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Productivity Commission
GPO Box 1428
Canberra City ACT 2601

Attention: Commissioners Philip Weickhardt and Wendy Craik

Via email: electricity@pc.gov.au

Dear Commissioners

Re: Submission DR100 – Australian Energy Market Operator – Electricity Market Regulation Public Inquiry

This letter is provided on behalf of Grid Australia in response to the above mentioned submission from the Australian Energy Market Operator (AEMO) to the Commission dated 15 January 2013.

Grid Australia notes that, while the submission from AEMO is relatively wide ranging it provides only limited new evidence to the Inquiry. To the extent that any new data has been provided this is largely of a confidential nature and has not been provided with the public version of the submission. Accordingly, it is not possible to comment on the veracity or significance of this data.

Nevertheless, two aspects of the AEMO submission do warrant further comment as follows:

1. The discussion on the competitive procurement of transmission services.
2. The lack of specific reference to the use of commercial incentives as a means to drive improved transmission service provision.

Competitive Transmission Service Provision

Much of the AEMO submission argues for changes to arrangements in transmission service provision to enable competitive provision of transmission system ownership. It should be noted that competitive provision of transmission plant and equipment is already in place as the normal means of procurement by Transmission Network Service Providers (TNSPs). This includes the competitive provision of plant and equipment required to accommodate new connections.

In relation to the competitive provision of transmission system ownership and/or operation, this is a much more complex question. Grid Australia has previously provided the Commission with a summary of the 'current state of play' on this matter in the United States. Essentially, this appears to be at an 'experimental' level of adoption, with the concept under significant challenge.

The AEMO submission, under the heading of "Competition in the United Kingdom" includes statements about the success of arrangements in the United Kingdom as follows:

> *"The UK Government and Ofgem (Office of the Gas and Electricity Markets) recognised the potential benefits of a co-ordinated approach to developing offshore electricity transmission infrastructure projects. These include lower overall capital costs, reduced environmental impacts and fewer planning delays. For these reasons, the decision was made to extend National Grid's onshore System Operator responsibilities to include offshore assets. National Grid's responsibilities include developing a co-ordinated electricity transmission system and the creation of a licence obligation requiring the System Operator to develop an Offshore Development Information Statement (ODIS).*
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> *In early 2011 the Department of Energy and Climate Change (DECC) and Ofgem launched the Offshore Transmission Coordination Project. This project included stakeholder input and specialist reports on the benefits, costs and risks associated with different offshore grid configurations, and on the potential regulatory and commercial measures for incentivising coordination.*
>
> *The findings suggest that coordinated offshore network development does indeed have the potential to deliver significant savings. Savings of between 8-15 per cent – or £0.5-3.5 billion[1] – capturing some of the potential benefits and risks associated with coordinated grid configurations have been identified in comparisons with radial transmission configurations.*
>
> *Modelling was undertaken by TNEI/PPA Energy and Redpoint Energy using four generation scenarios. The results found that coordination in respect of The Crown Estate (TCE) Round 3 Zones has the potential to deliver savings as well as increase as higher levels of generation are assumed."*

The first observation we would make is that the initiative referred to by AEMO appears to be as much about empowering the UK independent system operator to co-ordinate green-field transmission development as it is about promoting competition in shared transmission network service provision.

More importantly, and regardless of the intention of the initiative, it does not appear to be as successful as envisaged. As recently as 14 January 2013, the UK Public Accounts Committee (the Committee) published a report critical of the current UK licensing regime for offshore electricity transmission.

Among other matters, the Committee observed that the aim of a competitive market for offshore transmission, envisaged by the Department for Energy and Climate Change, and the Gas and Electricity Markets Authority (with Ofgem oversight), has failed to eventuate.

In this regard the Committee noted that:

- only two companies were successful out of the first six licences competitively tendered;
- the investors' estimated returns on the initial offshore licenses appeared to be *"extremely generous";* and

[1] Approximately $AUS0.7-5.4 billion

- licensees and their investors are provided a guaranteed income for 20 years, escalated by inflation, regardless of asset use.

The Committee concluded that:

> *"Not only is it unlikely that this new licensing system for bringing electricity from offshore wind farms onto the national grid will deliver any savings for consumers, it could well lead to higher prices"*.

Incentive Regulation of Transmission

The potential role and scope of incentive regulation of 'for profit' transmission service providers has emerged more clearly as an important issue in the latter stages of the Commission's Inquiry. The AEMO submission needs to be considered in the context of this issue. Specifically, it is apparent that two very different models for the future delivery and regulation of transmission services in the National Electricity Market are being used as reference points as follows:

1. A model based around arrangements operating in some parts of the United States involving a dominant role for the 'not for profit' Independent System Operator in the delivery of transmission services, including decision making on what major transmission augmentation projects will be undertaken.
2. A model based around arrangements operating in the United Kingdom relying on 'for profit' transmission system owners delivering transmission services in response to defined service outcomes and commercial incentives developed by the transmission regulator.

It is apparent from AEMO submissions over a number of successive reviews that AEMO is promoting a model similar to that operating in a number of regions within the United States. This includes AEMO undertaking a role in transmission service provision more aligned to that undertaken by US 'not for profit' Independent System Operators, such as PJM Interconnect. Part of this role is to decide which major transmission augmentation investments will be undertaken.

One key difference from the US arrangements is that AEMO is not promoting the use of deterministic planning standards for transmission in the NEM. At the present time, following the catastrophic power system failure in the North East United States in 2003, specific reliability standards are now legally mandated for wide application.

As the Commission is aware, AEMO and Grid Australia are working together to develop arrangements for the application of more economically based transmission planning standards. The Commission's issues with the measurement of Value of Customer Reliability, and the application of economic standards to low probability high consequence events, will need to be addressed satisfactorily as part of this process.

In contrast to the weaker accountability 'central planner' arrangements adopted in parts of the US, Grid Australia has been pressing for the continued development of commercial incentive arrangements to be applied to 'for profit' transmission service providers as the basis for transmission service delivery in the NEM. Consistent with the arrangements in the United Kingdom (UK) this includes the ongoing development of commercial incentives to encourage efficient augmentation investment, and the efficient integration of these decisions with other key inputs to the delivery of transmission service outcomes.

Grid Australia's position is that the use and development of incentive regulation of transmission services is consistent with the policy direction of the National Electricity Market since its commencement and, most importantly, best promotes the long term interests of consumers. Ofgem's review of the UK regulatory framework (RIIO) determined that an incentive based regime remained optimum, whilst also recognising the need for the design of the incentive package to be strengthened and redirected to reflect current key network service criteria.

However, the Commission has questioned the suitability of these arrangements for aspects of transmission regulation, including in relation to larger transmission augmentation investments. To address this Grid Australia has provided the Commission with further information on how the arrangements in the UK address the legitimate questions raised by the Commission on these matters. This evidence is set out in some detail in Grid Australia's submission to the Commission dated 1 February 2013 and is not repeated in full here.

Importantly, Grid Australia considers that a recommendation to adopt transmission arrangements based on those operating in some regions of the United States in the belief that this is 'best practice' is not soundly based. As set out in Grid Australia's earlier submissions, the arrangements in the United States reflect very different past and present ownership arrangements, and historical development of electricity utility regulation to that applying in either the UK or Australia. In many cases in the US, transmission assets are still owned by generation companies requiring an Independent System Operator, to adopt a more command and control approach to transmission investment.

Indeed, Grid Australia considers that 'best practice' transmission network regulation involves empowering the economic regulator to develop and apply commercial incentives to 'for profit' service providers. This was the deliberate policy choice made during the deregulation and subsequent privatisation of the UK electricity industry which, in turn, has been adopted in the development of the National Electricity Market.

This choice is also reflected in the recent changes by the AEMC to the Rules for the economic regulation of electricity networks. These Rule changes specifically provide for the Australian Energy Regulator to develop the incentive arrangements to apply to transmission service provision, including the incentives for efficient capital investment by transmission system owners.

Summary

Based on the available evidence Grid Australia considers that the ability to harness real benefits from contestable ownership and operation of shared network transmission services is yet to be established. The most recent evidence provided of the success of this model needs to be examined carefully in light of the recent report by the UK Public Accounts Committee. In any event procurement of transmission assets is already routinely undertaken on a contestable basis delivering many of the benefits of competition to consumers.

More generally, care needs to be taken to ensure that the integrated nature of a transmission system, with inherent economies of scale and scope, is properly recognised. Consideration needs to be given to how an integrated system may work in practice if proliferation of ownership and operating responsibilities within an integrated network is encouraged over time. Preserving clear accountability for transmission service delivery is essential.

Finally, Grid Australia considers that UK transmission 'incentive' regulation is closer to 'best practice' transmission regulation than the arrangements operating in the US. The UK

arrangements harness the 'profit motive' of commercial transmission service providers and will provide a better long term outcome for consumers than the 'command and control' style transmission investment arrangements in much of the US.

While the UK arrangements do present the regulator with challenges in developing incentive arrangements for larger transmission investments, recent experience in the UK shows that these challenges can be addressed with thoughtful incentive design. The evidence for this has been provided in detail to the Commission in Grid Australia's submission dated 1 February 2013.

The Australian Energy Regulator is already working on the development of improved transmission incentive arrangements for the NEM as required by recent changes to the National Electricity Rules. It is well placed to incorporate the lessons from the UK.

Yours sincerely,

Rainer Korte
Chairman
Grid Australia Regulatory Managers Group