ATTACHMENT 1: WESTERN POWER'S DETAILED RESPONSE TO REQUIRED AMENDMENT 34

Western Power's detailed response to Required Amendment 34

1. Introduction and Overview

The Authority's Required Amendment 34 sets out a number of revisions to Western Power's proposed Service Standard Adjustment Mechanism (SSAM) in sections 5.24A and B of the Access Arrangement. With the exception of the Authority's requirement that Western Power's financial exposure under the SSAM should be entirely uncapped, the SSAM specified in the Required Amendment is acceptable to Western Power.

This attachment explains Western Power's reasons for not accepting an entirely uncapped SSAM, and instead proposes that annual penalties and bonuses relating to System Minutes Interrupted for the meshed and radial transmission networks should be capped at a total of 1% of transmission revenue for each year. In particular, Western Power notes that:

- Western Power's financial exposure from an uncapped SSAM is unacceptably high;
- Legal advice indicates that the exclusion for force majeure events is unlikely to provide adequate protection against this financial exposure;
- Our insurers have indicated that insuring against this financial exposure can only be achieved through non-traditional markets and that premiums will be significant;
- Contrary to the Code objective, an uncapped scheme will provide an incentive to undertake economically inefficient investment in order to minimise the impact of highly improbable events; and
- The regulatory precedent provided by the Australian Energy Regulator's service performance incentive scheme indicates that a capped scheme is consistent with the Code objective.

2. Western Power's comments on Required Amendment 34

In its access arrangement revisions and in its second submission in response to the Draft Decision, Western Power proposed that:

- For the SSAM that will apply to the transmission network, the dead-bands would be removed, and the limits would be retained, which have the effect of limiting the total revenue at risk at approximately one per cent of target revenue. Western Power noted that this is consistent with the service target performance incentive scheme (STPIS) applied by the AER to transmission businesses.
- For the SSAM that will apply to the distribution network, the dead-bands and limits would be removed, but the total revenue at risk would be capped at one per cent of target revenue. Western Power noted that this is consistent with the STPIS applied by the AER to distribution businesses.

The Authority's reasoning in relation to the capping of Western Power's financial exposure under the SSAM is set out in paragraphs 1150 and 1151 of the Final Decision as follows:

> "Under the proposed access arrangement revisions, all of the measures of services standards for the transmission and distribution networks exclude force majeure events, which the Authority considers would include extreme weather events. For this reason, the Authority considers that the inclusion of limits on the values of service standards that may attract penalties and rewards under the service standard adjustment mechanisms are not a necessary protection for Western Power.
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> On the matter of a cap on the total amounts of revenue at risk under the service standard adjustment mechanisms, the Authority also considers that a cap is not consistent with the Code objective in circumstances where Western Power is protected from the effects of extreme events by exclusions from the measures of service standards, as is the case under the proposed access arrangement revisions. Moreover, the incentive rates under the service standard adjustment mechanism that will apply for the second access arrangement period are relatively low, and the risk to Western Power of penalties in excess of one per cent of revenue is small – requiring all service standards to depart from the benchmarks by considerable margins (in the order of 20 per cent)."

Following the publication of the Final Decision, Western Power has undertaken further analysis of its exposure under the SSAM specified in Required Amendment 34. Before turning to this analysis Western Power notes (in response to the comments contained in paragraph 1151) that:

- The provision of a cap on Western Power's financial exposure under the SSAM would be harmless even if one accepts the Authority's views that Western Power is protected from the effects of extreme events by force majeure provisions, and Western Power's exposure under the SSAM is limited by virtue of the incentive rates that apply.

- Under the Authority's view of Western Power's exposure (noted immediately above) it does not seem logical that the provision of a cap on Western Power's exposure would be contrary to the Code objective. Specifically, the Authority's view implies that the proposed cap would not affect the operation of the SSAM, which in turn implies that the inclusion of a cap could not be inconsistent with the Code.

In fact, contrary to the Authority's view Western Power's further analysis indicates that the potential loss of revenue due to transmission outages is a serious financial risk to the company.

It is acknowledged that the definition of transmission service standards makes provision for exclusions of highly unusual events (say, 1-in-20 year events) via the operation of "force majeure" provisions. Western Power is concerned, however, that the definition of force majeure is very subjective, and therefore is open to differing interpretations when applied to particular events.

The operation of transmission systems is highly complex, and occasionally, major transmission system malfunctions can arise from highly unusual events which are not predictable. In rare circumstances, a simple localised fault event can unexpectedly cascade into a major system event. For example, a recent event in the US resulted in 50 million customers being without supply for many hours, following a chain of events initiated by a transmission line fault caused by an overgrown tree. Under normal circumstances the initiating event would most likely cause a fault but no customer interruptions, however in this particular case, the resulting cascade failure led to very widespread supply interruptions.

Similarly, a major transmission outage occurred on the SWIS in 1994 as a result of the occurrence of widespread heavy fog following a long dry period. The outage affected the 330 kV lines supplying Perth, and it resulted in an almost complete blackout of the SWIS for approximately 220 minutes. Applying the incentive rate under the proposed SSAM for System Minutes Interrupted of $75,000 per 0.1 of System Minutes Interrupted, the penalty for this single event would have been approximately $165 million. For comparative purposes, it is noted that Western Power's net profit after tax for 2008/09 was $126.2 million.

By any measure, Western Power's potential financial exposure would be extreme.

In the circumstances, it is debatable (particularly with "the benefit of hindsight") as to whether this event would have been classified as a force majeure event under the SSAM.

Western Power has sought legal advice in relation to this matter. That advice[10] suggests that Western Power faces an unacceptably high level of financial risk, given the uncertainty regarding the operation of the force majeure provisions under the SSAM. In particular, the legal advice is that:

- The scope of what is a 'force majeure' event or an 'extreme event' is unclear.
- There may be circumstances where an event seemingly beyond the control of Western Power is nonetheless questioned as to whether it is an event of force majeure, for example, where overhanging trees form part of a complex matrix of circumstances causative of a system interruption.
- Exposure to potentially unlimited liability is likely to raise serious implications for obtaining adequate insurance coverage.

This legal advice is consistent with the rules and practices applying in the Australian National Electricity Market. In this regard, it is particularly noteworthy that the transmission determinations which have been completed by the AER since the introduction of its STPIS have all included a total cap on revenue at risk of 1%, divided up amongst the various service components, which included collars and caps without dead-bands. These constraints on financial outcomes apply even though an exclusion regime applies to remove the impact of extreme events. The revenue at risk for loss of supply events (frequency and duration) in each of the AER's determinations are as follows:

[10] A copy of the advice will be provided to the Authority under separate cover.

AER Determination	Revenue at risk for loss of supply events
TransGrid Transmission Determination 2009–10 to 2013–14	0.55%
ElectraNet Transmission Determination 2008–09 to 2012–13	0.5%
Transend Transmission Determination 2009–10 to 2013–14	0.55%

The purpose of the SSAM (and similarly, the AER's STPIS) is to provide incentives to the network business to meet or exceed the service standard benchmarks. The incentive rates proposed for Western Power's SSAM (which have been accepted by the Authority) provide a tangible financial incentive to the company to achieve the service standard benchmarks. Moreover, under Required Amendment 33 (which Western Power proposes to accept) the gain sharing mechanism will deem any positive above-benchmark surplus to be zero in a year that Western Power fails to meet service standard benchmarks for that year. This feature of the gain sharing mechanism has the effect of strengthening the incentives for Western Power to achieve the service standard benchmarks.

Given these considerations, and having regard to the nature of the extreme events which could result in Western Power facing an extreme financial exposure under the SSAM, no economic purpose is served by exposing Western Power to uncapped liabilities for network performance. Indeed, in light of the uncertainty regarding the operation of force majeure relief, exposing the company to an uncapped financial liability under the SSAM may ultimately lead to inefficient outcomes. For instance, in order to mitigate the financial risks it faces:

- Western Power may be incentivised to undertake additional investment that is unduly focused on minimising the impact of highly improbable events (such as the fog that led to widespread outages in 1994). Such an outcome would lead to customers bearing costs in excess of efficient levels, and this would be inconsistent with the Code objective. Such investment would not be so strongly incentivised if Western Power's financial liability were capped at an appropriate level.

- Western Power would seek to insure against the risk. Preliminary discussions with our insurance advisers indicate that non-traditional insurance would need to be utilised and would be subject to a full actuarial review prior to any undertaking to provide cover. Initial advice is that the first $15M would need to be self insured, and the external premium for insurance cover up to $200M would be in the order of $8M annually.

In this context, it is important to note that Western Power's submissions in response to the Draft Decision, including the forecast expenditures as approved by the Authority in the Final Decision, are based on an assumption that transmission revenue at risk would be capped at 1%. If Western Power's exposure under the SSAM were to be uncapped, then there would be a reasonable case for re-visiting (and increasing) the capital expenditure and operating expenditure forecasts for the forthcoming access arrangement period, to ensure that Western Power is provided with adequate expenditure allowances to meet the costs of mitigating the associated risk.

In light of the additional information set out above, Western Power believes there is a very strong case for the Authority to re-consider its position in relation to the capping of liability under the SSAM, and to adopt an approach to capping Western Power's exposure which is more consistent with the approach applied by the AER. As demonstrated above:

- The SSAM proposed by Western Power provides effective incentives for the company to achieve its service standard benchmarks. Western Power's proposed SSAM (which caps the company's financial exposure) is therefore consistent with the Code objective.

- An uncapped SSAM may well deliver higher-cost outcomes that are inconsistent with the Code objective.

3. Western Power's proposed approach for addressing the Required Amendment

Given the information set out above, and having regard also to the Authority's preference for Western Power's exposure under the SSAM to be uncapped, Western Power proposes that the SSAM should specify a cap only on the System Minutes Interrupted (meshed and radial) indicator, and that this cap should be set at +/-1.0% of transmission revenue.

This proposal would leave Western Power's financial exposure uncapped under the remaining performance measures within the SSAM – in accordance with the Authority's preference – whilst capping at a reasonable level Western Power's exposure to potentially extreme outcomes under the System Minutes Interrupted measure.

Western Power's proposal not only provides a SSAM that is more consistent with regulatory precedent and good regulatory practice elsewhere in Australia; it also demonstrably meets the Code objective.