

19 September 2013

Richard Khoe
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Richard,

Draft Determination: Recovery of Network Support Payments Rule Change

SP AusNet welcomes the opportunity to make this submission in response to the AEMC's Draft Determination on the Recovery of Network Support Payments Rule Change Proposal.

SP AusNet proposed this Rule Change to align the incentives for NSPs to adopt non-network solutions by addressing the ability of NSPs to recover network support payments. SP AusNet is disappointed that the AEMC has determined not to make a proposed rule. Of particular concern is the apparent lack of consideration given to the specific arrangements facing Victorian DNSPs and the barriers these businesses face in recovering network support payments to defer transmission connection asset augmentation.

SP AusNet favours non-network solutions where they would efficiently defer asset augmentation and provide value for consumers. SP AusNet has always strongly supported incentive-based regulation, and considers that, where the incentives are appropriate, strong incentive-based regulation contributes to the achievement of the National Electricity Objective (NEO). However, for the benefits of incentive-based regulation to be realised, the regulatory framework must provide the correct incentives for businesses to adopt the most efficient solution, whether it is network or non-network. Despite the AEMC's views to the contrary, the National Electricity Rules (NER) as currently drafted fall short in this regard.

This problem is particularly acute for network support arrangements entered into to defer augmentation of transmission connection assets in Victoria. As set out in the attachment, Victorian DNSPs currently face negative incentives to enter into network support agreements of this nature.

SP AusNet recognises the AEMC's reluctance to broaden the coverage of cost pass throughs on the basis that these weaken incentive-based regulation. On this basis, SP AusNet proposes a targeted, more preferable Rule that specifically addresses the distorted incentives in Victoria, for the AEMC's consideration. It is SP AusNet's view that the more preferable Rule, if made, will minimise the problems experienced by the Victorian DNSPs, while addressing some of the AEMC's original concerns with the initial Rule Change proposal.



The Victorian distribution businesses support the more preferable Rule proposed by SP AusNet in this submission.

If you have further questions regarding the information provided, or would like to request further information to help assess this Rule Change proposal, please contact Charlotte Coster, Regulatory Economist on 03 9695 6309.

Yours Sincerely,

John Howarth
Manager Regulation and Network Strategy



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Attachment – Case for making a more preferable Rule

This attachment sets out in detail where the current regulatory framework does not provide sufficient incentives for Victorian DNSPs to recover network support payments incurred to defer augmenting transmission connection assets and proposes a narrower, more preferable rule to address this.

SP AusNet agrees with the AEMC about the benefits of incentive-based regulation. However, while this form of regulation works well where the incentives are set appropriately, it should not be assumed that appropriate incentives exist in all cases in the current framework. As previously identified and as described in more detail below, transmission connection asset augmentation in Victoria is one such case.

We note the AEMC's concerns that the proposed Rule could weaken incentive regulation by broadening the coverage of cost pass throughs. However, it is not always the case that 'introducing additional cost pass throughs into the rules would weaken the overall incentive-based approach to regulation'¹. In specific circumstances, cost pass throughs are required to best achieve the NEO. The actual number of pass through provisions in the rules is irrelevant in this context.

For this reason, we propose that the AEMC make a more preferable rule that is limited to correcting the misalignment of incentives in relation to Victorian DNSPs augmenting transmission connection assets. This is narrower in scope and impact than SP AusNet's original rule change proposal. A draft of the more preferable rule is provided in Appendix 1.

Augmenting Transmission Connection Assets in Victoria

Victorian DNSPs uniquely have a licence obligation to plan transmission connection assets². For this reason, in Victoria, the DNSPs either initiate augmentations or contract for network support in relation to these assets. Elsewhere in the NEM, this responsibility falls to TNSPs.

Table 1 below summarises the differences in options available under the current NER for Victorian DNSPs (acting as the TNSP for the transmission connection planning function) and non-Victorian TNSPs to recover costs related to augmenting transmission connection assets according to whether the NSP:

- Adopts a 'traditional' network solution such as augmenting a transformer; or
- Contracts with a network support service provider to defer the augmentation of a connection asset.

¹ Draft Rule Determination – Recovery of Network Support Payments, AEMC, 8 August 2013, p. ii

² SPI Electricity Pty Ltd, *Electricity Distribution Licence*, 14 January 2005, clause 14. Clause 14 provides that '[t]he Licensee is responsible for planning, and directing the augmentation of, transmission connection assets to assist it to fulfill its obligations under clause 6 (Obligation to offer connection services and supply to a customer).' 'Augmentation' means, in relation to the transmission connection assets or the Licensee's distribution system, the process of upgrading the transmission connection assets or the distribution system by replacing or enhancing existing plant and equipment or by adding new plant and equipment and includes modifying any of the Licensee's distribution fixed assets.

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Table 1: Options to recover funding for network and non-network solutions relating to augmenting transmission connection assets under the current NER

Expenditure	Recovery method	Victorian DNSP (next period)	Victorian DNSP (current period)	Non-Victorian TNSP
Network (capex)	Recover through annual pricing proposal process	✓	✓	✗
	Capex allowance in regulatory determination	✗	✗	✓
Non-network (opex)	Substitute for capex allowance	✗	✗	✓
	Opex allowance in revenue determination	✓	✗	✓
	Specified pass through	✗	✗	✗
	Nominated pass through	✓	✗	✓

Recovery through the capex allowance or substitute

In non-Victorian NEM jurisdictions, the TNSP receives a capex allowance for augmenting transmission connection assets as part of the regulatory determination. If an option to enter into a network support agreement arises mid-period, the TNSP can use the capex allowance to fund the network support payments. Notwithstanding the differences in certainty of recovery for capex and opex³, this enables the TNSP to consider augmentation and network support on an equal footing.

However, in Victoria neither the TNSP nor the planning DNSP receives a capex allowance for augmenting transmission connection assets. Rather, the DNSP contracts with the TNSP to deliver the connection augmentation and recovers the cost of the contract associated with augmenting transmission connection assets through the annual pricing proposal process. Therefore, Victorian DNSPs are unable to fund network support payments as there is no capex allowance to redirect.

If the recovery of these contact costs through the annual pricing process applied to both network and non-network solutions this would have left the Victorian jurisdiction with an equivalent cost recovery mechanism to the rest of the NEM. However, the AEMC decision on 'DNSP recovery of transmission-related charges' (24 March 2011) explicitly prevents this.

'The Commission considers that given the broad nature of network support agreements, and only the Bairnsdale network support agreement being in existence which was previously approved by the ESC, only the Bairnsdale network support agreement payments should be included under the annual pricing proposal process. If there are any new network support agreements in the future, then this should be submitted to the

³ As recognised by the AEMC in the Power of Choice review, Final Report 30 November 2012, p. 220

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AER for its consideration under the distribution determination process or, in certain circumstances, as a cost pass through event⁴.

Recovery through an opex allowance

Where a Victorian DNSP can accurately forecast network support payments as part of a determination, the AER may approve an opex allowance to permit these costs to be recovered. However, unless the network support agreement is current, or the details of an agreement due to commence shortly are known, forecasting these payments is problematic.

In its draft determination, the AEMC considered that '[network support] costs are not sufficiently different to other costs which can be difficult to forecast at the time of the regulatory determination'⁵. SP AusNet strongly disagrees with this view.

It is difficult to accurately forecast network support payments as the market for network support services is currently very shallow. It is therefore not always clear up to five years in advance whether a proponent will be willing to provide a particular amount of network support at a specific location, or at a price that would make network support the most efficient option. It is also difficult to forecast what this price will be, as it will depend on the outcome of commercial negotiations. As network support agreements are a relatively new development, there are too few precedents to accurately predict the negotiation outcomes.

Therefore, unless a network support agreement is currently in place or close to being finalised, the efficient level of costs that will be incurred within the period will be unclear at the time the regulatory proposal is submitted.

If the more preferable Rule is made to allow Victorian DNSPs to pass through efficient network support payments not included in the regulatory determination, businesses would still provide a forecast opex allowance for network support payments where it was possible to do so. This would avoid the administrative burden of submitting a pass through application to recover these costs. However, the pass through would be in place to address the imbalance in incentives when considering unforeseen network support agreements mid-period.

Recovery through pass through arrangement

The only other way for a Victorian DNSP to recover network support payments is through a nominated pass through. In practice, this mechanism will be ineffective due to two major problems:

- It is not clear that the factors that the AER must have regard to in assessing a proposed pass through event are consistent with the AER accepting an event of this nature. These include whether the business could reasonably prevent such an event from occurring, or mitigate the cost impact of the event (in the case of network support, the answer to both would be yes).

⁴ Rule Determination – DNSP Recovery of Transmission-related Charges, AEMC, 24 March 2011, p.27

⁵ Draft Rule Determination – Recovery of Network Support Payments, AEMC, 8 August 2013, p. 17

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- The materiality threshold is 1% of the annual revenue requirement. The majority of network support payments would be unlikely to reach this threshold.

Summary

SP AusNet agrees that cost recovery via the regulatory determination is the strongest form of incentive regulation⁶, as it provides businesses with the discretion to determine what projects it undertakes within the regulatory period. However, this mechanism does not apply to recovering capex for transmission connection asset augmentation in Victoria. Unless network support payments have been provided for as part of the opex allowance, they will be unfunded. This means a Victorian DNSP would have a negative incentive to enter into network support agreements where no explicit provision had been made as part of the opex allowance. It is clear that any business responding to incentives would always choose the network option under these circumstances – why would a business incur costs it is unable to recover, when another option exists? This is clearly contrary to the NEO.

While these disincentives to contract for network support remain, Victorian DNSPs will always be predisposed towards network solutions. If the current arrangements continue to apply, Victorian DNSPs must carefully and clearly manage the expectations of network support service providers regarding the likelihood that a DNSP will enter into an agreement with them to provide network support services. The AEMC's consideration of this Rule Change proposal to date seems at odds with developments apparent in other areas of the regulatory framework, including requirements for DNSPs to publish a demand side engagement strategy, and streamlining the connection process for embedded generators. This sends mixed messages to potential network support proponents.

This issue will not be addressed by future changes in the regulatory framework resulting from previous reviews or rule change proposals (see Appendix 2 – Future Regulatory Changes).

More Preferable Rule

The more preferable Rule introduces a network support pass through into Chapter 6. A draft of the more preferable Rule is set out in Appendix 1. This pass through will be limited to cover network support payments associated with the deferral of transmission connection assets. Because Victorian DNSPs are uniquely responsible for planning transmission connection assets, it is likely to only be used by Victorian DNSPs.

The more preferable Rule is more targeted than the initial proposed Rule. The narrower focus addresses the AEMC's concerns that the initial proposed Rule would weaken the strength of incentive regulation by broadening pass throughs, and increase the AER's administrative burden. Including an opex roll forward mechanism in Chapter 6 is also no longer proposed in response to these concerns.

If the more preferable Rule is made, SP AusNet considers that the network support pass through mechanism would provide sufficient certainty over the recovery of opex

⁶ Consultation Paper – Recovery of Network Support Payments, AEMC, 11 April 2013, p. 17

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associated with network support agreements to allow consideration of network and non-network solutions on an equivalent basis.

Consistency of the more preferable Rule with the NEO

Section 91A of the National Electricity Law (NEL) permits the AEMC to make a more preferable Rule if the AEMC is satisfied that, having regard to the issue or issues that were raised by the market initiated proposed Rule (to which the more preferable Rule relates), the more preferable Rule will or is likely to better contribute to the achievement of the NEO.

SP AusNet contends that the more preferable Rule will make an important contribution to achieving the NEO. Removing the incentive bias from the current regulatory framework that network support services experience relative to transmission network augmentation projects will allow consumers to realise the long run pricing and reliability benefits offered by network support solutions. Amending the NER to encourage economically efficient outcomes of this kind contributes to the achievement of the NEO.

The benefits that can be realised are not theoretical. As SP AusNet explained in its submission to the Consultation Paper, the cost of the network support option offered to SP AusNet at the Cranbourne Terminal Station is not commercially rational if the costs cannot be recovered. However, if the regulatory framework provides a clear and certain path for cost recovery, SP AusNet can pass the savings from deferring network augmentation on to consumers while maintaining service and reliability standards.

Extensive work has been conducted by a number of organisations, including the AEMC, into the benefits of demand management solutions. Much of this effort has focused on identifying ways to encourage non-network solutions to alleviate the need for expensive network replacement and augmentation to ensure that electricity prices are minimised, and economic efficiency is maximised. This is consistent with the economic concepts underpinning the NEO:

For example, investment in and use of electricity services will be efficient when services are supplied in the long run at least cost, resources including infrastructure are used to deliver the greatest possible benefit and there is innovation and investment in response to changes in consumer needs and productive opportunities. The long term interest of consumers of electricity requires the economic welfare of consumers, over the long term, to be maximised.⁷

The asymmetric incentives embedded in the current regulatory framework do not encourage market outcomes that are consistent with these objectives. However, by making the proposed more preferable Rule, the AEMC will provide a regulatory framework that encourages DNSPs to seek, and providers of non-network services to offer, new and innovative network support products. Price-based competition will increase and new demand management service providers will be encouraged to enter. As the market

⁷ National Electricity (South Australia) (New National Electricity Law) Amendment Bill, House of Assembly, Wednesday 9 February 2005, p. 1451.

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deepens, DNSPs will gain experience in forecasting the need for and cost of non-network solutions, thereby shifting the focus of cost recovery away from a cost pass through mechanism to the distribution determination process.

SP AusNet submits that the more preferable Rule is a necessary pre-condition to developing the market for non-network alternatives to transmission connection asset augmentations, and that fostering market growth will translate into economic efficiencies of the kind the NEO was introduced to encourage.

The more preferable Rule is consistent with the Revenue and Pricing Principles

Section 88B of the NEL requires the AEMC to take account the revenue and pricing principles (RPPs) in making a Rule for or with respect to any matter or thing specified in items 15 to 24 and 25 to 26J of Schedule 1 of the NEL. The proposed more preferable Rule relates to matters specified in certain of these items.

SP AusNet submits that the proposed more preferable Rule is consistent with the RPPs in sections 7A(2) and 7A(3) of the NEL.

Section 7A(2)

The NEL relevantly requires that regulated NSPs be provided with a “reasonable opportunity” to recover at least their efficient costs incurred in providing direct control network services. Network support payments are such a cost.

SP AusNet reaffirms its position that the ability for an NSP to recover its efficient network support costs is limited to such an extent that the cost recovery opportunities cannot be said to be “reasonable”. The limitations are discussed in further detail in the preceding sections of this submission.⁸

In the absence of the more preferable Rule, Victorian DNSPs may bear costs that are properly incurred in the provision of direct network control services but for which they are denied adequate cost recovery opportunities. In SP AusNet’s view, this outcome is not consistent with the RRP in section 7A(2).

Section 7A(3)

Section 7A(3) states that a regulated NSP should be provided with effective incentives in order to promote economic efficiency with respect to the direct control network services it provides. Section 7A(3) specifies three examples of the economic efficiency that should be promoted:

- (a) Efficient investment in a distribution system or transmission system with which the operator provides direct control network services;
- (b) Efficient provision of electricity network services;

⁸ See also SP AusNet’s initial Rule change proposal and its submission in response to the Consultation Paper.

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- (c) Efficient use of the distribution system or transmission system with which the operator provides direct control network services.

SP AusNet submits that if the more preferable change is made, it would promote efficiency in each of these three areas. First, it will encourage efficient investment by equalising the regulatory incentives for implementing network solutions relative to network augmentations. Once the cost recovery bias towards augmentation is removed, Victorian DNSPs can evaluate network and non-network solutions on an equal footing. Secondly, the provision of electricity network services will be more efficient because non-network solutions are likely to be more readily adopted, resulting in reduced capital expenditure over a regulatory control period. Finally, efficient use of distribution and transmission systems will be promoted because non-network solutions can be used to provide sufficient capacity to meet demand without introducing substantial redundancy into the transmission network.

SP AusNet submits that making the more preferable Rule is an opportunity to achieve further economic efficiencies which, in the current climate of rising electricity prices, should be embraced.

Expected costs and benefits of more preferable Rule

SP AusNet considers the proposed more preferable Rule will have the same costs and benefits as its initial proposed Rule. As such, SP AusNet relies on section 7 of its Rule change proposal.

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Appendix 1 – More Preferable Rule

A more preferable Rule and consequential amendments are set out below for the AEMC's consideration.

[1] New Clause 6.6.1A

After the rule 6.6 heading, insert:

6.6.1AA Network support pass through

- (a) This clause applies where a *network support event* occurs with respect to a *regulatory year* (the **previous regulatory year**).
- (b) If a *network support event* occurs, a *Distribution Network Service Provider* must seek a determination by the *AER* to pass through to *Distribution Network Users* a *network support pass through amount*.
- (c) Where a *Distribution Network Service Provider* seeks a determination as referred to in paragraph (b), the provider must, within 60 *business days* of the end of the previous *regulatory year*, submit to the *AER* a written statement which specifies:
 - (1) the details of the *network support event* including whether the event was a *negative network support event* or a *positive network support event*;
 - (2) the amount that the provider proposes should be passed through to *Distribution Network Users* in the *regulatory year* following the previous *regulatory year* as a result of the *network support event*;
 - (3) evidence:
 - (i) of the actual increase in the amount of *network support payments*, including certification by an independent and appropriately qualified expert; and
 - (ii) that such amounts occur solely as a consequence of the positive *network support event*.
- (d) If the *AER* determines that a *positive network support event* has occurred in respect of a statement under paragraph (c), the *AER* must determine the *network support pass through amount*, taking into account the matters referred to in paragraph (i).
- (e) If the *AER* does not make the determination referred to in paragraph (d) within 60 *business days* from the date it receives the *Distribution Network Service Provider's* statement and accompanying evidence under paragraph (c), then, on the expiry of that period, the *AER* is taken to have determined

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that the amount as proposed in the *Distribution Network Service Provider's* statement under paragraph (c) is the *network support pass through amount*.

- (f) If a *negative network support event* occurs (whether or not the occurrence of that event is notified by the provider to the *AER* under paragraph (c)) and the *AER* determines to impose a requirement on the *Distribution Network Service Provider* in relation to that *negative network support event*, the *AER* must determine the *network support pass through amount* taking into account the matters referred to in paragraph (i).
- (g) A *Distribution Network Service Provider* must provide the *AER* with such information as the *AER* requires for the purpose of making a determination under paragraph (f) within the time specified by the *AER* in a notice provided to the provider by the *AER* for that purpose.

Consultation

- (h) Before making a determination under paragraph (d) or (f), the *AER* may consult with the relevant *Distribution Network Service Provider* and such other persons as the *AER* considers appropriate, on any matters arising out of the relevant *network support event* as the *AER* considers appropriate.

Relevant factors

- (i) In making a determination under paragraph (d) or (f), the *AER* must take into account:
 - (1) the matters and proposals set out in any statement given to the *AER* by the *Distribution Network Service Provider* under paragraph (c);
 - (2) in the case of a *positive network support event*, the increase in costs in the provision of *standard control services* that the provider has incurred in the preceding *regulatory year* as a result of the *positive network support event*;
 - (3) in the case of a *positive network support event*, the efficiency of the *Distribution Network Service Provider's* decisions and actions in relation to the risk of the event, including whether the provider has failed to take any action that could reasonably be taken to reduce the magnitude of the *positive network support event* and whether the provider has taken or omitted to take any action where such action or omission has increased the magnitude of the amount in respect of that event;
 - (4) the time cost of money based on the *weighted average cost of capital* for the provider for the relevant *regulatory control period*;
 - (5) the need to ensure that the provider only recovers any actual increment in costs under this paragraph (i) to the extent that such

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increment is solely as a consequence of a *network support event*;
and

- (6) any other factors the *AER* considers relevant.

[2] Chapter 10 Amended Definitions

materially

In the definition of *materially*, insert “(other than a *transmission connection asset network support event*)” after “For the purpose of the application of clause 6.6.1, an event”.

network support event

In the definition of *network support event*, insert after “provided for in the *revenue determination*.” the following:

- (c) If, at the end of a *regulatory year* of a *regulatory control period*, the amount of *network support payments* made by a *Distribution Network Service Provider* for that previous *regulatory year* is higher or lower than the amount of *network support payments* (if any) that is provided for in the *annual revenue requirement* for the *Distribution Network Service Provider* for that *regulatory year*, this constitutes a *network support event*.
- (d) In calculating the amount for the purposes of a *network support event* referred to in paragraph (c), the amount of *network support payments* made by a *Distribution Network Service Provider* must not include an amount of *network support payments* that are a substitute for a *network augmentation* where an allowance for capital expenditure in relation to that *network augmentation* has been provided for in the distribution determination.

[3] Chapter 10 Substituted Definitions

In chapter 10, substitute the following definitions:

negative network support event

For a *Transmission Network Service Provider*, an event which entails a *Transmission Network Service Provider* making lower *network support payments* in the preceding *regulatory year* than the amount of *network support payments* (if any) that is provided for in the *annual building block revenue requirement* for the provider for that *regulatory year*.

For a *Distribution Network Service Provider*, an event which entails a *Distribution Network Service Provider* making lower *network support payments* in the preceding *regulatory year* than the amount of *network support payments* (if any) that is provided for in the *annual revenue requirement* for the provider for that *regulatory year*.

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positive network support event

For a *Transmission Network Service Provider*, an event which entails a *Transmission Network Service Provider* making higher *network support payments* in the preceding *regulatory year* than the amount of *network support payments* (if any) that is provided for in the *annual building block revenue requirement* for the provider for that *regulatory year*.

For a *Distribution Network Service Provider*, an event which entails a *Distribution Network Service Provider* making higher *network support payments* in the preceding *regulatory year* than the amount of *network support payments* (if any) that is provided for in the *annual revenue requirement* for the provider for that *regulatory year*.

network support payment

A payment by a *Transmission Network Service Provider* to:

- (a) any Generator providing *network support services* in accordance with rule 5.4AA; or
- (b) any other person providing a *network support service* that is an alternative to network augmentation.

A payment by a *Distribution Network Service Provider* to a Generator or any other person providing a *network support service* that is an alternative to *transmission connection asset* network augmentation.

network support pass through amount

The amount that should be passed through to *Transmission Network Users* or *Distribution Network Users* in the *regulatory year* following the preceding *regulatory year*, in respect of a *network support event* for that *Network Service Provider*.

[4] Chapter 10 New Definitions

transmission connection assets

The assets that deliver the *connection services* provided by a *Transmission Network Service Provider* to another *Network Service Provider* to connect their *networks* where neither of the *Network Service Providers* is a *Market Network Service Provider*.

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Appendix 2 – Future Regulatory Changes

While the AER's new Capital Efficiency Sharing Scheme (CESS) corrects the imbalance in efficiency incentives between capex and opex within period, it does not address the certainty of recovery of opex across regulatory control periods, nor does it address the connection asset issue in Victoria as a capex allowance is not received to augment these. Under the current NER, the AER is unable to resolve this issue, as its role is in applying the NER – by approving an opex allowance/ nominated pass throughs at the time of determination, or by assessing cost pass through applications that may arise mid-period. If the AEMC or the AER have a different view we would be interested in this.

Also, fundamental to RIT-D process is the ability to recover opex and capex on an equivalent basis. This allows NSPs to consider the costs and benefits of network and non-network options on an equal footing. If neutral cost recovery incentives are not in place, this could change the outcome of the RIT-D process towards the least efficient option.

In addition, while the Power of Choice review discussed the certainty of recovery of capex compared to opex, it did not go into great detail or make any recommendations on this. It also did not discuss cost recovery for augmenting connection assets in Victoria.