



Office of Energy
Government of **Western Australia**

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Dear Robert

SUBMISSION – WESTERN POWER’S PROPOSED ACCESS ARRANGEMENT

In response to the Authority’s request of 17 January 2007, please find attached a submission from the Office of Energy.

Thank you for the opportunity to comment on these matters.

Yours sincerely

(signed)

JASON BANKS
A/COORDINATOR OF ENERGY

12 February 2007

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Office of Energy Submission on Network Access Rights Relating to Western Power's Revised Proposed Access Arrangement for the South West Interconnected Network

1. Submission Summary

The Office of Energy wishes to respond to the Economic Regulation Authority's (the "Authority") request for submissions concerning Western Power's Revised Proposed Access Arrangement. In particular, the Office of Energy would like to comment on the ability of the network service provider to reallocate contracted connection point capacity, as proposed in clause 3.2 of the Electricity Transfer Access Contract ("ETAC").

The Office of Energy also makes comment on the trading of connection capacity rights and some of the issues raised in the Parsons Brinckerhoff Associates Report (the "PB Report").

The Office does not address question 2 in the Authority's request for submissions, apart from noting that providing this extra flexibility for the treatment of capital contributions is seen as a positive and practical initiative to manage the price path of regulated network tariffs.

The Office of Energy wrote separately to the Authority on 16 January 2007 regarding the headworks charge issue in question 3.

The Office of Energy considers that an appropriate mechanism is required to allocate unused contracted connection point capacity in the regulated South West Interconnected Network ("SWIN"). The mechanism should be designed to prevent inefficient investment in the network, mitigate the potential for anti-competitive behaviour and recognise that network services are regulated.

Clause 3.2 of the ETAC, as proposed, provides the network service provider with the ability to reallocate contracted connection capacity, after taking account of the Users particularly circumstances. The Office believes that a clause similar to clause 3.2 of the ETAC is an appropriate mechanism and administratively simple process for achieving these objectives.

Western Power's Access Arrangement, to be approved by the Authority under the *Electricity Networks Access Code 2004* (the "ENAC"), provides the regulatory basis for access to and enhancement of the SWIN. While Users may contract with Western Power on any terms of access they can negotiate, there are approved prices published for access to reference network services and contract terms cannot conflict with ring fencing, the applications and queuing policy and technical rules.

The Office believes that any concerns that Western Power may act unreasonably when exercising clause 3.2 of the ETAC, can be addressed through applying conditions, processes and timeframes on Western Power's use of this clause. Moreover, an appeals mechanism, such as a ruling by an independent party, could be provided for in the event that a User believes that Western Power has acted unreasonably.

It is not clear to the Office what, if any, incentives there are to encourage Western Power to act unreasonably in the exercise of clause 3.2 of the ETAC. Western Power has advised the Office that it is prepared to consider any reasonable suggestions for providing appropriate protections for Users.

Clause 3.2 provides a simple, low cost means by which unused capacity can be reallocated by Western Power, where other Users are seeking access to that capacity. This mechanism also allows the priority of the access application queue to be maintained. In the event contracted capacity is reallocated, Users are kept financially whole through rebate provisions for the return of any capital contributions. This mechanism complements the regulated automatic transfer of capacity, under the Customer Transfer Code, when retailer serviced customers churn.

The Office is concerned that unless other regulatory mechanisms are put in place, that simply removing the ability of Western Power to reallocate unused capacity could lead to practises that are not in the best interests of Users or consumers. The trading of monopoly infrastructure outside of the regulated environment could lead to Users either withholding capacity for commercial advantage or else selling spare capacity at prices well above the regulated tariffs and hence extracting rents. It also could allow Users to buy their way around the applications queue. The Office understands that these concerns are shared by some Users.

While the section 115 of the *Electricity Industry Act 2004* or Part IV of the *Trade Practises Act 1974* could be used to address anti-competitive behaviour, this action could be time consuming, difficult to prove in a court and expensive to pursue and hence reduce the value of such recourse.

The Office believes it is important that an effective access regime is established to limit the need for court action to address anti-competitive behaviour.

It may be argued that having to pay access charges for unused capacity will encourage Users to sell that capacity, however, it must be recognised that the access charges for shared network capacity for generators is only 10% of the charge paid by loads. Therefore, the economic incentive for generators not to withhold capacity from competitors may not be strong enough to prevent such behaviour. This may be particularly so if a generator has the opportunity to seek premiums above the regulated tariffs and rebate of capital contributions which would apply under clause 3.2.

The Office recommends that as a matter of pragmatism, and in order to not hold up the approval of the Access Arrangement, that Western Power be allowed to reduce contracted connection point capacity, but that adequate additional provisions be included to protect the legitimate interests of Users.

However if the Authority decides that instead Users should be able to bilaterally trade capacity, then a regime needs to be established to clearly identify how capacity is to be allocated to Users and what and how capacity can be traded. In addition, if economic signals in the form of regulated tariffs are to be relied upon to mitigate the potential for the withholding of capacity, the Authority should assure itself that these are appropriate.

In regard to the bilaterally trading of capacity the Office submits the following. Whilst markets can deliver greater allocative efficiency than administrative processes, there are equity arguments for the use of administrative processes in regulated arrangements. An example is the applications and queuing policy. Arguably, greater allocative efficiency could be achieved if this policy was replaced with an auction, with the highest bidder going to the top of the queue and the network service provider receiving the proceeds. This would, however, raise significant issues in regard to equity in the provision of regulated services.

2. Proposed Clause 3.2 of the ETAC

2.1. Western Power's Supporting Case

Western Power has proposed clause 3.2 of the ETAC to address three issues:

- to maximise the utilisation of the covered network and avoid unnecessary duplication;
- to prevent users from blocking another's access by "sitting" on capacity; and
- to prevent users from trading capacity rights at a premium.

Clause 3.2 would allow Western Power to reduce a User's connection capacity subsequent to determining how much connection capacity a user 'reasonably' requires after taking into account the circumstances of the User.

Where an affected User has made capital contributions, a rebate mechanism exists for the return of the relevant portion of these capital contributions.

Western Power suggests that it would use clause 3.2 infrequently, given that it will only apply to connection points where the User is clearly expected to use less than its contracted capacity and another User seeks that spare capacity. It is understood Western Power has never activated a similar clause in existing access contracts.

Section 115 of the *Electricity Industry Act 2004* and Part IV of the *Trade Practises Act 1974* can be used to address anti-competitive behaviour. However, mounting such action through the courts can prove to be very time consuming and also expensive with outcomes that are difficult to predict. Hence Western Power suggests that the practical value of such recourse to Users is limited.

Western Power sees its ability to reallocate spare capacity between Users as a relatively simple, low overhead cost method by which Users could be prevented from sitting on capacity to the detriment of others, and thus connection capacity would be efficiently allocated amongst users and potential users in accordance with the access queue.

Western Power is also concerned that trading of contracted capacity could result in capacity on this regulated network being traded by Users and potential Users in an unregulated manner with the possible abuse of market power.

It can be argued that, providing Users remain within the terms of their access contracts, it should be of little concern to Western Power that users are choosing not to use all of their connection point capacity. The Office agrees that Western Power is likely to be commercially indifferent to such circumstances. It is therefore encouraging to see Western Power proposing arrangements in the form of clause 3.2 in an effort to establish an effective and efficient access regime.

2.2. Connection Capacity Pricing Signals to Users

The Office is concerned that the access prices for generators do not reflect the full cost of the service, so a generator could find that siting on capacity is financially advantageous to limit competition or extract a premium from trading the capacity to a future User.

It is understood that of the revenue requirement for the shared transmission network, 50% is allocated to the common services charge which is only paid by loads and the remaining 50% is allocated to generators and loads on a 20:80 basis from which the Use of System charges are calculated. Therefore generators only pay for about 10% of the cost of the shared network.

It is therefore important to provide an appropriate mechanism to ensure the reallocation of unused capacity to ensure the efficient use of the network, given that economic signals may not be strong enough to achieve this on their own.

2.3. Section 5.3 of the Electricity Network Access Code 2004 (“ENAC”)

Section 5.3 of the ENAC requires a standard access contract to be:

- 1) reasonable; and
- 2) sufficiently detailed and complete to:
 - a) form the basis of a commercially workable access contract; and
 - b) enable a user or applicant to determine the value represented by the reference service at the reference tariff.

Providing Western Power the ability to reduce a User's contracted capacity on written notice should be accompanied by sufficient safeguards to ensure the requirements of section 5.3 are met. It is understood Western Power is willing to consider reasonable amendments to clause 3.2 by the Authority.

2.4. The ENAC Objective

The PB Report makes the comment that:

Unilateral altering of access contracts is heavy handed and is not consistent with the objectives of the Access Code in that competition is best promoted if parties deal with one another on an arms length commercial basis and both parties to the contract have similar negotiating power.

The Office considers that provided a User's rights to contracted connection capacity are adequately protected, then it would be difficult to argue that clause 3.2 of the ETAC is incompatible with the ENAC's objective set out in section 2.1.

The PB conclusion is based on the assumption that both parties are at arms length and have similar negotiating power. In situations of scarce capacity, tight project timeframes and where access charges may not be cost reflective, this assumption is unlikely to apply.

Through Western Power ensuring appropriate reallocation of spare capacity under a regulated environment, it can be argued that economically efficient investment in, and operation and use of, Western Power's networks and network services is facilitated. Clause 3.2 of the ETAC is considered by the Office to have a positive impact on the promotion of competition in markets upstream and downstream of the networks.

2.5. International Jurisdictions

The PB Report notes that it can find no precedent in the international jurisdictions it considered where a service provider has a unilateral right to reduce contracted capacity. While this is not a persuasive argument against proposed clause 3.2 of the ETAC in itself, it suggests that other jurisdictions have found adequate mechanisms to manage the issues raised by Western Power without such a contractual power.

Further, as the PB Report states, the trading of transmission entry capacity in the UK *'is limited to new or increases in capacity sought by generators and does not include user-to-user trading'*. It appears that trading does not apply to distribution systems.

Despite attempts to do so, the Office has been unable to determine the amount of use of the UK mechanism and its effectiveness, but recognises that this is worthy of further investigation.

2.6. Interaction between Proposed Clauses 3.2 and Clause 3.7 of the ETAC

The PB Report suggests that the effect of clause 3.7 of the ETAC in conjunction with proposed clause 3.2 of the ETAC is that; *'it appears that Western Power proposes a heavy-handed right to unilaterally reduce contracted demand and to ask a user for a capital contribution to recover the investment costs associated with connection assets that Western Power considers are no longer required.'*

The Office notes that this statement is inaccurate, as clause 3.7 only allows Western Power to require the User to pay a 'Reduced Demand Fee' if *'the User gives notice to Western Power seeking to: (B) reduce the Contracted Capacity at a Connection Point'*.

The clause is not constructed to apply when the roles are reversed and in the case of proposed clause 3.2 of the ETAC, Western Power would be the party wishing to reduce the contracted capacity.

2.7. Previous Policy Decision

The Office notes that a clause (A4.10) dealing with similar issues to those in proposed clause 3.2 of the ETAC was included in a public consultation draft of the ENAC during its development. The clause was deleted from subsequent drafts.

Clause A4.10 was discussed at the Access Code Development Committee (ACDC) meeting of 1 June 2004 and some ACDC members expressed reservations about the clause, because there are situations in which a user may legitimately have reserved excess capacity (for example because it needs future capacity to meet its expansion aspirations).

The proposed clause 3.2 requires Western Power to have regard to the nature, condition and use of a User's facilities and equipment installed, or to be installed within a reasonable time. This, or a similar requirement should address User's legitimate desire to contract for excess capacity for future expansion requirements.

2.8. Standard Access Contract

It is worth noting that the proposed clause 3.2 is merely part of a proposed Standard Access Contract. In principle, an access contract can contain any terms the parties agree to, as long as they comply with the ring fencing, queuing and technical rules provision of the ENAC. The inclusion of such a clause in an access contract would be open to negotiation in any contracting process.

In practise however, it may be difficult for a User to negotiate with Western Power to modify such a clause that appears in Standard Access Contract. The Office expects that if this clause is included in the Standard Access Contract that it will likely apply in almost all cases.

3. Contracted Connection Capacity Trading

3.1. ENAC Provision

An alternative method of allocating unused connection capacity within the SWIN is through the trading of this connection capacity between market participants.

The Office of Energy submits that whether any more formal provisions are needed to deal with trading and relocation of that capacity is an entirely separate question to whether or not clause 3.2 should be included.

At one end of the spectrum the trading of connection point capacity could be implemented under a regimented trading market, with its own regulatory code and market operator. This is certainly not provided for under the current ENAC provisions, and the Office of Energy considers that this is too complex to be a reasonable or necessary course of action at this time.

Alternatively, trading could be on a much simpler bilateral basis, but would need adequate consideration before it could be implemented. Part of this consideration is whether such a trading scheme provides any net benefits over a regulated reallocation of spare capacity by the network service provider. There is potential scope for increased allocative efficiency through a market (formal or informal), however, the Office is concerned about the equity impacts of this on Users of regulated services.

3.2. Implications of Bilateral Trading of Capacity

Trading of contracted connection point capacity is not explicitly provided for in the current access regime and it is understood that it is not allowed for in access contracts. Providing for trading of contracted capacity has a number of implications, including transferring control of spare capacity outside of a regulated environment. It is apparent to the Office of Energy that these implications have not been adequately considered and/or debated.

The Office believes that the establishment of more formal arrangements for bilateral trading of a network capacity is a policy question rather than a regulatory one. The Office does not believe that more formal arrangements for bilateral trading were intended as a policy outcome of Government during the development of the ENAC.

4. Conclusion

The Office has a number of concerns with moving to a bilateral contracted connection capacity trading scheme:

- the pricing signals for generators are relatively weak and so there is not adequate disincentive for Users to withhold capacity;
- despite enquiries, the Office has been unable to determine if the UK bilateral trading model suggested by PB has been successful;
- bilateral trading of capacity rights in the UK only applies to generators trading transmission entry capacity;
- there is no experience with, or systems established to deal with, trading of contracted connection capacity in the SWIN;
- the issues associated with a contracted connection capacity trading scheme for the SWIN do not appear to have been adequately considered and debated; and
- there is not sufficient time to consider, consult on and implement an appropriate contracted connection capacity trading scheme, in advance of the first access period.

5. Recommendations

- The Office of Energy considers that Western Power should be able to reallocate capacity, subject to appropriate conditions.
- The Office of Energy believes the Authority should propose reasonable and appropriate amendments to clause 3.2 of the ETAC, if amendments are necessary to satisfy the requirements of the ENAC.

OFFICE OF ENERGY
12 February 2007