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The benchmark agreement and interconnection rules papers

Invitation for cross-submissions

Report to MEUG

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Preface

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1. Introduction

1.1 Background

The Electricity Commission (the Commission) has invited cross-submissions in response to the submissions received on its two consultation papers:

- Benchmark agreement consultation paper and draft benchmark agreement, 19 May 2006; and
- Interconnection rules consultation paper and draft interconnection rules, 9 June 2006.

The Commission has carried out an initial consideration of the submissions[1] it has received on the two papers and has decided to seek cross-submissions.

1.2 Issues the Commission believes have been well canvassed

In its call for cross-submissions the Commission indicates that it considers that the following issues have been well canvassed in submissions:

- the inclusion of requirements relating to interconnection asset services in the Rules, and that the benchmark agreement cover connection services and interconnection information services;
- the structure of transmission agreements;
- the categories of counterparties that must enter into transmission agreements; and
- the asset availability approach to defining connection services and interconnection asset services.

1.3 Issues the Commission seeks further comment on

The Commission considers that it would benefit most if cross-submissions were to focus on other issues including:

- the types of service measures and levels;
- compensation and liability, in particular whether these should extend to the coverage of indirect costs, the level of any liability caps, and the extent to which the unconditional service guarantee can and should be considered as being feasible at this or a later time;

[1] The submissions on both these papers are accessible through the Commission's webpage http://www.electricitycommission.govt.nz/consultation/xsubsBA/view

- the Commission's proposal for developing an Outage Protocol covering connection and interconnection assets;
- the Commission's proposal that technical disputes under the benchmark agreement be considered by the Rulings Panel; and
- the Commission's proposal for rule changes relating to consistency with the Grid Reliability Standard (GRS), and particularly the issues raised by submitters relating to disputes between connected parties and Transpower regarding the level of reliability provided by connection assets.

1.4 Some additional questions from the Commission

The Commission also indicates that there are some additional questions that it would appreciate feedback in relation to. These are:

- whether, as an alternative to the Commission's current proposal that technical disputes under the benchmark agreement be referred to the Rulings Panel, parties would prefer either of the following options:
  - the status quo as per the existing rules; the Rulings Panel would have no jurisdiction; or
  - provide that the Rulings Panel should be available as the final dispute resolution for both technical and other issues related to the benchmark agreement, but that other dispute resolution options under the benchmark agreement would continue to be available;
- whether counterparties should be given greater decision-making rights in relation to investments in connection asset for reliability purposes; and
- whether customers should be given the opportunity to specify their own Value of Lost Load (VOLL) for use in applying the GRS to connection assets, subject to a reasonableness requirement on the customer's estimate.

In Section 2 we consider the issues the Commission has indicated it particularly wants cross-submissions to focus on. In Section 3 we respond to the additional questions asked by the Commission and in the final section we make some observations on a joint submission relating to the HVDC link made by three generator-retailers with South Island generating assets.

2. Further comments

2.1 Service measures and levels

We note that many of the submitters have devoted very little attention to the service measures and the means by which the service levels will be initially determined. We did consider these issues in relation to both connection and

interconnection services in our paper for MEUG's submission. In summary, the views we submitted were:

- the units of measurement for customer service measure (4) for connection assets, which relates to Transpower consulting with customers in advance of planned outages, is unclear. We suggested that it could possibly be intended to be the number or proportion of instances in which Transpower failed to consult in the prescribed manner;
- it is unfortunate, given how central the economic impacts of outages are to consumers, that the Commission has decided not to introduce measures of how outages in the transmission system affect the cost of delivered electricity for connection and interconnection customers;
- it is unfortunate the Commission has not considered it reasonably practicable to enforce reliability and availability measures for connection and interconnection assets; and
- it is a sensible proposal to set service levels on the basis of the actual level of service over the last five years with recourse to the Rulings Panel if the parties are unable to agree.

Transpower is one submitter that has provided reasonably extensive comments on the service measures and levels. In our opinion most of its comments are without any merit. We would include in this category the following:

- that the customer service measures should not be enforceable and should be for information purposes only;
- that Transpower should be subject to less detailed requirements to provide information than proposed, and should not be required to provide information already available elsewhere;
- that the Commission should adopt definitions that are consistent with those already used by Transpower;
- that the availability and reliability measures for interconnection should not be included in the Rules because they are for information only;
- that there should be no further consideration of market–related measures for connection and interconnection assets; and
- that the Rulings Panel should only settle disputes which arise under the benchmark agreement with the agreement of both Transpower and its customer.

There are, however, a couple of suggestions from Transpower that do have merit. Namely:

- that the requirement it meet the capacity measures should be subject to a force majeure exemption.; and
- the definitions of the measures should be clear.

While we accept a force majeure clause, we think it must be drafted to provide a very narrow exemption for acts of god that are totally unpredictable and uncontrollable and then only to the minimum extent possible. To require Transpower to be responsible for the consequences of such events is not reasonable. On the other hand, the exemption should be narrow in terms of the events that can trigger it so Transpower cannot effectively engineer its own excuses; moreover, the exemption should be limited to the minimum necessary to deal with the event.

Meridian Energy in its submission raises the frequency of reporting against service measures and suggests a six month cycle instead of the one year cycle proposed. Meridian Energy also suggests that the proposed service measures should be viewed as a starting point and that a planned approach to improving them and expanding their scope should be adopted. In our view, both of these suggestions have merit and we support them.

2.2 Compensation and liability

The Commission proposed for connection services and interconnection information services that Transpower and its counterparty should only be liable for the direct costs resulting from them breaching the benchmark agreement. Moreover, it proposed the cap on liability under each benchmark agreement should be $5 million for each event up to a maximum of $20 million per annum. For interconnection services, the Commission proposed the normal rule breach processes would apply and the cap on Transpower's liability would be $2 million per incident and $6 million per annum.

The Commission is interested in receiving cross-submissions on compensation and liability, and, in particular, whether these should extend to the coverage of indirect costs, the level of any liability caps, and the extent to which the unconditional service guarantee can and should be considered as being feasible at this or a later time.

In our paper for MEUG's submission we noted that the Commission's current proposal relating to the benchmark agreement was of very limited practical benefit to Transpower's counterparties. This is because the two important service measures for potential liability – availability and reliability - are not enforceable and it is unlikely that customers could ever establish material direct costs as a result of breaches of the other service measures. We favoured making all the service measures enforceable and the adoption of a universal service guarantee. We argued that the development of such guarantees would not be time consuming and that the amounts per event should be capped at levels significantly below the levels of the current caps.

We have read the numerous submissions on the issue, including those by Transpower. None of them have caused us to change our mind. Indeed, the

concern raised in some submissions that Transpower would pass the costs of any liability back to its customers through charges reflects a concern we share.

The problem with a high liability cap is that it will encourage Transpower to adopt excessively conservative behaviour, to the detriment of consumers. The problem with making consequential costs a liability borne by Transpower is that often it will be the actions, or lack of actions, by Transpower's customers that will dictate the occurrence and level of these losses. Whether a customer has a back-up plant or not will influence the impact of an outage on the customer very greatly. Whether the customer has fuel available for it and has test run it regularly will also be significant for the overall costs incurred. Thus, for efficiency reasons, indirect costs are best managed by customers, and not by Transpower.

We suggest the following arrangement. Transpower be required to provide a universal service guarantee with a modest sum associated with each breach, possibly varied according to the nature of the breach. Counterparties would be entitled in the event of a breach to the bigger of either their direct costs or the universal service guarantee payment. Transpower's price path threshold under Part 4A of the Commerce Act 1986 could be reset so that it will recover an estimate of the total universal service guarantee payments it should make if its performance is satisfactory, other things equal. Because it will be a threshold Transpower would retain any savings it makes and would bear any excess costs it incurs relative to the 'satisfactory' performance level of payments implicit in its threshold.

If this arrangement was adopted, the Transpower Board could allocate the risks and benefits of the scheme to Transpower's maintenance subcontractors and managers and employees so they are appropriately incentivised, but that is a matter for the Transpower Board and not the contract or Rules.

We believe this arrangement is easily organised and introduced and would not be difficult to run.

2.3 Outage Protocol development

The Commission proposes that any reduction in circuit capacity (either from withdrawal of assets or change in configuration) or outage will be subject to an Outage Protocol. The changes covered will include permanent withdrawal of assets or partial withdrawal, and planned outage and unplanned outage of any circuit.

The Commission proposes that for interconnection assets, the grid owner will be required to demonstrate the benefits of any planned reduction in capacity or planned outage exceed the cost to market participants. The

Commission anticipates that the Outage Protocol will not require detailed application of the net benefit assessment for all outages. The analysis will focus on the significant outages.

The Commission further proposes that for connection assets, Transpower will be required to consult counterparties on planned outages. If Transpower and the counterparty agree on the timing and duration of outages, then no further process will be required. If Transpower and the counterparties are unable to agree, then Transpower will have the right to determine timing and duration of the outage, by applying a net benefit test based on minimising the cost to Transpower and the customer. The counterparty will be able to refer any alleged breaches to the Rulings Panel for review of Transpower's decision about costs and benefits.

The Commission proposes for unplanned outages, the Outage Protocol will require Transpower to develop procedures in advance of outages in order to deal with them in a way that minimises costs and maximises benefits.

The Commission proposes that the draft Outage Protocol, including the methodology for the net benefit test will be developed by Transpower. The Commission will then consult interested parties and approve the protocol. The Outage Protocol will become a schedule to Section VII of Part F of the Rules.

The reason the Outage Protocol is included in the Rules and not as a schedule to the benchmark agreement is that it is proposed it will apply to both connection and interconnection assets, and the latter are dealt with in the Rules.

The proposal that if for connection contracts Transpower and the connected party cannot agree then Transpower has the right to proceed without agreement seems somewhat unusual to us. Since the connected counterparty will bear many of the costs of not proceeding why it would be efficient to override its decision is difficult to understand. The justification given that "with approximately 15,000 outages per year, and most of these for connection assets, it could be expensive and difficult to administer"[2] does not seem plausible as there will still be a need to consult with customers about each outage even if Transpower has the final power to decide. It would appear administratively easier for Transpower to accept the customer's decision in these cases, than to consult and then do a cost benefit analysis before disregarding the customer's views.

With the caveats about the need for the Outage Protocol being in the Rules and who should finally decide in the context of a planned outage of a connection asset, we support the Commission's proposals.

[2] *Interconnection rules*, p.62.

2.4 Technical disputes resolved by the Rulings Panel

The Commission proposes that technical disputes under the benchmark agreement will be resolved by the Rulings Panel. Submitters have objected to this proposal on two grounds. That the Rulings Panel may not have the technical expertise necessary to appropriately deal with such disputes and that it will mean that technical disputes will be dealt with by the Rulings Panel and other disputes will be dealt by the Courts. This will lead to confusion, disputes over the right forum and potentially to 'forum shopping' by disputants.

The argument that the Rulings Panel may not have the technical expertise appears to us to have little merit. Over time the members will develop considerable technical knowledge and, any rate, such expertise should be easy to hire by the Panel. We consider the other argument does have merit and as a result we believe that either all disputes should go to the Rulings Panel or none, and that the halfway house is not satisfactory.

Our initial preference is for the Rulings Panel to deal with none, but disputes under the parallel Interconnection Rules will go to the Rulings Panel and so this suggests there is some merit in using the Rulings Panel for all benchmark agreement disputes as well. However, we consider this would be a case of one mistake - dealing with interconnection through the Rules rather than through benchmark agreements - leading to another. So, despite the proposed treatment of disputes about interconnection assets, our preference is for the Rulings Panel to have no role. This will reinforce that a benchmark agreement, or an agreement entered into voluntarily in lieu of one, is a bi-lateral contracts between Transpower and its customer. We see considerable merit in the relationship being of a bi-lateral contractual form. This is a view shared by most submitters.

2.5 Consistency with the GRS

As the rules are currently drafted, there is no requirement on Transpower to propose investments when and where the level of connection assets is inadequate to satisfy the GRS. The Commission proposes that the benchmark agreement require Transpower to propose to a counterparty an investment to meet the GRS within six months of the grid reliability report (GRR) identifying that connection assets are not expected to meet the N-1 security criterion at a grid exit point over the following five years.

Where Transpower and the counterparty are unable to agree on an investment proposal, Transpower will be required to submit the proposal to the Commission as part of the grid upgrade plan (GUP). Where Transpower and the counterparty agree on a higher or lower level of investment than the GRS then they will have to follow the current rules and obtain the approval of the Commission to vary the level of reliability below the GRS, or certify

to the Commission that they have consulted with affected end use customers in relation to a proposed increase in reliability above the GRS, and there are no outstanding issues.

In our paper for MEUG's submission we claimed that the Commission's proposals are a tumble down the slippery slope to the effective implementation of N-1 as the GRS for all grid exit points and the elimination of economic rationality in the investment decision making relating to the transmission grid.

We noted that the GRS is meant to be an economic test; the grid passes it if "the power system is reasonably expected to achieve a level of reliability at or above the level that would be achieved if all economic reliability investments were to be implemented."[3] The N-1 criterion is a backstop safety net for the standard for the core grid alone.

We further argued that the concerns we raised at the time about the inclusion of the N-1 backstop are unfortunately looking increasingly justified. We urged that the Commission should remove the backstop now before it completely undermines rational economic investment decision making in relation to the grid.

We strongly urged the Commission to rethink its proposals in relation to the GRS for connection assets. The timeframe for investment in connection assets to deal with reliability issues is typically not long. We suggested the requirement on Transpower should be to inform the counterparty when it believes the connection assets will not meet the GRS within the next two years. It should be the obligation of the counterparty to either arrange for Transpower, or some other party, to undertake the investment to bring the standard of the connection assets up to the GRS, make alternative arrangements so the GRS is met, or go through the process in the Rules to allow the standard to be lower at the grid exit point. It should be the counterparty's decision as to which of these options it chooses.

We have read the submissions of other parties, including Transpower, on this matter and still believe our considerable concern about this aspect of the Commission's proposal is justified. We are encouraged that two of the Commission's additional questions clearly relate to means of overcoming our concerns and putting customers back into a stronger position to determine the kind of connection assets they should have.

[3] EGR, Part F, Section III, Schedule F3, 4.1.

3. Additional questions

3.1 Role of the Rulings Panel

The first additional question the Commission has asked those making cross-submission to address is:

> *whether, as an alternative to the Commission's current proposal that technical disputes under the benchmark agreement be referred to the Rulings Panel, parties would prefer either of the following options:*
>
> - *the status quo as per the existing rules; the Rulings Panel would have no jurisdiction; or*
> - *provide that the Rulings Panel should be available as the final dispute resolution for both technical and other issues related to the benchmark agreement, but that other dispute resolution options under the benchmark agreement would continue to be available;*

We have already considered this question in Section 2.4 above. On balance, we prefer the status quo as per the existing rules under which the Rulings Panel would have no jurisdiction in relation to the benchmark agreements. Our reason is this will preclude disputes about the forum for settling disputes and reinforce the essential contractual character of the benchmark agreements. We have reached this view after reading the submissions of others about forum confusion, and forum shopping. We noted that interconnection rule disputes will end up at the Rulings Panel but decided that to have benchmark agreements all go to the same body would be to compound the error of the Commission in relation to using rules for interconnection assets. We believe there are considerable advantages in terms of the parties having to deal with one another if the relationship between Transpower and its customers is a bi-lateral contractual relationships.

3.2 Decision making over connection assets

The second additional question the Commission has asked those making cross-submission to address is:

> *whether counterparties should be given greater decision-making rights in relation to investments in connection asset for reliability purposes*

The Commission has spelt out how it thinks could be achieved:

- if Transpower identifies that connection point capacity is likely to fall below the N-1 criterion, Transpower would be required to investigate

whether the connection assets meet the GRS and, if not, develop alternative proposals to enable the connection assets to meet the GRS, and propose these alternatives to the counterparty;

- Transpower and the counterparty be given six months to agree on whether to invest or take come other action; and
- if no agreement is reached within six months:
  - the counterparty could either carry out investment itself, contract with a third party to do so or take some other action subject to complying with the need to have the Commission agree to a lower grid reliability standard and good electricity industry practice;
  - if the counterparty or a third party carries out the investment, Transpower could be required to provide access to its land for the purposes of that investment; and
  - Transpower would be able to dispute under the benchmark agreement whether the designated transmission customers proposal complied with good electricity industry practice

We have considered the essence of this question in Section 2.5 above and effectively endorsed the amended proposal. We think this proposal is a significant development as it will open Transpower up to competition in relation to a major aspect of its current investment activities. The best way to deal with issues that arise from the existence of a monopoly is generally to deal with the root cause, the presence of the monopoly. It is not often easy to do this, but in this case it is and the Commission is to be commended for seizing the opportunity.

3.3 Setting the Value of Lost Load

The third additional question the Commission has asked those making cross-submission to address is:

> *whether customers should be given the opportunity to specify their own Value of Lost Load (VOLL) for use in applying the GRS to connection assets, subject to a reasonableness requirement on the customer's estimate.*

We consider that this proposal is a desirable complement to the proposal that connection customers be given decision-making over the kinds of connection assets that they should have and pay for. We support the proposal, including the additional requirement relating to reasonableness. The Transpower direct connect customer will bear all the costs of its own decisions and is unlikely to mispecify the value of lost load to it. Moreover, a distributor will have pass-through of transmission charges and so is unlikely to understate the value of lost load to avoid capital investment. It may, however, overstate it if its weighted average cost of capital (WACC) is

below what the regulator allows (which is often the case) and it believes it can undertake the additional investment itself, rather than have Transpower do it. For then it will earn and get to retain the above WACC yield on the increased asset base.

4. HVDC joint submission

In our paper for MEUG's submission we queried the decision of the Commission to treat the HVDC link in a like manner to interconnection assets. We suggested this could encourage South Island generators to challenge the Commission's decision when setting the guidelines to Transpower for the transmission pricing methodology to treat the HVDC link like a connection asset jointly held by them. Our concern was not unfounded. Meridian Energy, Trustpower and Contact Energy have made a joint submission pointing out the Commission's inconsistency. They have also noted that there has been much more north to south flow on the grid recently and that this undermines the Commission's rationale for charging South Island generators.

The existence of the joint submission is *prima facie* evidence of an arrangement or understanding between these three competing generator-retailers. The apparent purpose of the joint submission is to fix, maintain or control the price of the HVDC service to the three generators and others, and the three acquire the service of that asset in competition with one another; when the facility is fully utilised, what capacity one uses the others cannot. The joint submission on the HVDC links pricing appears to us, therefore, to be an arrangement that is caught by section 30 of the Commerce Act. If this is found to be the case, the arrangement is deemed to be a breach of section 27 of the same Act.

We note that the balance of north-south use of the HVDC has been unusual this year and that this change is advantageous to one of the arguments put forward by the South Island generators. No coherent explanation of the change in the pattern of flows has been offered. The prospect that the flows are being controlled to advance the arguments of South Island generators should be urgently considered by the Commission. It is believed by some that in the mid 1990s generators controlled flows on the HVDC link with a view to inducing Transpower to agree to contracts which had Transpower accept the rentals as part of its revenue stream for use of this asset. When Transpower accepted this arrangement the flows changed and the rentals and Transpower's revenue from the HVDC declined. The advantages from reversing the Commission's decisions in relation to the HVDC charges are even greater now than the advantages in the mid 1990s from having Transpower accept the rental as part of its income.