18 August 2022

Anna Collyer
Chair
Australian Energy Market Commission
Level 15,
60 Castlereagh Street
SYDNEY NSW 2000

Lodgement: online

Dear Ms Collyer,

Recovering the cost of AEMO's participant fees: Directions paper

Energy Networks Australia (ENA) appreciates the opportunity to respond to the Australian Energy Market Commission's (AEMC's) directions paper on the Recovering the cost of Australian Energy Market Operator's (AEMO's) participant fees rule change.

ENA is the national industry body representing Australia's electricity transmission and distribution and gas distribution networks. Our members provide more than 16 million electricity and gas connections to almost every home and business across Australia.

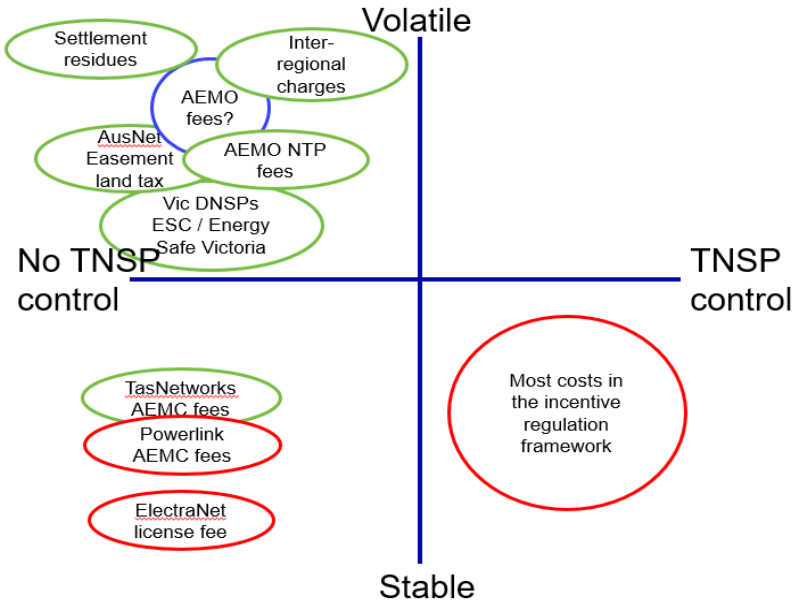
Our submission is set out in the Appendix to this letter. It responds to the questions set out in the AEMC's directions paper and provides more background and context for the proposed rule change. A number of important issues should be recognised in the further consideration of this rule change:

- The power system is undergoing major transformation to allow for two-way energy transfer in an increasingly complex de-centralised environment, which has increased the complexity and costs of network operational management for both AEMO and Transmission Network Service Providers (TNSPs). A component of AEMO's costs is being allocated to TNSPs for the first time, while clearly TNSPs are not the driver of AEMO's increasing costs.
- AEMO's costs and fee allocations have very different characteristics to normal operating costs. They are very difficult to forecast and, where regulatory periods do not align to the five-year fee setting process, forecasts may not even be available for several years of a regulatory control period. This creates significant new cost recovery risks for TNSPs that would flow through into adverse price and service outcomes for customers in the absence of the proposed rule.
- There is very limited practical scope for TNSPs to influence AEMO's costs, either in their work together or through stakeholder engagement forums related to AEMO's budgets and fees. TNSP functions are tightly defined in the Rules and relevant instruments, leaving little discretion over the activities performed or ability to impact on or transfer costs to AEMO.
- The structure of the AEMO participant fee recovery process under the Rules was not designed with incentive regulation in mind and is not a fit-for-purpose framework to hold

TNSPs to account for AEMO's costs. Requiring TNSPs to bear these costs in their allowances could create perverse incentives (for example to shift the transmission costs to other participants) for no benefit to customers.

- Absent the proposed rule, TNSPs outside a current revenue determination process would be unable to recover the costs of AEMO's participant fees under current pass-through arrangements. This would deny TNSPs the ability to recover their efficient costs, contrary to the revenue and pricing principles.
- Recovering AEMO's fee allocation through an ex-ante allowance would provide little or no incentive for TNSPs to control costs that are largely outside their control, but rather introduce the certainty of large windfall gains or losses to TNSPs and consumers, contrary to the intent of the incentive regime.

Full pass-through of costs that are non-controllable, material, volatile and difficult to forecast is good regulatory practice and is consistently applied to other TNSP costs of a similar nature, such as the state easement land tax recovered by AusNet. The chart below shows a range of fees that are recovered by TNSPs, with those circled in red being recovered through ex-ante incentive regulation and those circled in green being recovered through some form of full pass-through or true-up process.



Any questions on our submission should be directed to Dominic Adams, General Manager - Networks, at dadams@energynetworks.com.au.

Yours sincerely,

Andrew Dillon
Chief Executive Officer

APPENDIX – DETAILED SUBMISSION TO THE DIRECTIONS PAPER

TNSPs are operating in a power system that is undergoing major transformation

As the power system undergoes major transformation, with large-scale synchronous generation displaced by both large-scale and distributed inverter-based generation, the complexity of system planning and operation increases dramatically for TNSPs and AEMO.

This in turn is driving significant and increasing costs to AEMO which must ultimately be recovered from consumers. While TNSPs are not the cause of these costs, the market transformation is creating an increasingly complex power system, requiring greater effort and interaction between AEMO and TNSPs, which has driven increased costs in both AEMO and TNSPs.

This changing environment provides the context for AEMO's most recent fee allocation process, which for the first time since the inception of the NEM, determined that TNSPs should receive an allocation of its core fees (set at a 17.5% share). It also explains the widespread and understandable stakeholder concerns over increased costs and the transparency of the AEMO budgeting process.

The introduction of participant fee allocations for TNSPs creates a step change risk for TNSPs and customers, should a direct pass-through mechanism not be allowed. Generators and retailers face little to no barriers to passing on increasing AEMO costs to customers. Generators can pass on cost changes in their market bids freely and retailers can pass on cost changes in annual repricing cycles. Conversely, TNSPs operate under regulated revenue caps and are subject to cost allowances over five-year regulatory periods and must offset any cost increases through savings elsewhere, impacting service levels.

AEMO's costs and fee allocation process create significant risks for TNSPs and customers under ordinary cost recovery processes

AEMO determines the allocation of participant fees every five years. The current fee determination allocated a 17.5% share of NEM core fees to TNSPs from 1 July 2023.[1] TNSPs will pay their share of fees on a pro-rata basis reflecting energy consumed in their region. While the fee determination commenced on 1 July 2021, the commencement of allocations to TNSPs was delayed by two years to "provide sufficient time for TNSPs to seek the necessary transitional arrangements to be put in place for all TNSPs to recover the fees."[2] This was the intent of the present rule change.

While TNSPs will collectively pay a fixed share of NEM fees, actual fees (from which the 17.5% is apportioned) will vary:

- each year as AEMO undertakes its annual budgeting and fee setting process, and
- every five years as AEMO resets the allocation of fees across participant classes.

Recent history has shown AEMO's fees can escalate rapidly and with little warning. This is

[1] See AEMO, Electricity Fee Structures: Final report and determination, March 2021.
[2] Ibid at p.17.

likely to become more commonplace as the power system continues to undergo major transformation, which is outside the control of TNSPs. A reallocation of fees could also create a step-change in actual fees for a TNSP. This could be either a step change increase or a step change decrease. Many of the drivers of increasing cost and the allocation of fees based on the 'involvement' of participants are also outside AEMO's control. These drivers include government and rule maker decisions and managing the ongoing risks to security and reliability driven by a rapidly transforming power system. The sources of uncertainty on TNSPs' share of AEMO participant fees are not just outside of the TNSP's control.

Table 1 shows NEM revenue requirements and fees for the 2021-22 and 2022-23 financial years.[3] NEM fees will grow almost 90 per cent between the 2021-22 and 2022-23 financial years, with no ability to foresee the fees that will apply from 1 July 2023 when the allocation of NEM fees to TNSPs begins.

Table 1 – NEM revenue requirements and fees

	Budget 2021-22	Budget 2022-23	Variance	Variance
NEM Revenue Requirement ($m)	103.5	195.8	92.3	89.2%
Consumption (GWh)	175,365	176,022	656	0.4%
NEM Fee by Participant type				
Market Customer Fee ($/MWh)	0.4000	0.7540	0.3540	88.5%
Wholesale Participants Revenue Requirement ($m)	33.3	63.0	29.7	89.2%
NEM Benchmark Fee* ($/MWh)	0.5901	1.1122	0.5221	88.5%

This uncertainty makes forecasting AEMO's participant fees for the purposes of setting allowances over a 5-6 year period particularly difficult. The factors above make it impossible for AEMO to accurately forecast and publish its expected costs over this period. Even if it could, this would still not eliminate the risk of a step change in the fee allocations on a five yearly cycle.

In light of the difficulty in forecasting AEMO fees, it is quite likely that AEMO's actual costs for TNSPs could be many tens of millions higher or lower than expected. Consider these scenarios:

- *AEMO's costs increase rapidly and are between $100 and $150 million higher than forecast for the last three years of a TNSP's regulatory period.* The TNSP will pay its share of the 17.5% of increased costs, and assuming it is one of the larger TNSPs, this would create an under-recovery of opex by around $5 to $7.5 million per annum. This would be below the cost pass-through materiality threshold of 1% of MAR and would be worn by the TNSP. It would however be over 3% of opex for the TNSP and would impact headcount and function at a time when resources are strained and technical challenges

[3] AEMO, 2022-23 AEMO Budget and Fees.

are increasing.

- *AEMO's costs remain stable, and the allocation to TNSPs reduces to 10% only one or two years into a TNSP's regulatory period.* In this case the forecast will be significantly higher than actual for the last three or four years of its regulatory period. Based on AEMO's 2022/23 allocation of NEM fees, this would be around $4.5 million per year for one of the larger TNSPs, again below the cost pass-through materiality threshold. The TNSP would keep the over-recovery at the detriment of customers, who would also pay these costs through other participants' fee allocations.

Each of these scenarios results in adverse outcomes for customers. In the first instance, the result is a potential reduction in the capacity of TNSPs to deliver reliable networks and new infrastructure in a timely fashion, with significant flow-on impacts for the energy system transition. In the second instance the result is customers paying more than efficient costs. In both cases there is no ability for the TNSP to control or influence the costs it is bearing.

TNSPs all have different five-year regulatory control periods. For individual TNSPs, impacts could vary significantly, with winners and losers dependent on when AEMO fee increases / fee structure reallocations occur in relation to regulatory control periods for each business.

The critical point is that the allocation of costs to participants that have no capacity to effectively manage or control those costs creates new risks for customers, where a clean pass-through of those costs and risks, such as occurs with generators and retailers, would be more efficient and transparent in the long-term. It is the lack of controllability and predictability that make these costs fundamentally different to other operating costs, including most other "fees" such as vehicle registration fees.

While these uncertainties present ongoing challenges, there are also very real challenges for TNSPs now as fees will begin on 1 July 2023. Ausnet included AEMO's fees in its opex forecast, but already is on track for actual costs to exceed forecasts over $3 million (over the 5-year period) as AEMO's actual costs and NEM fees increased significantly in just 12 months. This forecast to actuals gap is likely to worsen with each year's update of AEMO's actual costs. This is an important litmus test because the timing around setting Ausnet's opex forecast was aligned to the start of the AEMO's fee setting process, yet by year one of the period these forecasts are already materially wrong.

Other TNSPs face trying to incorporate even more uncertain fee forecasts or do not have the fees built into their opex forecast at all. These TNSPs will wear these costs unless they can be passed through. The allocation of fees has occurred under existing rules, so a pass-through application as a change of regulatory obligation or requirement event, suggested by the AEMC in the directions paper, is unlikely to be available. If it were not rejected, the AER is likely to consider the 'change event' occurred in March 2021 when AEMO published the final determination on participant fees, in which case the 90 business day timeframe for TNSPs to submit a cost pass-through application has lapsed.[4]

Further, even if the existing pass-through provisions were available, actual fees or variances may be below the 1% cost pass-through materiality threshold in each given year, and the cumulative effect of five years (for a regulatory period) of unexpected costs could have a significant effect on TNSPs' ability to operate their networks. The impacts would be exacerbated if fees were above the threshold in any year(s) but the AER rejected cost pass-

[4] For example see AER, ElectraNet 2022/23 Inertia Shortfall Cost Pass Through, Decision, June 2022, pp. 6-7.

through applications under the existing rules. This situation would not provide TNSPs with a reasonable opportunity to recover at least the efficient costs they incur, and would therefore be inconsistent with the revenue and pricing principles in the National Electricity Law.

The design of the incentive regime underpinning the regulatory requires TNSPs to absorb manageable cost variations and allows significant unforeseen and externally imposed costs to be passed through. However, as noted above, the level of risk TNSPs face has increased as the power system is rapidly transforming and severe weather events become more commonplace. The allocation of AEMO's participant fees to TNSPs and the recovery of these through ex-ante incentive-based regulation would introduce new risks that are unlike other risks and costs faced by TNSPs. They are subject to step changes and cost drivers that render them unforecastable and as such cannot be accommodated under the current arrangements. This would compromise the risk and reward balance in regulatory frameworks that has underpinned the successful story of continued efficient investment in network infrastructure in the NEM.

Limited practical scope for TNSPs to further reduce AEMO's costs

TNSPs work together with AEMO on a range of critical functions that support the secure and reliable operation of the NEM. While TNSPs and AEMO interact across a broad range of areas and functions, the principal areas of close interaction are in network planning and operations.

Examples of network planning interactions include joint planning activities, the development of protection schemes, planning related to the provision of system security services, collaboration on demand and connection point forecasting. Examples of operations interactions include those related to the operation and maintenance of the network and implications for market operation, as well as engagements that support the secure operation of the market such as load shedding and system restart services.

The functions across planning and operations are implemented and operationalised through committees such as the joint planning committee and the NEM operations committee. TNSPs and AEMO also have regular bilateral engagements across planning and operations functions. These regular interactions allow a space to discuss and agree approaches to manage functions efficiently across all parties and reduce total system costs.

There is very little practical scope for TNSPs to influence AEMO's costs because:

- There is limited duplication of effort between TNSPs and AEMO. The planning and operations committees tend to effectively identify duplications and address them. For example, AEMO is reviewing the need for it to conduct connection point forecasting and may instead rely on TNSP connection point forecasts to avoid duplication.
- There is no scope for TNSPs to transfer functions and tasks to AEMO to reduce their costs. The rules and guidelines allocate planning and operations functions and obligations relatively clearly. Where they are not allocated clearly, or where there is some discretion, TNSPs and AEMO agree the detail of roles and responsibilities within the committee structure or bilaterally. For example, responsibilities across operations functions are set out in delegations for each TNSP on AEMO's website.[5]
- AEMO is unlikely to accept any attempt to transfer functions or reduce the quality of engagement with it. AEMO is at the centre of a once in a lifetime transformation of the

[5] See https://aemo.com.au/en/energy-systems/electricity/national-electricity-market-nem/system-operations/power-system-operation/schedules-for-delegations.

energy system and is kept busy enough with this work. Any attempt to transfer functions to AEMO or reduce the quality of engagement would be called out and resisted within the committee and bilateral engagement processes. By way of example, AEMO's 2022-23 budget doubled from the previous year as a result of a historical under-recovery, for which it has come under scrutiny. AEMO has stated that this would in effect prevent it from voluntarily taking on more responsibilities and accepting a transfer of functions.

Given the above, there is very limited scope for TNSPs to reduce AEMO's costs in a practical or material way. The AEMC has also acknowledged that TNSPs have a limited ability to control costs incurred by AEMO.[6] Investments made in improving processes or information quality could free some time for AEMO staff and potentially also TNSP staff. Such investments however are unlikely to result in a material reduction of total costs. Any such efficiencies are likely to be quite marginal when compared with the total AEMO costs currently attributed to TNSPs in participant fees, which, if TNSPs were allocated fees in 2022-23, would be over $30 million.

The other potential area in which TNSPs could influence AEMO's costs is by exerting pressure on AEMO generally and in appropriate forums. This potential gain has been largely overstated in submissions to the consultation paper. TNSPs already engage actively and collaboratively with AEMO on its costs and work program. TNSPs' engagement on AEMO's costs and fees is driven firstly by a desire to reduce the TNSP component of consumer bills and secondly to build social license for the broader energy industry and its transition. This is likely also the principal driver for retailer and generator engagement with AEMO on its costs and fees. There is nothing to suggest that TNSPs would gain greater influence over AEMO's costs and fees than other participants simply because the fees were subject to ex-ante incentive regulation rather than a direct pass-through mechanism.

ENA has multiple representatives on AEMO's Reform Delivery Committee (RDC) and on the Financial Consultation Committee (FCC). These forums work with industry and consumer groups on the timing and coordination of reform implementation and on AEMO's budget and fees processes. There is no evidence to suggest that ENA and its representatives are not engaged sufficiently in these processes nor that there would be an uplift in engagement if the rule change does not proceed as proposed. Furthermore, the RDC and FCC are both consultative committees, with AEMO holding ultimate decision-making authority. It is difficult to see how an uplift in TNSP engagement could result in a reduction in AEMO's costs beyond any counterfactual situation.

Recovery of AEMO participant fee costs through an ex-ante allowance does not provide incentives for TNSPs to influence AEMO's costs

Incentive based regulation, through setting ex-ante expenditure allowances, provides strong incentives for TNSPs to manage costs that are within their control. However, in this case, AEMO's costs are so far outside of TNSPs' control that applying this framework will not incentivise TNSPs to expend extra effort to change AEMO's costs over and above existing engagement. Indeed, it could perversely incentivise TNSPs to focus efforts on reducing the network allocation, which provides no benefit to end consumers. These points are expanded upon below.

[6] AEMC, Response to objection to use of expedited process for Recovering AEMO participant fees rule change request, 22 May 2022, p. 3.

Firstly, for the reasons described above, there are very few practical opportunities for cost reductions in the work that is conducted between AEMO and TNSPs. Indeed, the vast bulk of cost increases is occurring in areas that are fundamentally driven by large-scale renewable connections. This work would continue on a trajectory that TNSPs are unable to influence, with AEMO's costs following the needs of the system at the time.

Secondly, TNSPs are unable to significantly further influence AEMO's total cost envelope through additional engagement in relevant forums and committees. TNSPs already engage actively in these forums, and AEMO retains ultimate decision-making authority on matters relating to its budget and fees and accordingly it is unlikely that additional TNSP effort would yield a material reduction in AEMO costs.

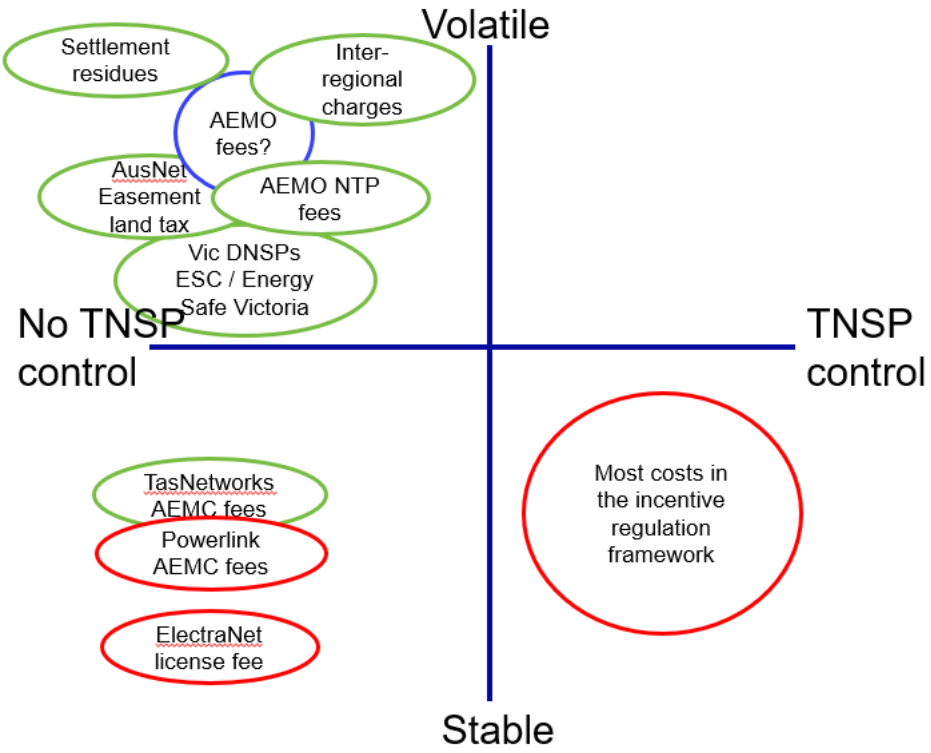
Incentive based regulation through setting an ex-ante opex allowance is not an appropriate tool because TNSPs cannot influence AEMO's costs in any practical and material way. It would transfer risk to TNSPs who are in no position to manage the risks. An under-recovery would put a TNSP's operations at risk at a time when efficient investment and operation is critical, while an over-recovery would lead to customers paying more than efficient costs – both scenarios are detrimental to the long-term interests of consumers and contrary to the intent of incentive regulation.

The structure of the AEMO participant fee recovery process under the Rules was not designed with incentive regulation in mind and is not a fit-for purpose framework to hold TNSPs to account for AEMO's costs.

As such, a cost pass-through for AEMO fees in each TNSP's transmission prices for a given financial year is the fairest and most efficient and transparent mechanism by which to recover AEMO's participant fees allocated to TNSPs. This is considered best regulatory practice and is applied non-controversially to similar large and difficult to forecast non-controllable TNSP costs including settlement residues, Victoria's easement land tax and many other regulator fees.

Figure 1 shows a range of fees that are recovered by TNSPs, with those circled in red being recovered through ex-ante incentive regulation and those circled in green being recovered through some form of full pass-through or true-up process that essentially keeps the TNSP whole over time.

Figure 1 – cost recovery for a range of TNSPs' costs of a similar nature to AEMO participant fees



In some cases the cost recovery pathway for some of these costs has been imposed by government. However, the consistent design principle underpinning incentive regulation is that large, volatile and unpredictable costs that are outside the ability of the TNSP to control should be passed through in full. This is also consistent with the well-established principle that costs and risks should be borne by the party best placed to manage them. Allocating costs to a party in the supply chain that is not able to manage or control them only creates new risks that are passed through to the consumer in the form of higher costs, lower quality services, or both.

Were the rule change not to be made, this would leave the AEMO participant fees as an outlier under current arrangements as a large, volatile and externally imposed cost that cannot be controlled by TNSPs.

A clean pass-through of these costs to customers in a manner consistent with the approach taken to AEMO's national transmission planner fees would minimise the risk of adverse outcomes for customers and would also be more administratively efficient.

Similar commentary also appears in the AER's determination of jurisdictional schemes for some DNSPs. Declaration as a jurisdictional scheme allows the DNSP to recover both the scheme's costs and any under/over cost recovery through the annual pricing review, rather than seeking an allowance for the scheme's costs at each regulatory determination. The AER's approval of CitiPower, Powercor and United Energy's request to recover Energy Safe Victoria costs as a jurisdictional scheme states that this form of cost recovery "reduces the steps a DNSP needs to undergo to recover the actual costs associated with the jurisdictional scheme obligations".[7]

Administrative efficiency is also noted in the proposed rule change from NICE, which is

[7] See AER, Determination – request for the ESV Levy Scheme to be determined a jurisdictional scheme, March 2021.

discussed in the section below.

Alternative cost recovery paths

ENA agrees with NICE that if the AEMC determines that it should make the proposed rule change it should also consider the administrative burden and ease of implementation. Taking these factors into account ENA supports considering the option of amending clause 2.11 of the NER to prohibit the recovery of costs from NSPs. This would allow the direct recovery of costs from customers through market participants, rather than incurring the administrative costs of direct pass-through arrangements for NSPs.

CNSP transfer payments to TNSPs

As set out in ENA's submission to the consultation paper, we support amendments to allow for the required transfer of payments between CNSPs and TNSPs. This is currently required to support arrangements in Victoria where AusNet is charged the market Participant fees and then seek revenue from AEMO, who is the CNSP. AEMO in its Victorian transmission role publishes the transmission charges in Victoria and recovers the revenue. The portion of AEMO's revenue that recovers these participant fees then goes back to AusNet, which has the regulatory obligation to pay AEMO in their market operator role.

Similar issues may arise as new TNSPs enter through contestable transmission investment frameworks in some jurisdictions. ENA considers arrangements should be flexible enough to manage the variety of circumstances that could arise in the future.

Amendment of unders and overs definitions in the NER

ENA reiterates the position set out in our submission to the consultation paper that it is important that the rules amend the under and overs definitions to allow adjustments to the TNSPs' regulated revenues to occur correctly. Without this change, any recovery of AEMO participant fees (including NTP fees) would contribute towards an over-recovery on the part of the TNSP, which triggers an unintended downward adjustment to the TNSPs' future revenue requirements.

This amendment is required to make the arrangements for NTP fees work as intended, regardless of whether or not the AEMC makes the proposed rule regarding the approach to cost recovery for other AEMO participant fees.