services to be provided) without undermining the revenue-capping process. Transend has therefore proposed a set of pre-conditions that a service should satisfy in order to be treated as an 'excluded service'. These pre-conditions are:

- (i) The quantum of services (and therefore the prospective costs and revenues) are difficult to forecast at the commencement of a regulatory period;
- (ii) A customer (load or generation) specifically requests the service to meet the customer's specific requirements, as defined by the customer;
- (iii) The revenue and costs arising from the provision of excluded services do not affect the revenue-capped transmission services. There are two aspects here:
 - The costs of providing excluded services should be separated from the assessment of the building blocks for revenue-capped services. This ensures that costs are only recovered once; and
 - Customers requesting excluded services pay for them, rather than the costs being met by the generality of customers.
- (iv) The Commission must have confidence that the agreed price for an excluded service is 'fair and reasonable' – by, for example, having an appeal mechanism that allows the regulator to determine the terms and conditions of the service provision in the event of a dispute; and

¹ Subject to various "pass-through" provisions, and "excluded projects", as per the ACCC's recent draft statement of regulatory principles.

- (v) An excluded service is unlikely to always be provided on a contestable basis. It is noted that *contestable services* should be permanently outside the revenue cap process. Therefore, an excluded service must be classified in a manner that it is likely to include some non-contestable services².

3 CONSISTENCY WITH THE CODE

Transend notes that the Commission's recently published draft statement of regulatory principles contemplates a number of Code changes in order to improve the incentive properties of the regulatory regime. Given the prospect of changes to the Code, it is a good opportunity to consider revising existing definitions or provisions, if this is considered desirable. As a general comment, Transend notes that the Code provisions in relation to revenue determination and price setting could be substantially improved.

Nevertheless, although the existing Code should not be considered sacrosanct – Transend's view is that the use of excluded services is not inconsistent with the Code. We note, for example, that 'excluded services' is a defined term in the Code – meaning "*Transmission services* the costs of and revenue for which are excluded from the *revenue cap* which applies to *prescribed services*." Unfortunately, the term 'excluded services' is not used in chapter 6 of the Code, which relates to revenue and price setting (although '*distribution excluded services*' is used).

It is worth noting that the Commission has previously suggested that the revenue cap must apply to all prescribed or non-contestable services. Unfortunately, this has led the Commission to argue that, *ex ante*, it must set a revenue cap to cover all non-contestable services – and, by implication, the Commission is prevented from excluding some non-contestable services from the revenue cap, even on a temporary basis. The Commission's position on this issue is problematic – not only does it require a forecast of the costs and revenues of services that have not yet been requested or defined – but it also presupposes that a reasonably accurate forecast of the 'non-contestable' services can also be made.

Moreover, the Commission's interpretation of the Code on this point is too narrow. In particular, clause 6.2.4(f) states:

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.

Our reading of this clause is that the ACCC cannot revenue-cap services that are *contestable*. It does not say that all *non-contestable services* must be revenue-capped. In any event, Transend's suggested approach is that 'excluded services' may only *temporarily* exclude the revenues and costs of some non-contestable services from the revenue cap. Once the quantum of services is known at the next regulatory period, the costs and revenues from these services may be swept into the revenue cap³.

Revenue and costs of excluded services that are considered to be 'contestable' will remain outside the revenue cap permanently. The *temporary* exclusion from the revenue cap does not have any adverse impacts on either those customers procuring the excluded services or the generality of customers.

² It is noted that an excluded service could be a mix of "contestable" and "non-contestable services". Transend's view (discussed later in this paper) is that excluded services cannot sensibly be defined to only include "non-contestable" services. To do so, re-introduces a forecasting problem – what proportion of future connection services, for example, are likely to be contestable?

³ If services are "contestable" they should be permanently excluded from revenue cap. This is consistent with the Code requirement that only "non-contestable" services should be subject to revenue capping.

In summary, Transend's view is that the Code does not prevent the Commission from adopting the concept of excluded services as proposed in this note.

4 CONSISTENCY WITH THE DRAFT STATEMENT OF REGULATORY PRINCIPLES

The recently released draft statement of regulatory principles proposes, amongst other things, that the capital expenditure framework should change. In particular, the Commission is contemplating an 'excluded projects' category of expenditure, which essentially provides for additional revenue as and when 'material and uncertain' projects are triggered by a pre-defined event during a revenue cap period.

Transend welcomes the approach – although the details are still being worked through. An important question arises as to whether the proposal to develop 'excluded services' cuts across or duplicates the Commission's approach to 'excluded projects'. In Transend's view, there is no inconsistency in approach. However, the titles of 'excluded projects' and 'excluded services' may need to be changed to minimise the prospect of confusion.

The 'excluded projects' approach is looking at the costs of forecasting 'regulated transmission services'. It is rightly focusing on particular projects that may or may not proceed, where an assumption one way or the other could have a material impact on the maximum allowed revenue.

In contrast, the 'excluded services' definition is focusing on the question of 'what are the regulated services?' Logically, this question should be addressed before considering the costs of providing regulated services (to which the 'excluded projects' initiative relates). In Transend's view, it is a necessary first step in the regulatory process. At present, the draft statement of regulatory principles doesn't address the matter in detail.

We note, however, that it could be argued that the 'excluded projects' approach obviates the need to define 'excluded services'. One argument is that 'everything should be treated as *regulated transmission services* and we can deal with uncertainty adequately through the excluded projects route'. In our view, this is a second best approach because the excluded services route is a neat way of improving the accuracy of the revenue-setting process. In particular, 'excluded services' manages uncertainty in revenue from a group of projects 'activities', such as new connections, that may individually fall below the materiality cap applied to 'excluded projects'.

5 PROTECTION AGAINST MONOPOLY PRICING

As noted earlier, an important issue from the Commission's perspective is that charges for excluded services should be subject to some form of price regulation. It is worthwhile considering first the potential *service candidates* for 'excluded services' – on the basis of those services that are likely to satisfy pre-conditions 1, 2 and 3 listed earlier.

In Transend's view, the following services could be treated as 'excluded services'

- (vi) New transmission connection services;
- (vii) Connection application fees;
- (viii) Funded augmentations; and
- (ix) Negotiable services⁴.

In relation to connection services and application fees, clauses 5.3.3(c)(5) and 5.3.6 (c) of the Code states that:

⁴ See appendix for a short discussion of the definition of *Negotiable Services*.

“The amount of the application fee which is payable on lodgment of an *application to connect*, such amount not being more than necessary to:

- (i) cover the reasonable costs of all work anticipated to arise from investigating the *application to connect* and preparing the associated offer to *connect*; and
- (ii) meet the reasonable costs anticipated to be incurred by *NEMMCO* and other *Network Service Providers* whose participation in the assessment of the *application to connect* will be required”

and

“The offer to *connect* must be fair and reasonable and must be consistent with the safe and *reliable* operation of the *power system* in accordance with the *Code*. Without limitation, unless the parties otherwise agree, to be fair and reasonable an offer to *connect* must offer *connection* and *network services* consistent with schedule 5.1 and (as applicable) schedules 5.2, 5.3 and 5.3a must not impose conditions on the *Connection Applicant* which are more onerous than those contemplated in schedules 5.1, 5.2, 5.3 or 5.3a.”

If a customer believes that the offer to connect or the connection application fee is not fair and reasonable, the customer is able to initiate a dispute in accordance with the Code provisions in clause 8.2. This should provide adequate assurance that charges will be ‘fair and reasonable’.

In relation to funded augmentation, it is noted that the definition of funded augmentation is:

A transmission network augmentation for which the Transmission Network Service Provider is not entitled to receive a charge pursuant to Chapter 6.

It may be the case that this definition makes it clear that funded augmentation must be excluded from the revenue cap – so perhaps the issue of protection from excessive charges does not arise. Nevertheless, our preliminary review of the Code does not indicate any explicit control on the charges a TNSP levies in relation to ‘funded augmentations’.

In relation to Negotiated Services⁵, Transend notes that the clause 6.5.9 of the code 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*.

Presumably, the purpose of the negotiating framework is to ensure that the outcome from negotiations is ‘fair and reasonable’. It achieves this by giving the customer certain rights, including access to information, which may not be forthcoming if the TNSP were able to exercise its market power in an unfettered manner. Providing that the ‘negotiating framework’ is fit for purpose, the Commission should have confidence that the price and service outcomes are fair and reasonable.

⁵ See appendix for a short discussion of the definition of *Negotiable Services*.

6 CONCLUDING COMMENTS

This short note has outlined:

- (i) the benefit of adopting excluded services and clearly defining regulated revenue;
- (ii) some draft 'pre-conditions' that should be applied in developing excluded service definitions;
- (iii) the consistency of the proposed approach with the Code and the draft statement of regulatory principles; and
- (iv) the existing Code provisions that protect customers from 'excessive' charges.

On the basis of this paper, Transend believes that the Commission should carefully consider the merits of adopting an excluded services arrangement. This should be addressed in the finalisation of the statement of regulatory principles.

APPENDIX 1: DEFINITION OF NEGOTIABLE SERVICES

The Code defines Negotiable Services (in relation to Transmission 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:
 - (1) described in schedule 5.1;
 - (2) outlined in the standards published in accordance with clause 6.5.7(b); or
 - (3) 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*.

As noted earlier, ‘excluded services’ is a defined term in the Code – meaning “*Transmission services* the costs of and revenue for which are excluded from the *revenue cap* which applies to *prescribed services*.”

One interpretation is that the definition of *Excluded Services* lends support to the view (expressed in this paper) that *Negotiable Services* should be treated as falling outside the revenue cap (at least on a temporary basis). On the basis of practical simplicity, it could be argued that all ‘*Negotiable Services*’ should either be included or excluded from the revenue cap. The presence of *Excluded Services* in the definition of *Negotiable Services* would support the inference that all *Negotiable Services* should be excluded from the revenue cap.

An alternative view, is that it is tautological (and therefore wrong) to simultaneously define *Negotiable Services* as including *Excluded Services*, and to define *Excluded Services* as including *Negotiable Services*. On this view, it could be argued that the Code does not allow the approach suggested in this paper.

In our view, both of these views miss the critical point that the Code has not been drafted in a consistent or logical manner. It could be improved upon. The task now is to find an appropriate approach that is consistent with the objectives of the Code. In Transend’s view, it is better to step back from the Code definitions somewhat – to ensure that the regulatory approach makes sense. In relation to *Negotiable Services*, the strongest case for excluding revenue and costs (at least temporarily) from the revenue cap is that negotiation is only meaningful if it can lead to a different revenue outcome for the TNSP. If the revenue from *Negotiable Services* is revenue-capped, then negotiation is meaningless because it has no impact on the TNSP’s revenue. On this view, despite the definitional problems that exist in the Code, Transend believes that there is an overwhelming case for treating *Negotiable Services* as being outside the revenue cap.