

Australian Energy Market Commission

CONSULTATION PAPER

National Electricity Amendment (Recovery of Network Support Payments) Rule 2013

Rule Proponent

SP AusNet

11 April 2013

**RULE
CHANGE**

For and on behalf of the Australian Energy Market Commission

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About the AEMC

The Council of Australian Governments (COAG), through its then Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. In June 2011, COAG established the Standing Council on Energy and Resources (SCER) to replace the MCE. The AEMC has two main functions. We make and amend the national electricity, gas and energy retail rules, and we conduct independent reviews of the energy markets for the SCER.

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1 Introduction

On 17 December 2012, SP AusNet (proponent) submitted a rule change request to the Australian Energy Market Commission (AEMC or Commission) in relation to cost recovery of network support service arrangements that defer either distribution network augmentation and/or connection assets used to connect a transmission network to a distribution network (“transmission connection assets”).

Currently, distribution network service providers (DNSPs) may be able to recover their costs for network support service arrangements that defer network augmentation under their revenue allowance and, in certain circumstances, via nominated pass throughs. In contrast, as well as recovering costs for network support service arrangements under their revenue allowance and nominated pass throughs, transmission network service providers (TNSPs) can recover these via specific network support pass throughs.

The proponent proposes for DNSPs to be able to recover costs for the distribution network support service arrangements via specific network support pass throughs similar to the TNSP arrangements. Also as currently available to the TNSP, the proponent proposes for an arrangement to apply to the DNSP where a network support service arrangement crosses over multiple regulatory control periods requiring this to be automatically rolled forward as opex.

The proponent also considers that specific network support pass throughs should apply to recovery of costs associated with network support service arrangements that defer transmission connection assets, and that this be made available to both DNSPs and TNSPs. This is especially an issue that could arise in Victoria where Victorian DNSPs are responsible for planning transmission connection assets.

This consultation paper has been prepared to facilitate public consultation on the rule change request, and to seek stakeholder submissions on the rule change request.

This paper:

- sets out a summary of, and a background to, the Recovery of Network Support Payments rule change request proposed by the proponent;
- identifies a number of questions and issues to facilitate the consultation on this rule change request; and
- outlines the process for making submissions.

2 Background

This chapter provides background information on the rule change request including the current arrangements in respect of the issues raised and the problem that has been identified by the proponent, and past AEMC decisions relevant to this rule change request.

2.1 What are network support service arrangements?

A network support service arrangement typically involves the sourcing of local generation by a network service provider (NSP) in order to address forecast constraints in its shared network.¹ In certain circumstances, a NSP may find it more cost effective to use generators as a non-network solution for network support to maintain system reliability, rather than undertake shared network augmentation (such as building additional transmission lines).² The payments are agreed between the generator and NSP.³

Network support service arrangements also provide a direct benefit to network customers and end users as it can defer the need for shared network augmentation.⁴ Hence, they would result in lower charges in the long term, while maintaining the reliability of the network.⁵

For the purposes of this paper, "network support payments" as currently defined under the National Electricity Rules (NER or rules) will be referred to as "transmission network support service arrangements".⁶ However, a transmission network support service arrangement is only one type of network support service arrangement. Such arrangements could also be used to defer distribution network augmentation ("distribution network support service arrangements") and transmission connection assets ("transmission connection support service arrangements").

In contrast to transmission network support service arrangements, transmission connection support service arrangements are excluded from being recovered via specific network support pass throughs because the definition of "network" explicitly excludes "connection assets".⁷ Specific network support pass throughs also do not extend to distribution network support service arrangements, even if they are non-network alternatives to network augmentation.

1 AEMC, *Network Support Payments and Avoided TUOS for Embedded Generators*, Consultation paper, 23 June 2011, p. 4.

2 Ibid.

3 Ibid.

4 Ibid.

5 Ibid.

6 Definition of "network support payment", Chapter 10 of the NER.

7 Definition of "network", Chapter 10 of the NER.

The proponent is seeking to expand the types of network support service arrangements that can be recovered under specific network support pass throughs to distribution network and transmission connection support service arrangements.

2.2 Possible means of recovery of costs for network support service arrangements

This section describes potential mechanisms by which a NSP could recover costs for network support service arrangements under the NER.

In contrast to transmission network support service arrangements, costs of distribution network and transmission connection support service arrangements can only currently be recovered as part of the overall revenue allowance (option 1 below) and, in certain circumstances, via nominated pass throughs (option 2 below). There is no ability for these costs to be recovered through any other mechanism.

2.2.1 Option 1: Regulatory determination process

NSPs are currently subject to five-year regulatory control periods. The Australian Energy Regulator (AER) makes regulatory determinations by applying the building blocks approach. This allows the AER to determine the annual revenue requirements that DNSPs are entitled to for providing standard control services and TNSPs for providing prescribed transmission services.

As part of this process, the AER considers a NSP's forecast expenditure which has to reasonably reflect efficient and prudent costs based on realistic estimates of forecast demand and cost inputs. These costs may include capital expenditure (capex) or operating expenditure (opex) associated with shared network augmentations for TNSPs and DNSPs, and transmission connection assets for TNSPs.

Similar to network augmentations, NSPs can currently seek to recover costs associated with network support service arrangements as capex or opex under their revenue allowance at the regulatory determination stage.

However, under this approach alone, NSPs would be unable to recover mid-period any extra costs which were not included at the time of the regulatory determinations. On the other hand, NSPs could fund such arrangements if they deferred capex in their revenue allowance set at the start of the regulatory control period.

2.2.2 Option 2: "Standard" cost pass throughs

The NER provide for general cost pass through arrangements. These include types of pass through events which are specified in the NER, and nominated pass through events which may be specified by the AER.

Nominated pass throughs are currently available to TNSPs and DNSPs. Under this approach, the AER can determine whether to allow for certain defined events to be

passed through as costs to consumers during a regulatory control period. These types of events are defined by the AER in the regulatory determination process. In the context of distribution network and transmission connection support service arrangements, the NSP may seek costs for these to be classified as nominated pass through events. Where they are approved, NSPs may apply to the AER during the regulatory control period to recover additional costs which fall within that category of event.

If the NSP makes an application for a nominated pass through event, the AER has a standard 40 business days (with the ability to extend this time for complex matters) to confirm the event and the amount to be passed through to consumers. The AER does undertake some economic assessment on the efficiency of costs for such applications. There is also a materiality threshold of one per cent of the maximum allowed revenue (MAR) for making these applications.

The AER must consider nominated pass through factors when determining nominated pass through events.⁸ The intention of the nominated pass through event considerations is that a pass through event should only be accepted when it is the least inefficient option and event avoidance, mitigation, commercial insurance and self-insurance are found to be inappropriate.⁹ That is, it is included after ascertaining the most efficient allocation of the risks between NSPs and end consumers.¹⁰ However, these are considerations only.¹¹ Therefore, the NSP and the AER can come to a mutual understanding that a pass through event is inconsistent with the factors for consideration, but may still be the more efficient mechanism.¹²

2.2.3 Option 3: Specific network support pass through events

Specific network support pass throughs

The specific network support pass through is the current approach that applies in transmission under Chapter 6A of the NER.

Once a TNSP enters into a transmission network support service arrangement with an embedded generator during a regulatory control period, the TNSP may recover "network support payments" from its customers, even if these were not included in the revenue allowance. This amount to be recovered is referred to as a "network support event",¹³ and is the amount of "network support payment" that is either higher or lower than the amount that the TNSP provided in its annual building block revenue

⁸ Definition of "nominated pass through event considerations", Chapter 10 of the NER.

⁹ AEMC, *Cost pass through arrangements for Network Service Providers*, Final rule determination, 2 August 2012, p. 20.

¹⁰ Ibid.

¹¹ Ibid.

¹² Ibid.

¹³ Definition of "network support pass through amount", Chapter 10 of the NER.

requirement for that regulatory year.¹⁴ The "network support payments" can be recovered via this specific network support pass through process if approved by the AER, provided such payments have not already been recovered under the capex allowance, which avoids double cost recovery issues.¹⁵

Specific network support pass throughs are quite similar to the standard cost pass throughs. However, in addition to different decision-making timeframes between specific network support pass throughs and standard cost pass throughs, a unique difference is that there is no materiality threshold for specific network support pass throughs. On the other hand, standard cost pass throughs have a materiality threshold of one per cent of the MAR. The AEMC in 2006 considered that no materiality threshold for specific network support pass throughs was required because it would be too high and the intention was to remove any disincentive against non-network solutions associated with forecasting difficulties.¹⁶

Specific network support pass throughs are also prescribed in the NER, while nominated pass throughs are assessed and classified at each regulatory reset. Considering this together with the materiality threshold, the nominated pass through appears to provide a greater degree of scrutiny than the specific network support pass through.

Opex roll forward arrangement

In addition to the specific network support pass through, an opex roll forward arrangement is also currently used in transmission for transmission network support service arrangements. At a regulatory reset, if there is an existing transmission network support service arrangement which would continue into the next regulatory control period, the AER must "roll forward" this as opex for the next regulatory control period. The rationale for this approach is discussed in section 2.4.2.

2.2.4 Option 4: Recovery through the pricing process (distribution only)

With respect to the annual pricing proposal process, DNSPs may consider the annual pricing proposal process for recovery of costs associated with network support service arrangements. Under this option, the DNSP would pass on any new network support service arrangement risks into its annual pricing.

In practice, there is little time available for the AER to completely assess the DNSP's annual pricing proposal. This means that there would not be any rigorous economic assessment of the defined costs being proposed to recover from consumers. This is in contrast to the regulatory determination process where the AER has over 18 months to assess the costs, including examining the types and efficiency of costs incurred by DNSPs to ensure these costs meet regulatory requirements. However, the AEMC

¹⁴ Definition of "network support event", Chapter 10 of the NER.

¹⁵ Ibid.

¹⁶ AEMC, *Review of the Electricity Transmission Revenue and Pricing Rules*, Transmission revenue: rule proposal report, February 2006, p. 80.

rejected this avenue for DNSPs to recover costs for network support service arrangements in a rule change in 2011.¹⁷

2.3 Victorian arrangements for transmission connection assets

In the case of shared transmission network augmentation, this is generally provided for in the NER as a prescribed TUOS services. Charges for these services are recovered from all customers.

In contrast, a transmission connection asset provides a connection service and is not part of the transmission network. Where this service is provided by a TNSP to a DNSP, it is a prescribed exit service. The associated charge for this service is wholly recovered from each relevant customer, such as a DNSP, associated with that connection point. The DNSP then recovers this cost through to its own customers under the annual pricing process.

As noted in the rule change request, Victorian DNSPs have a different role in transmission connection asset planning compared to DNSPs in other regions of the national electricity market (NEM). Under their licence code,¹⁸ Victoria DNSPs are responsible for planning and directing both new, and upgrades to, transmission connection assets.¹⁹ Under the National Electricity Law (NEL), the Australian Energy Market Operator's (AEMO) declared network functions are to plan, authorise, contract for and direct augmentation of the declared shared transmission network in Victoria.²⁰

With respect to how costs for transmission connection assets (which provide prescribed exit services) are recovered in Victoria, AEMO apportions revenue for prescribed TUOS services and prescribed common transmission services, while SP AusNet as the TNSP apportions revenue for the prescribed connection services including prescribed exit services. This means that SP AusNet (as the TNSP) levies the prescribed exit service charges to its customers including the DNSPs. As in the other jurisdictions, DNSPs recover these costs from their customers via the annual pricing process.

2.4 Past considerations

2.4.1 Rule change on economic regulation of transmission services (2006)

The specific network support pass through regime was introduced in the NER for transmission in 2006.²¹ At the time, the AEMC supported the TNSPs' justification for

¹⁷ AEMC, *DNSP Recovery of Transmission-related Charges*, Final rule determination, 24 March 2011, p. 27.

¹⁸ Victorian distribution licence, clause 14.

¹⁹ AEMC, *Network Support Payments and Avoided TUOS for Embedded Generators*, Final rule determination, 22 December 2011, p. 25.

²⁰ NEL, section 50C(1)(a).

²¹ AEMC, *Economic Regulation of Transmission Services*, Final rule determination, 16 November 2006.

specific network support pass throughs because it was difficult to forecast such payments and not allowing as pass throughs for unexpected cost fluctuations could disincentivise TNSPs from adopting non-network solutions.²²

The AEMC also considered that certain network support service arrangements are within the TNSP's control.²³ In particular, where a TNSP substitutes a network support service arrangement for capex that has already been included in its regulated allowed revenue, it would be inappropriate to treat this as an additional cost.²⁴

2.4.2 Rule change on demand management (2009)

In 2009, further changes were made to the specific network support pass through regime under Chapter 6A.²⁵ There was a concern that there was a difference in certainty of cost recovery between capex and opex used to address network constraints.

Under a network option such as a network augmentation, a TNSP would be guaranteed to recover costs that may be incurred over a period of time which crosses multiple regulatory control periods because these costs would be rolled forward in the regulatory asset base (RAB) as capex.²⁶ On the other hand, under a non-network option (such as a transmission network support service arrangement), a TNSP would have less certainty on whether the AER would approve revenue allowance as opex for ongoing payments if the incurred costs continued over the next regulatory control period.²⁷

Such an outcome for network support service arrangements increases the risks associated with their cost recovery via opex, and may create a disincentive against network support service arrangements.²⁸ To address this, the NER was amended which introduced the opex roll forward arrangement.

2.4.3 Rule change on DNSP recovery of transmission-related charges (2011)

In early 2011, the AEMC made a rule determination that clarified certain charges that DNSPs can recover from its customers via the annual pricing process.²⁹ These charges had to be clearly defined, outside the control of DNSPs, subject to other regulatory processes which determine whether they are efficient, and cannot be reasonably

²² AEMC, *Review of the Electricity Transmission Revenue and Pricing Rules*, Transmission revenue: rule proposal report, February 2006, p. 80.

²³ Ibid.

²⁴ Ibid.

²⁵ AEMC, *Demand Management*, Final rule determination, 23 April 2009.

²⁶ Ibid, p. 36.

²⁷ Ibid.

²⁸ Ibid.

²⁹ AEMC, *DNSP Recovery of Transmission-related Charges*, Final rule determination, 24 March 2011.

forecast by the DNSP at the time the AER makes the DNSP's regulatory determination.³⁰

As part of this process, the Victorian DNSPs proposed for network support service arrangements to be recovered from their customers under the annual pricing process.³¹ However, the AEMC considered that such arrangements were too broad in nature to be recovered under this process.³² Instead, we suggested that a better approach would be for such costs to be recovered under the DNSP's regulatory determination process or cost pass throughs in certain circumstances.³³

An exception to this was SP AusNet's network support service arrangement with Bairnsdale Power Station.³⁴ This was allowed to be recovered through the annual pricing process as a transitional arrangement because it was a previous network support service arrangement approved by the Essential Services Commission of Victoria (ESCV).³⁵

2.4.4 Rule change on network support payments and avoided TUOS for embedded generators (2011)

At the end of 2011, the AEMC made a rule determination to address a perceived overlap between payments made to embedded generators in relation to network support and avoided TUOS.³⁶ The rule as made recognised that payments for avoided TUOS and network support may compensate for different services. Accordingly, in some instances, it may be appropriate for an embedded generator to receive both payments. Therefore, TNSPs are required to take avoided TUOS payments into account when negotiating network support service arrangements with embedded generators.

Relevant to this SP AusNet rule change request, a number of DNSPs (including SP AusNet) raised the issue that network support service arrangements could also facilitate for distribution network augmentations.³⁷ In addition, SP AusNet and United

³⁰ Ibid, p. 14.

³¹ United Energy Distribution, Submission to first round consultation on DNSP recovery of transmission-related charges rule change request, 8 October 2010, pp. 4, 8-9.

³² AEMC, *DNSP Recovery of Transmission-related Charges*, Final rule determination, 24 March 2011, p. 27.

³³ Ibid.

³⁴ Ibid.

³⁵ Ibid.

³⁶ AEMC, *Network Support Payments and Avoided TUOS for Embedded Generators*, Final rule determination, 22 December 2011.

³⁷ Ergon Energy, Submission on the Network Support Payments and Avoided TUOS for Embedded Generators rule change request, 22 July 2011, p. 5; Jemena, Submission on the Network Support Payments and Avoided TUOS for Embedded Generators rule change request, 21 July 2011, p. 3; Joint submission from SP AusNet and United Energy, Submission on Network Support Payments and Avoided TUOS for Embedded Generators rule change request, 11 November 2011, pp. 2-3; United Energy, Submission on Network Support Payments and Avoided TUOS for Embedded Generators rule change request, 21 July 2011, p. 12.

Energy also raised the potential for transmission connection support service arrangements, noting the role of Victorian DNSPs in planning transmission connection assets.³⁸

At the time of that rule change request, United Energy considered that DNSPs may undertake network support service arrangements but would have little control of these charges and cannot forecast them as part of the regulatory determination process.³⁹ It noted that there was no equivalent specific network support pass through as in transmission for distribution, but considered that the annual pricing process would be a more appropriate mechanism to recover these costs.⁴⁰

In response, the AEMC noted that network support payments under the NER were limited to TNSPs and related to deferral of transmission network augmentations.⁴¹ Therefore, the AEMC did not accept the DNSPs' proposal.

We stated that if the shared transmission network augmentations to facilitate a connection do not pass the regulatory investment test for transmission (RIT-T) undertaken by AEMO, then as TNSP, it would have no driver to seek a network support service arrangement to defer the works.⁴² The Victorian DNSP therefore has a greater incentive to evaluate competing options from AEMO (for a new transmission connection asset or an upgrade of existing connection assets), and from embedded generators and other non-network solutions as a substitute.⁴³ As such, the Victorian DNSP would be the party more likely to enter negotiations, and subsequently contract, with embedded generators.⁴⁴ These contracts, although equivalent to the transmission network support service arrangements that TNSPs in other jurisdictions would enter, are not governed by the NER as transmission network support service arrangements are.⁴⁵

The AEMC understood at the time that the driver for negotiations to defer transmission connection assets between a DNSP and embedded generator were likely to be specific to Victoria.⁴⁶ Therefore, the benefits of that rule change in Victoria were likely to be less than in other jurisdictions.⁴⁷ However, the AEMC did not believe that

38 Joint submission from SP AusNet and United Energy Submission on Network Support Payments and Avoided TUOS for Embedded Generators rule change request, 11 November 2011, pp. 2-3.

39 United Energy, Submission on Network Support Payments and Avoided TUOS for Embedded Generators rule change request, 21 July 2011, p. 14.

40 Ibid.

41 AEMC, *Network Support Payments and Avoided TUOS for Embedded Generators*, Final rule determination, 22 December 2011, pp. 25-26.

42 Ibid.

43 Ibid.

44 Ibid.

45 Ibid.

46 Ibid.

47 Ibid.

the rule as made would detrimentally impact upon DNSPs entering into contracts with embedded generators whether this occurred in Victoria or any other jurisdiction.⁴⁸

2.4.5 Rule change on cost pass through arrangements for network service providers (2012)

In 2012, the AEMC made a determination with respect to the cost pass through regimes for distribution and transmission.⁴⁹ We emphasised that cost pass throughs should be only used where other, more suitable means of addressing these costs are less appropriate.⁵⁰ This is to protect the incentive mechanisms that operate under the building block approach used in regulatory determinations.⁵¹ It also ensures that prices for consumers are no more than necessary to provide an appropriate level of service.⁵²

However, the AEMC also recognised that the NSP should be provided with a reasonable opportunity to recover its efficient costs for providing regulated services.⁵³ These costs include events that are outside of its reasonable control.⁵⁴

Of particular relevance to this SP AusNet rule change request, the AEMC extended nominated pass throughs to transmission. Additional factors were also introduced for the AER to consider when determining nominated pass throughs.⁵⁵

2.4.6 Review on Power of Choice (2012)

Also in 2012, the AEMC considered the treatment of demand-side participation (DSP) as opex at regulatory resets in which network support service arrangements are a type of contracted DSP.⁵⁶ There was the possibility that the DNSPs' DSP projects could straddle over multiple regulatory control periods, and the opex roll forward arrangement for transmission network support service arrangements was considered as a possible solution.⁵⁷

However, the AEMC decided not to recommend making such an amendment to the distribution rules.⁵⁸ The AER's submission to the review stated that it will be better to

48 Ibid.

49 AEMC, *Cost pass through arrangements for Network Service Providers*, Final rule determination, 2 August 2012, p. 20.

50 Ibid, p. i.

51 Ibid.

52 Ibid.

53 Ibid.

54 Ibid.

55 Ibid.

56 AEMC, *Power of choice review - giving consumers options in the way they use electricity*, Final report, pp. 228-229.

57 Ibid.

58 Ibid.

consider the efficiency of expenditure at each reset than implementing a rule change which requires the AER to automatically accept future costs of an earlier agreement.⁵⁹ We agreed with the AER that it would be superior for the AER to consider the efficiency and prudence of all on-going DSP costs at each regulatory reset than locking in expenditure that might not be required in future regulatory control periods.⁶⁰ The DNSP can substantiate a case to the AER for such costs as part of its revenue proposals.⁶¹

Further, we also noted that the transmission opex roll forward arrangement is specific to one form of DSP ie transmission network support service arrangements.⁶² We considered that it would be very hard to draft and apply a similar provision which covers all forms of DSP.⁶³

Notwithstanding the above, the AEMC considered that the element of uncertainty associated with maintaining the current opex arrangements for DNSPs' DSP projects could be reduced if the AER publishes principles or guidelines on the factors for considering their efficiency at regulatory resets.⁶⁴ We note that the AER is currently developing guidelines as part of its Better Regulation program.

59 Ibid.

60 Ibid.

61 Ibid.

62 Ibid.

63 Ibid.

64 Ibid.

3 Details of the rule change request

3.1 Proponent's identification of the problem

There are two specific issues that the proponent raises:

- DNSPs are unable to recover costs for distribution network support service arrangements in the same way TNSPs can for transmission network support service arrangements via specific network support pass throughs (including the opex roll forward arrangement); and
- DNSPs and TNSPs are unable to recover costs for transmission connection support service arrangements via specific network support pass throughs (including the opex roll forward arrangement).

3.1.1 Cost recovery mechanism for transmission network support service arrangements extended to distribution

With respect to the first issue, from the proponent's perspective, this would mean:

- DNSPs cannot recover costs of distribution network support service arrangements initiated within the current regulatory control period;
- DNSPs have less incentive to contract distribution network support service arrangements until the next regulatory control period even if these are the lowest cost solutions; and
- DNSPs are not afforded with the same level of certainty to recover costs for distribution network support service arrangements as TNSPs have under specific network support pass throughs (including the opex roll forward arrangement).

3.1.2 Cost recovery mechanism for transmission network support service arrangements extended to deferred transmission connection assets

With respect to the second issue, this is of particular interest to Victorian DNSPs who are responsible for transmission connection planning. The proponent considers that DNSPs would be more likely in Victoria to enter into transmission connection support service arrangements.

Similar issues described in section 3.1.1 with respect to distribution network support service arrangements can also apply to transmission connection support service arrangements. Here, there is also the question of DNSPs being unable to recover costs for deferred transmission connection assets.

3.2 Proponent's proposed solution to the problem

The proponent's rule change request proposes to amend the NER to:

- allow DNSPs to recover distribution network support service arrangements through specific network support pass throughs equivalent to that currently available to TNSPs;
- apply the opex roll forward arrangement to DNSPs where network support service arrangements cross over multiple regulatory control periods; and
- extend the scope of specific network support pass throughs (which includes the opex roll forward arrangement) to allow for TNSPs and DNSPs to recover costs for transmission connection support service arrangements.

The proponent's rule change request includes a proposed rule.

3.3 Proponent's rationale for the solution

In its rule change request, the proponent provides its rationale for the proposed rule. It states that the proposed rule would:

- promote efficient investment, which in turn would benefit customers, by allowing TNSPs and DNSPs to consider network and non-network solutions associated with network augmentations and transmission connection assets on an equal footing;
- enable recovery of efficient costs for:
 - DNSPs with respect to distribution network support service arrangements; and
 - TNSPs and DNSPs with respect to transmission connection support service arrangements; and
- remove a potential disadvantage against providers of network support services where the cost recovery arrangements currently do not favour distribution network and transmission connection support service arrangements.

4 Assessment framework

The Commission may only make the proposed rule if satisfied that it promotes the national electricity objective (NEO) as set out under section 7 of the NEL. The NEO under section 7 of the NEL states:

“The objective of the Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to-

- (a) price, quality, safety, reliability and security of supply of electricity;
and
- (b) the reliability, safety and security of the national electricity system.”

The Commission's assessment of the rule change request must also include other considerations such as taking into account the revenue and pricing principles and any relevant Standing Council on Energy and Resources (SCER) statement of policy principles.⁶⁵ We consider that there is no relevant SCER statement of policy principles.

Efficiency in the long term interests of consumers is about reliable supply at lowest possible cost. With this in mind, in assessing the rule change request, the following points aim to reflect the NEO:

- the ability of the proposed rule to provide **effective incentives**. A NSP should have an incentive to only incur costs which are efficient. This should also encourage innovation. This promotes productive and dynamic efficiency and is in the long term interests of consumers with respect to price;
- the ability of the proposed rule to allow **efficient selection of network and non-network solutions**. The NSP's choice on whether to augment its network to transport electricity from sources of production to meet demand or seek network support service arrangements to locate embedded generation on its network will impact on the cost of meeting demand and therefore productive and dynamic efficiency. The extent to which the NSP can choose alternative options for meeting demand at potentially lower costs will increase this level of efficiency. The NSP may need to trade-off the risk between long term solutions with higher costs and short term solutions with lower costs;
- the ability of the proposed rule to allow **recovery of efficient costs**. Regulation should only allow for an "efficient" level of costs to be recovered by NSPs (including a reasonable profit), rather than allowing an automatic pass through of all expenditure. Costs are efficient if they are lower than the value of the benefit they provide. In the case of network investment, the benefit provided is

⁶⁵ The revenue and pricing principles are set out under section 7A of the NEL. Under section 33 of the NEL, the AEMC must have regard to any relevant Ministerial Council on Energy (now known as the SCER) statement of policy principles in making a rule. As of the publication of this Consultation Paper, there is no relevant SCER statement of policy principles.

increased reliability of electricity supply. Setting the appropriate level of scrutiny via the appropriate cost recovery mechanism should reflect this ideal. Keeping prices to consumers close to long term costs of production promotes allocative efficiency; and

- the ability of the proposed rule to allow for **proportionality**. The costs arising from the processes and regulatory requirements should be proportionate to the benefits. For instance, the implementation and administration costs of the proposed rule need to be proportionate to the benefits of the proposed rule.

The above points are also consistent with the revenue and pricing principles. In particular:

- the NSP should be provided with effective incentives in order to promote economic efficiency with respect to direct control network services that it provides;⁶⁶ and
- the NSP should be provided with a reasonable opportunity to recover at least the efficient costs in providing direct control network services.⁶⁷

Under section 91(8) of the NEL, the Commission may only make a rule that has effect with respect to an adoptive jurisdiction if satisfied that the proposed rule is compatible with the proper performance of AEMO's declared network functions. The proposed rule does not appear to affect these functions.

Question 1 **Is the assessment framework presented in this consultation paper appropriate for assessing this rule change request?**

⁶⁶ NEL section 7A(3).

⁶⁷ NEL section 7A(2)(a).

5 Issues for consultation

We have identified a number of issues for consultation that appear to be relevant to this rule change request. These issues outlined below are provided for guidance. Stakeholders are encouraged to comment on these issues as well as any other aspect of the rule change request or this paper including the proposed assessment framework.

5.1 Extent of the problem

In consideration of the rule change request, it is important to understand the materiality of the problem if it exists.

To provide an example of the possible magnitude for network support service arrangements, Table 5.1 below shows these costs incurred by Victorian DNSPs in the previous regulatory control period 2006-2010.⁶⁸

With respect to SP AusNet's costs in Table 5.1, these included costs for the network support service arrangement with the owners of Bairnsdale Power Station. Therefore, in the context of this rule change request, the magnitude of unrecoverable costs as it relates to SP AusNet may be now less than what is represented in Table 5.1 below.⁶⁹ Also, it is unclear whether the costs provided in this table include transmission connection support service arrangements.

Table 5.1 Example of materiality of costs relating to network support service arrangements: Victorian DNSP costs for the regulatory period 2006 to 2010

Victorian DNSP	Total network support costs (2006-10) (\$m, nominal) (note 1)	Proportion of total network support costs (2006-10) to total revenue requirement (2011-15) (%) (note 2)
CitiPower	0	0
Jemena	2.936	0.3
Powercor	0	0
SP AusNet	43.66	1.78
United Energy	0.025	0

Note 1: Sourced from United Energy Distribution (on behalf of the Victorian electricity distributors) submission on DNSP recovery of transmission-related charges rule change request, 3 September 2010, pp. 9-10.

⁶⁸ This information was provided as part of the submission from Victorian DNSPs on the DNSP Recovery of Transmission-related Charges rule change process.

⁶⁹ The AEMC's final rule determination for that rule change allowed for SP AusNet's Bairnsdale Power Station network support service arrangement to be recovered as part of the transitional arrangements because it was a legacy agreement approved by the ESCV.

Note 2: Total revenue requirement sourced from the AER's final regulatory determination for Victorian DNSPs for the regulatory control period 2011-2015 (29 October 2010, p. 832).

As noted before, the above is only an example of the magnitude of costs with respect to Victorian distribution network support service arrangements (and possibly transmission connection support service arrangements). It does not represent the magnitude of costs across the NEM. Therefore, we are uncertain of the materiality across the NEM with respect to this rule change.

We also note that over time, the number of DSP projects may increase for DNSPs. Therefore, if the number of distribution network support service arrangements is material at this time, it may therefore be substantially greater in the future and provide more weight to justify this rule change.

We welcome more evidence from stakeholders to substantiate the extent and materiality of the problem. Such evidence could include existing costs to NSPs and embedded generators for network support service arrangements, the number of network support service arrangements, and the purpose of those network support service arrangements.

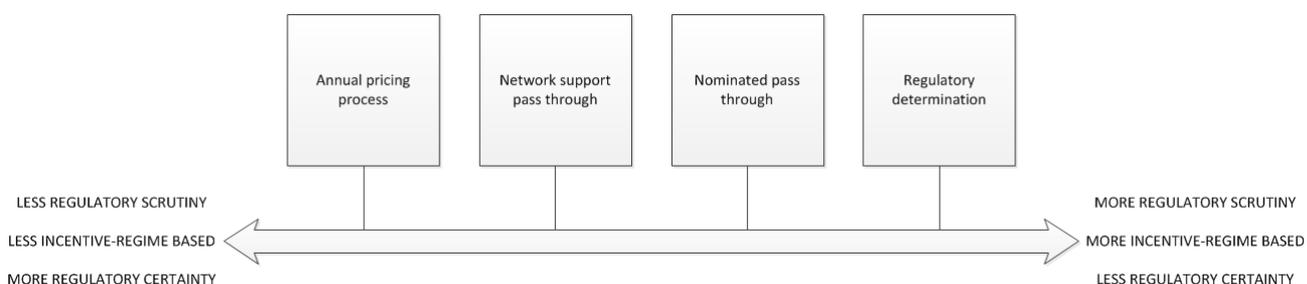
Question 2 **Is the recovery of costs for network support service arrangements a material problem in the NEM? If so, please provide evidence to support your views.**

5.2 Cost recovery of distribution network support service arrangements

5.2.1 Cost recovery options

In section 2.2, we noted a number of possible avenues in which NSPs could recover costs associated with network support service arrangements. However, each approach differs in terms of regulatory scrutiny and nature. Figure 5.1 provides a comparison between the different ways in which costs associated with network support service arrangements could be recovered and the degree of regulatory scrutiny, incentives, and regulatory certainty.

Figure 5.1 Differences between cost recovery options for network support service arrangements



In this section, we consider specifically cost recovery mechanisms for distribution network support service arrangements as it relates to DNSPs. The same questions about the appropriate cost recovery mechanisms could arise in relation to transmission connection support service arrangements, but these will be discussed further under sections 5.3 and 5.4 as it relates to both TNSPs and Victorian DNSPs.

Regulatory determinations

Network regulation under the NER is based on the principles of incentive regulation. A NSP forecasts required expenditure, the regulator approves an allowance, and then the NSP is rewarded if it can “beat” the allowance during the regulatory control period by retaining any underspend for the remainder of the period, and bears the risk of costs being higher than the allowance. This encourages NSPs to incur only efficient costs, and by revealing the level of efficient costs consumers can benefit in future regulatory periods through lower costs.

With respect to distribution network support service arrangements, it is questionable whether it should be treated differently to any other type of DSP project. Notably, the AEMC was of the view in its Power of Choice review that DSP projects in general should be better considered under the regulatory determination process to allow for sufficient regulatory scrutiny for such projects.⁷⁰

Cost pass throughs

Ideally, all costs should be recovered through the regulatory determination process. This is because this process provides the most sufficient level of regulatory oversight to protect consumers, is consistent with the principles of incentive regulation, and ensures the efficiency of such costs.

However, it is acknowledged that certain costs are wholly or largely beyond the control of the NSP, such as those resulting from a change in regulatory arrangements (eg change in reliability standards or safety regulations). Since NSPs are less able to minimise these costs, they are given a special status within the regime.

Subject to AER approval, these costs may be added to the NSP’s revenue allowance mid-period. If such an approach was not taken for these types of costs then the risks faced by an NSP would be higher, which may mean the cost of capital required by its investors would be higher.

Specific network support pass throughs

For specific network support pass throughs to be appropriate for distribution network support service arrangements, these arrangements should have some quality that distinguishes them from other costs in their controllability by NSPs. It may be that they are exceptionally difficult to forecast. Alternatively, recovery in this way may promote network support solutions as efficient alternatives to capex.

⁷⁰ The AEMC’s reason for this is provided in section 2.4.6 of this paper.

The question to be considered is whether such specific pass throughs should be subject to the same criteria as nominated pass throughs. That is, a distribution specific network support pass through may only be accepted when it is the least inefficient option, and event avoidance, mitigation, commercial insurance and self-insurance are found to be inappropriate.

Nominated pass throughs

For a specific network support pass through to be appropriate for distribution network support service arrangements, there should be some reason why these arrangements should not be included as a nominated pass through event. Related to this, there should also be some reason why less scrutiny should be given to distribution network support service arrangements via specific network support pass throughs as opposed to under nominated pass throughs.

For example, if the benefits of such a category of cost pass through are clear and certain, it may be that it should be prescribed in the NER rather than being subject to AER approval at the time of a regulatory determination. This would, however, offer less flexibility than allowing the AER to include distribution network support service arrangements as a category of nominated pass through event in its regulatory determination.

In addition, we noted in sections 2.2.2 and 2.2.3 that a materiality threshold applies to nominated pass throughs while there are none applicable to specific network support pass throughs. This raises a question as to why distribution network support service arrangements should not be subject to a materiality threshold if specific network support pass throughs were to apply to them.

We note that Victorian DNSPs did not seek to have a nominated pass through for network support service arrangements in the last AER regulatory determination. Therefore, Victorian DNSPs are unable to recover any costs via this option during this regulatory control period. Pending the AEMC's rule determination on DNSP recovery of transmission-related charges at the time, the AER had approved nominated pass throughs relating to network charges. In particular, this allowed for nominated pass through applications for the total of the avoided TUOS, inter-DNSP payments and transmission connection costs a DNSP has incurred, up until 31 May of any one year or period during the forthcoming regulatory control period.⁷¹

Opex roll forward arrangement

If the transmission cost recovery regime for transmission network support service arrangements was fully applied to distribution network support service arrangements, then the opex roll forward arrangement would also need to be considered in addition to the specific network support pass through. If such a regime was extended to distribution network support service arrangements, then the DNSP would be

⁷¹ AER, Victorian electricity distribution network service providers: Distribution determination 2011-2015, Final decision, October 2010, pp. 787-789.

guaranteed ongoing cost recovery for distribution network support service arrangements that occurred in the previous regulatory control period.

Generally, network support service arrangements may comprise of two elements: an availability payment and a performance payment if the non-network option is called on.⁷² There is uncertainty about whether NSPs will be able to recover payments under an ongoing network support service arrangement (operating expenses) in future regulatory control periods. Payments made in the previous regulatory control period may not be an accurate reflection of costs in subsequent regulatory control periods because a network support option may not have been called upon in the initial regulatory control period. To address this potential problem in transmission, the opex roll forward arrangement was introduced in 2009 which guarantees that the remaining costs of a transmission network support service arrangement must be accepted as allowed opex in future regulatory determinations.

This raises the issue of whether the same concern in 2009 for transmission network support service arrangements could also apply to distribution network support service arrangements. That is, compared to capex for a network solution, whether the DNSP would have less certainty with the AER approving its revenue allowance as opex for ongoing distribution network support service arrangements if the incurred costs continued over the next regulatory control period.⁷³ We need to assess whether the DNSP would be susceptible to increased risks associated with cost recovery for distribution network support service arrangements via opex, and be disincentivised against entering into those arrangements.⁷⁴

In the absence of the opex roll forward arrangement, the DNSP may be discouraged from recovering costs for distribution network support service arrangements as opex. This is because opex is set on a "revealed cost" basis, meaning that historical costs would be used to determine future costs. If there are low costs associated with such arrangements in a previous regulatory control period, the DNSP may not be able to recover full costs for these arrangements in the forthcoming regulatory control period.

Alternatively, the DNSP could seek a capex allowance. However, although the overall costs may be low for distribution network support service arrangements compared to the alternative network solution, the depreciative nature of the capex allowance may not be a viable option for the DNSP to recover these costs.

In the AEMC's Power of Choice review, the AEMC decided not to recommend the application of the opex roll forward arrangement to DSP projects in general.⁷⁵ As network support service arrangements are a subset of DSP, a question is raised as to why these arrangements should be treated any differently from other types of DSP projects.

⁷² AEMC, *Power of choice review - giving consumers options in the way they use electricity*, Final report, p. 228.

⁷³ AEMC, *Demand Management*, Final rule determination, 23 April 2009, p. 36.

⁷⁴ Ibid.

⁷⁵ The AEMC's reason for this is provided in section 2.4.6 of this paper.

Question 3 **Should recovery of costs associated with distribution network support service arrangements be subject to full incentive regulation ie only permitted to be recovered as part of the revenue allowance?**

Question 4 **If distribution network support service arrangements were to be recovered through a pass through regime, is the current “nominated pass through” the appropriate mechanism? Or, should the current specific network support pass through and/or the opex roll forward arrangement apply?**

5.2.2 Differences between distribution and transmission

Scope of the rule change request

The issue raised by the proponent primarily relates to distribution, although there is an element of transmission raised through the transmission connection assets issue. Given this, we are proposing to limit any rule changes to the distribution issues and not the arrangements for transmission (with the exception of transmission connection support service arrangements). That is, our view is that the scope of the rule change request does not allow changes to the current transmission arrangements beyond those that apply in respect of transmission connection assets.

However, when determining what changes should be made to distribution, we will need to bear in mind if there are any substantive reasons for any difference between transmission and distribution.

Differences between distribution and transmission

The AEMC has previously stated that generally the rules for distribution and transmission in Chapters 6 and 6A respectively should be the same unless there are substantive reasons for a difference.⁷⁶ There should be no reason for any differences unless these are based on a fundamental difference between the characteristics of transmission and distribution networks or their owners.⁷⁷ Differences in the NER not based on this may lead to ambiguity and a loss of clarity.⁷⁸ In time, it may be possible for Chapters 6 and 6A to be merged into one.⁷⁹

⁷⁶ AEMC, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services*, Final rule determination, 29 November 2012, p. 97.

⁷⁷ Ibid.

⁷⁸ Ibid.

⁷⁹ Ibid.

There may be substantive reasons for the differences between the current arrangements for cost recovery of distribution and transmission network support service arrangements. For example, there are differences in size between projects in transmission and distribution. Transmission projects are likely to be larger but less in number than in distribution. In distribution, if distribution network support service arrangements are used for more numerous and smaller projects, the administrative burden on the AER to assess them may not be proportional to the net benefit of the projects. This is because there would be an increase of mini determinations mid-period.

We also note that when specific network support pass throughs (including the opex roll forward arrangement) were added to Chapter 6A there was no possibility of recovery through nominated pass through events. Nominated pass throughs are now available in transmission, which aligns the standard cost pass through arrangements between transmission and distribution.

If specific network support pass throughs (including the opex roll forward arrangement) also apply to distribution network support service arrangements, then it could be argued that there would be a reduction in the level of risks for DNSPs associated with having expenditure approved and uncertainty of forecast expenditure. With such reduction in risks, this could mean a reduction to the rate of return for capex and opex which reflects the relative risks and values of either type of expenditure.

If it is justified that distribution should be treated differently to transmission, and not allow specific network support pass throughs (including the opex roll forward arrangement) for distribution network support service arrangements, it would still be possible to make a more preferable rule.⁸⁰ For instance, specific network support pass throughs (including the opex roll forward arrangement) could be introduced for transmission connection support service arrangements only. This is discussed in the next section.

Question 5 **Are the differences between transmission and distribution sufficient to justify different cost recovery mechanisms for transmission and distribution network support service arrangements?**

5.3 TNSP cost recovery of transmission connection support service arrangements

As an alternative to transmission connection assets, the TNSP could consider that a non-network solution is a better alternative for providing prescribed exit services. The

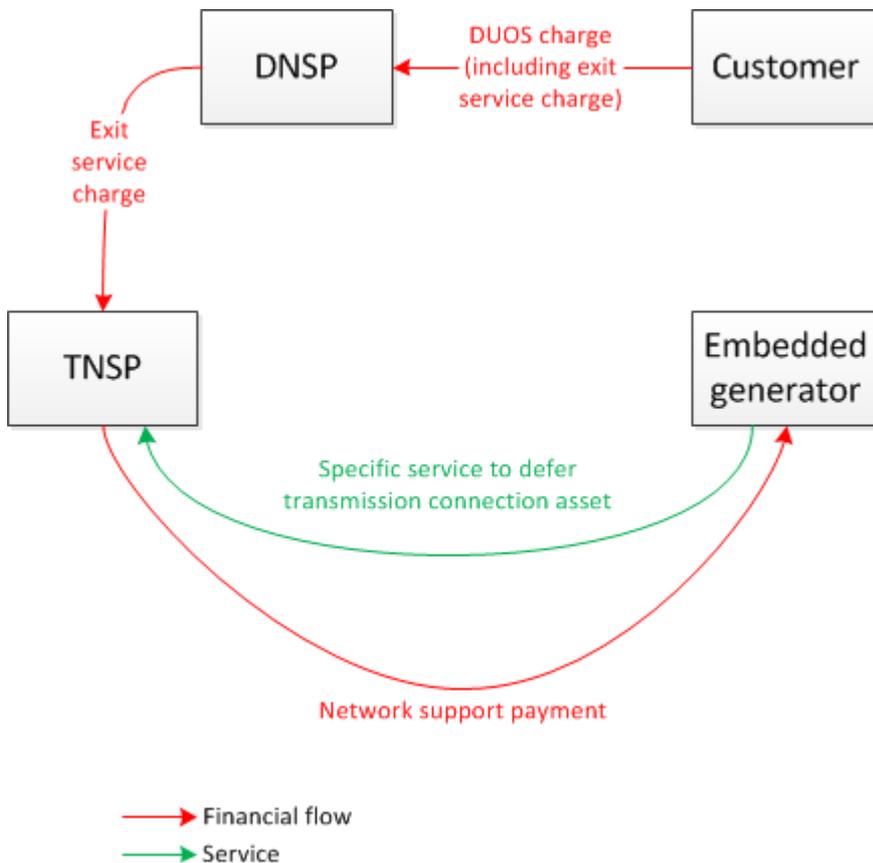
⁸⁰ Under section 91A of the NEL the AEMC may make a rule that is different (including materially different) from a market initiated proposed rule (a more preferable rule) if the AEMC is satisfied that, having regard to the issue or issues that were raised by the market initiated proposed rule (to which the more preferable rule relates) the more preferable rule will or is likely to better contribute to the achievement of the national electricity objective.

TNSP currently can only recover transmission connection support service arrangements under its revenue allowance or as a nominated pass through if available. However, if the TNSP has a limited revenue allowance or the arrangement cannot be (or has not been) classified as a nominated pass through event, it may not be able to consider this option.

If a rule change was made to allow transmission connection support service arrangements to be recovered via the specific network support pass through (including the opex roll forward arrangement), then there may be an increased likelihood that these transmission connection support service arrangements could be undertaken mid-period.

Such a transmission connection support service arrangement would be likely to be recovered on the same basis as if a transmission connection asset was built. This means that the type of charge on customers for the TNSP to recover costs under either the network or non-network option with respect to a transmission connection asset would be the same because it provides the same service, being a prescribed exit service. This would be recovered entirely from the DNSP connecting at the connection point. To illustrate this point, see Figure 5.2 below.

Figure 5.2 Proposed approach for TNSPs to recover costs for transmission connection support service arrangements



A possible reason that transmission connection support service arrangements are excluded from being recovered under specific network support pass throughs

(including the opex roll forward arrangement) may be because there are various types of connection assets. In this rule change request, we refer to transmission connection assets which connect the transmission and distribution networks and provide for prescribed exit services. However, there are other types of connection assets that provide services which are not prescribed exit services. For instance, connection services for large loads and generators would be regulated as negotiated services and raise different issues.

More generally, a reason for treating transmission connection assets differently from augmentations of the shared network may be that for a connection there is only a single counter-party. That party could itself contract with a non-network service provider to defer the need for a transmission connection asset (and therefore service). In contrast, the shared transmission network is used by everyone, and so it is necessary for the users to jointly appoint an agent (the TNSP) to procure non-network solutions on their behalf.

There could be other valid reasons why transmission connection support service arrangements were never recoverable under specific network support pass throughs (including the opex roll forward arrangement). We welcome stakeholder views as to why it has not and whether it should be.

<p>Question 6 Are there reasons why specific network support pass throughs should allow for transmission connection support service arrangements?</p>
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5.4 Victorian arrangements

In section 2.3, we considered the Victorian arrangements for transmission connection assets where Victorian DNSPs are responsible for planning and directing these assets, and making investment decisions for these assets. Given these arrangements, Victorian DNSPs may have an incentive to seek non-network alternatives to augmentation of transmission connection assets if they are a lower cost option. Victorian DNSPs may prefer to enter into a transmission connection support service arrangement with an embedded generator and seek to recover those costs from their customers. SP AusNet as a TNSP may not wish to bear the risk of entering such an arrangement where it does not have the responsibility for choosing the non-network option.

However, as the current NER do not allow transmission connection support service arrangements to be recovered under specific network support pass throughs (including the opex roll forward arrangement), Victorian DNSPs may not be allowed to recover costs for transmission connection support service arrangements mid-period. That is, unless these arrangements could be classified as nominated pass throughs or allowed for as part of the DNSP's revenue allowance.

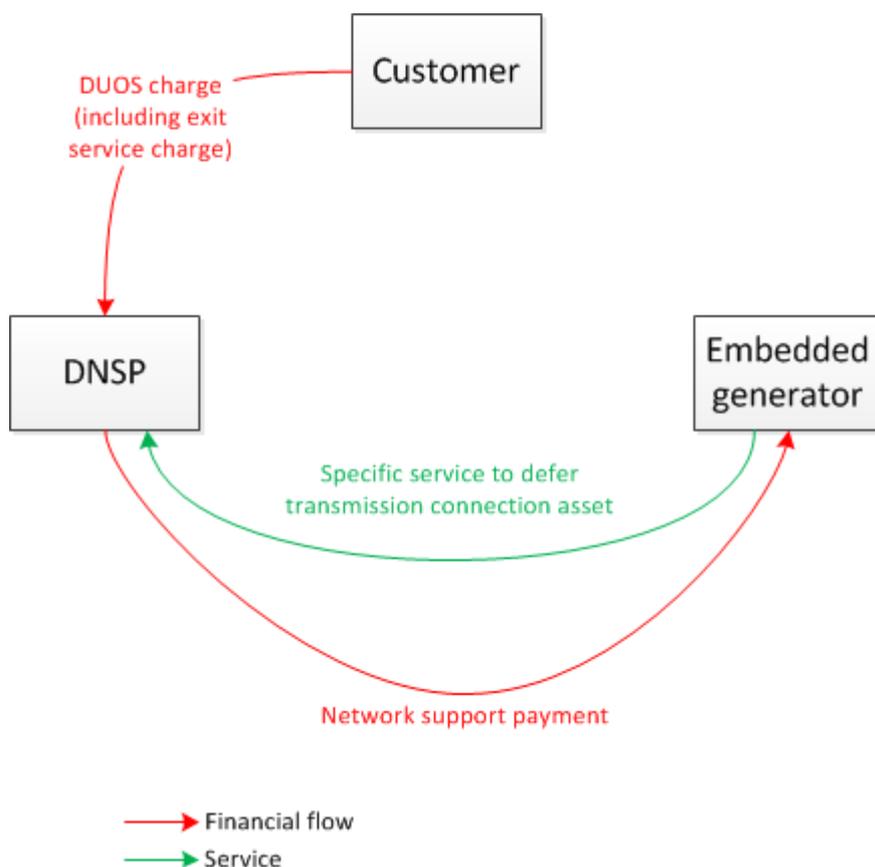
We discussed in section 5.3 the scenario in which the TNSP could recover costs for transmission connection support service arrangements. However, the proponent's

proposal to extend this to DNSPs as well could create a different basis in recovering costs under the network option versus non-network option. This is because under the network option according to the NER, the TNSP levies the prescribed exit service charge onto the DNSP (who in turn would recover these costs onto its own customers).

On the other hand, under the non-network option as proposed by the proponent, the DNSPs would be able to bypass the TNSP by directly levying its customers. This could involve a DNSP recovering costs for network support service arrangements that defer augmentation of transmission assets. It is unclear whether this would mean a DNSP can recover for the provision of a transmission service in its own network charges associated with deferring a transmission connection asset.

This raises the question on whether there should be a clear delineation between the one who plans for that asset to provide a service and the one who charges for the provision of that service. It is also unclear whether TNSPs or DNSPs in other jurisdictions currently utilise transmission connection support service arrangements as Victorian DNSPs propose it could do. To illustrate this point, see Figure 5.3 below.

Figure 5.3 Proposed approach for DNSPs to recover costs for transmission connection support service arrangements



Question 7 Should DNSPs be able to recover costs for deferring transmission connection assets?

Question 8 **Is this problem unique to Victoria? Should this be addressed through Victorian specific arrangements?**

5.5 Savings and transitional requirements

If a rule change were made, there are two possibilities on when the rule could commence: at the next regulatory reset; or immediately. With respect to the former option, this would mean that affected NSPs would be unable to recover costs associated with their network support service arrangements mid-period where these were not incorporated as part of their regulatory determinations. If the latter option applied, it would mean that NSPs may be able to recover these costs mid-period.

In general, the AER's revenue allowance assumes a certain set of regulatory arrangements. For example, the allowed rate of return is based on, among other things, the risk faced by the NSP. The capex and opex allowances may also be based on the ability for the NSP to recover network support service arrangements during the regulatory control period. If specific network support pass throughs (including the opex roll forward arrangement) are introduced or expanded mid-period, the AER's regulatory determination could not be revisited. To continue the rate of return example, if specific network support pass throughs (including the opex roll forward arrangement) are introduced, the risk would reduce, yet the allowed rate of return would not have changed. This suggests it may be more appropriate to commence any rule change at the time of the next regulatory reset.

Question 9 **If a rule were to be made, when should the rule commence operation?**

Question 10 **Are there any other transitional requirements that should apply to the rule change?**

5.6 Impact on existing jurisdictional requirements

If changes were made to the NER, consideration needs to be given to any potential overlap between the existing jurisdictional arrangements (where they exist) for each jurisdiction and the NER. For instance, Victorian DNSPs are subject to licence conditions setting out their responsibility for planning, and directing the augmentation of, transmission connection assets.⁸¹

⁸¹ Victorian distribution licence, clause 14.

We are not aware of any overlap at this stage and welcome comments from stakeholders with respect to this and any other jurisdictional arrangements.

Question 11 **Are there any relevant jurisdictional requirements that may be impacted by the rule change? If so, please specify which instrument and when the potential overlap or conflict arises.**

6 Lodging a submission

The Commission has published a notice under section 95 of the NEL for this rule change request inviting written submissions. Submissions are to be lodged online or by mail by 10 May 2013 in accordance with the following requirements.

Where practicable, submissions should be prepared in accordance with the Commission's Guidelines for making written submissions on rule change requests.⁸² The Commission publishes all submissions on its website subject to a claim of confidentiality.

All enquiries on this project should be addressed to Charles Hoang on (02) 8296 7800.

6.1 Lodging a submission electronically

Electronic submissions must be lodged online via the Commission's website, www.aemc.gov.au, using the "lodge a submission" function and selecting the project reference code ERC0154. The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.

Upon receipt of the electronic submission, the Commission will issue a confirmation email. If this confirmation email is not received within 3 business days, it is the submitter's responsibility to ensure the submission has been delivered successfully.

6.2 Lodging a submission by mail

The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated. The submission should be sent by mail to:

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

or by fax to (02) 8296 7899.

The envelope must be clearly marked with the project reference code: ERC0154.

Except in circumstances where the submission has been received electronically, upon receipt of the hardcopy submission the Commission will issue a confirmation letter.

If this confirmation letter is not received within 3 business days, it is the submitter's responsibility to ensure successful delivery of the submission has occurred.

⁸² This guideline is available on the Commission's website.

Abbreviations

AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
capex	capital expenditure
Commission	See AEMC
CRNP	cost reflective network pricing
DNSP	distribution network service provider
DSP	demand-side participation
ESCV	Essential Services Commission of Victoria
MAR	maximum allowed revenue
NEL	National Electricity Law
NEM	national electricity market
NEO	national electricity objective
NER	National Electricity Rules
NSP	network service provider
opex	operating expenditure
proponent	SP AusNet
RAB	regulatory asset base
RIT-T	regulatory investment test for transmission
rules	See NER
SCER	Standing Council on Energy and Resources
TNSP	transmission network service provider
TUOS	transmission use of system