Australian Energy Regulator

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Submission to the Australian Energy Regulator's Pricing methodology guidelines: System strength pricing consultation paper

The Australian Energy Council (AEC) welcomes the opportunity to make a submission to the Australian Energy Regulator's (AER) Pricing methodology guidelines: System strength pricing consultation paper (Paper).

The AEC is the industry body representing 20 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the majority of the electricity in Australia, sell gas and electricity to over ten million homes and businesses, and are major investors in renewable energy generation.

The AEC is broadly supportive of the AER's approach and would like to thank the AER for hosting a forum on the Paper.

Section 4.1.1 – Issues in using forecasts beyond the 5-year regulatory determination

4) Should our guidance specify a minimum period for "long-run", and if so, is 10 years reasonable?

The AEC believes that 10 years is an appropriate long-run time period to price and recover the costs of system strength. As noted in the Paper it aligns with AEMO's System Strength report and TNSPs transmission annual planning reports' (TAPR) forecast periods.[1] From a financial perspective it also aligns with the duration of the Commonwealth Government Security (CGS) which is used to determine the risk-free rate when determining the weighted average cost of capital (WACC).

Section 4.2. – Long-run economic cost concepts

The appears to be no explicit question on which approach for estimating the long run costs of system strength services should be applied to determine the system strength unit price (SSUP). The Paper discusses two long-run marginal cost (LRMC) estimation methods (ie, average incremental cost (AIC) and perturbation) which both require significant estimation, forecasting and resources. The Paper also describes a simpler approach namely, long-run average cost (LRAC).

The Paper provides a simplistic example of LRAC estimation.[2] In practice LRAC should be calculated in the same manner as levelised cost of electricity (LCOE). To use the example in the Paper, 300MVA of system strength is provided at a cost of $30 million. The LRAC estimation process would involve:

[1] Paper, pp27-28
[2] Paper, p29.

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- Establishing a discounted cash flow over a 10-year period to recover the cost of the initial capex and any life cycle capex and/or opex;
- discounting the cash flows using a nominal WACC; and
- discounting the quantity of system strength using the real WACC.

This would then produce a levelized cost of system strength which would be SSUP in dollars per MVA/year. Employing this approach would require the SSUP to be indexed by inflation each year.

The AEC considers long run average cost (LRAC) to be the most appropriate way to price system strength. It is simple and straight forward technique and is understood well by the likely purchasers of system strength. In contrast techniques that involve estimating LRMC require many assumptions/forecasts and the estimates are less transparent. The other benefits of using LRAC to determine the SSUP are:

- sharper pricing for generators who consume system strength, thus sending a better technological and locational investment signals;
- stronger financial recognition of generators that provide system strength; and
- allocating more system strength costs to causers of strength declines rather than load so fewer residual costs have to be recovered from transmission customers.

Section 5.1.3 – Should there be consistency in the permitted long-run pricing methodology?

14) Should the AER permit SSSPs to choose between different long-run pricing methodologies?

The AEC is of the view that SSSPs should not be allowed to use different long-run pricing methodologies and that LRAC is the most appropriate method.

Section 5.2 – Annual indexation

16) Should the system strength unit price be indexed? If so, what method should be used for indexation?

As noted earlier our suggested LRAC approach for estimating the SSUP would require indexation as it is a nominal approach. The AEC considers the AER's method of indexing the MAR would most likely provide the greatest consistency.

Section 7.2 – Relevant differences between AEMO and other SSSPs

22) Are there any areas where our guideline should treat AEMO differently to other SSSPs because of any of differences between how AEMO is regulated and how other SSSPs are regulated?

The AEC believes that all its recommendations in this submission for SSSPs should apply to AEMO. The AEC does not consider the differences between AEMO and other SSSPs to require the former to be treated any differently to other SSSPs.

Inter-regional issues

Where system strength nodes may be impacted by investments in neighbouring regions, the obligation should be jointly shared between the relevant SSS Providers rather than relying on

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joint planning to ensure costs are appropriately attributed to the parties consuming system strength.

Conclusion

In summary the key points of this submission are:

- The long-run is 10 years;
- LRAC to determine the SSUP;
- The same guidelines apply to AEMO as SSSP provider in Victoria; and
- Inter-regional issues need to be considered.

Any questions about our submission should be addressed to Peter Brook, by email to peter.brook@energycouncil.com.au by telephone on (03) 9205 3103.

Yours sincerely,

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