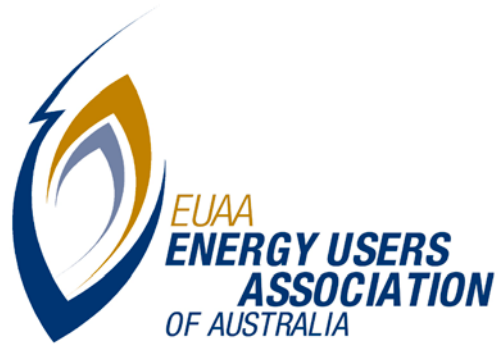


The Australian Energy Market Commission

Via: www.aemc.gov.au

24 November 2016



To whom it may concern,

AER Proposed Rule Change for Replacement Expenditure Planning Arrangements

Thank you for the opportunity to participate in this important process.

The Energy Users Association of Australia (EUAA) is the peak body representing major Australian energy users. Our membership covers a broad cross-section of the Australian economy including significant retail, manufacturing and materials processing industries.

The annual energy bills paid by our members collectively amounts to many billions of dollars and constitutes a significant cost to their business. Even small movements in energy prices can make a big difference to the financial stability of our members and greatly affects their ability to create employment and shareholder returns.

The EUAA welcomes the Australian Energy Regulator's proposed rule change relating to electricity networks' replacement expenditure and its focus on the National Electricity Objective of the long-term interests of consumers.

Consumers are now paying a high price for failures in past network regulation when we consider that the level of approved investment, operating costs and WACC were all above what an efficient network would need to build and operate the network to meet the NEO.

It is pleasing to see that, as the AEMC notes in its Consultation Paper on this matter, that there are a range of related initiatives within COAG and the AEMC to address the past lack of focus on the NEO in network regulation.

Energy users have watched with interest how the NEO has been interpreted over time – generally by parties that are not consumers and with little consultation. In network regulation, the NEO was interpreted as requiring networks to have the ability to earn a high rate of return that did not, in consumers' views, reflect the relative allocation of risk between networks and consumers.

It has been claimed this was so to ensure the networks invested to meet mandated reliability standards. The assumption was that this is what consumers wanted. Unfortunately, consumers were not given the opportunity to provide their views on the balance between price and reliability. Efforts to ensure network efficiency, such as via benchmarking, were limited until recently and in any case networks continue to find reasons why their circumstances are different to the benchmark case and hence benchmarking has had limited application or positive price effects for consumers.

It is our view that network regulation produced a strong bias allowing asset owners to constantly propose network solutions that increased their regulated asset base (RAB) on which they would earn the high WACC. Networks were very successful in increasing their RAB, leveraging their information asymmetry and a merits review process to their favour.

Consumers now see past network regulation leaving a legacy of a large increase in network prices and, given the fall in network demand well below what the networks had forecast, many stranded or underutilized assets of a 20th century grid that consumers must pay for.

Now we have the challenge to build a 21st century grid to ensure system security and reliability with much more distributed intermittent renewable generation. This requires the transparent and comprehensive consideration of all network and non-network solutions. Technology and consumer demand patterns are changing rapidly and network solutions are long-lived assets and may continue to be left behind. If there is not a significant recalibration of attitudes to network investment we will see consumers paying for stranded assets built for the 20th century energy system not the vastly different 21st century grid that we see will be required.

While this rule change is being considered in the context of other related rule changes, it must be seen in the context of a more holistic approach to electricity market reform. A major reason for the current level of stranded assets was the lack of political will to move to cost reflective pricing for both the network and energy components in the past. The absence of peak load pricing meant massive network investment for the peak, which did not eventuate as forecast. So rather than a few consumers paying a bit more for their peak consumption, everyone now pays a lot more for many years for network assets that are no longer required.

This lack of political will continues as moves to implement cost reflective network tariffs face political barriers. Market signals will continue to be distorted and bad network investment will continue to be made with consumers having to foot the bill. In the absence of this political will, consumers are left with supporting rule changes such as this to get more discipline in network planning and to overcome the inherent higher RAB bias in the network regulation framework.

Overall the EUAA strongly supports the proposed rule change. However, we consider that it does not go far enough in some aspects. This is particularly around the principle of balancing regulatory burden and the benefits of greater transparency and consultation to achieving the NEO. We think that the AER has erred too far on the side of reducing the regulatory burden and the AEMC Consultation Paper gives too much emphasis and hence apparent credence, to the balance between the two.

Overinvestment in the past was facilitated by the large information asymmetry between the networks on the one hand and the AER and consumers on the other. The volume of material and the form in which it was presented by networks, created huge barriers for consumers and the AER in undertaking the required evaluation. This rule change proposal goes some way to “lifting the veil” to improve transparency. We think it could have gone further by requiring even more transparency and information disclosure.

The criteria used by the AER on where to draw the “transparency line” for further disclosure is “regulatory burden” and “administrative cost”. We think the AER has used these criteria to draw the line too much in favour of the networks. As the AER notes in its rule change application¹

“Network businesses will also already have internal planning procedures in place for asset management, including retirement and reinvestment. The rule change will likely fine-tune these planning processes and require them to be undertaken transparently and consultatively...Currently, internal best practice planning requires that project options are assessed to determine the most efficient outcome...We therefore expect the additional costs will primarily relate to the administrative costs of consultation and administration of the APR reporting requirements...these additional costs may be minimised by using the existing planning processes already available for augmentation.”

Given a choice between paying for a small increase in regulatory compliance costs for networks and paying for a bad investment decision for the next 30 years, consumers will always favour the former.

Finally, we would emphasise the crucial importance of ensuring the AER has sufficient resources to undertake the tasks that would result from this rule change, specifically:

- Establishing the guidelines for the analysis to apply to all networks e.g. risk analysis, probability of failure and consequences, and
- critically and comprehensively reviewing the information provided by the networks

The AER have clearly been under-resourced in the past and this has enabled the networks to escape the scrutiny their proposals should have had to give comfort to consumers the NEO was being

¹ AER Request for Rule Change p.20

implemented. Implementation of the proposed rule change will bring significant benefits to consumers if implemented quickly and efficiently by a properly resourced AER.

Further, the EUAA believes that expanding the role of the Consumer Challenge Panel to evaluate the network investment proposals e.g. exemption reports, following this rule change would be valuable contribution towards achieving the NEO.

Specific Questions asked in the Consultation Paper

The problem

Question 1

- (a) Are non-network solutions a viable alternative to replacing network assets on a like for like basis*
- (b) How does this differ from the potential for a non-network solution to provide a viable alternative to augmenting the network?*

Question 2

- (a) Are the current annual planning reporting requirement in the NER relevant and likely to be useful for replacement expenditure?*
- (b) If any, where are the gaps in the current annual planning reporting requirements in the NER for replacement expenditure?*

Question 3

- (a) What do NSPs currently do to plan for asset replacement in practice?*
- (b) To what extent does this address the perceived problems identified by the AER?*

The combination of changes in technology availability and cost and changes in demand patterns across the networks mean that non-network solutions are increasingly viable alternatives for both network replacement and augmentation. This is particularly the case where changing grid demand patterns mean that a like for like replacement may not be required. The EUAA agrees with the AER that the current Chapter 5 arrangements do not adequately focus on planning for network replacement, where the focus is on replacement, not augmentation capital. In this case like for like may not be the most efficient alternative.

As demand growth slows and technological change accelerates, the risk of long life network assets being stranded increases. With the regulatory bias in favour of network solutions, the EUAA supports measures to increase transparency around the network investment evaluation process. Too much of the allowable revenue cap is being set without a proper options evaluation – too much “top down” evaluation and not enough “bottom up” analysis of particular projects. Consumers are expected to “trust” the network to act in consumers’ best interests. Recent history of network regulation suggests this has not been the case.

The lack of discussion of options creates not just a barrier to proper evaluation by the AER but also a barrier to consumer participation in the revenue cap setting process. There is a significant asymmetry in information between the networks on the one hand and the AER and consumers on the other. Greater transparency around the investment justification helps break down those barriers, addresses the information asymmetry, allow much more rigorous AER evaluation of network proposals and facilitates increased stakeholder engagement by both consumers and non-network solution providers.

Our members are vitally interested in reliability and security of supply – provided efficiently, not inefficiently through over investment. In a low grid demand growth environment, the focus should be on the efficient management of existing assets and the efficient choice of network vs non-network options, or indeed “doing nothing”, not locking consumers into costly mistakes.

Annual planning reporting requirements on replacement in practice

Question 4

To what extent would the proposed information to be reported in the APRs be useful for energy market stakeholders, including non-network service providers, network service providers, connection applicants and the AER and why?

As noted above, network regulation has developed to provide networks with a strong incentive to increase their RAB. Non-network solutions are not in their interests – particularly when they are provided by other parties in competition with the network. So it is understandable why networks were so active in the recent AER review of the ring-fencing guideline. Consumers want a level playing field for

the development of the 21st century grid. The proposed Annual Planning Report information helps facilitate this level playing field.

Question 5

- (a) Is it appropriate that the scope of the new reporting requirements include planned asset de-ratings as well as planned retirements?*
- (b) To what extent does this add to the administrative burden of the NSP?*

The AER proposed scope of the Annual Planning Reports should include both planned retirements and planned asset de-ratings. It is difficult to understand how it could be argued that undertaking proper planning to assist in achieving the NEO could be regarded as an administrative burden. The lack of proper planning in the past has resulted in significant over investment and stranded network assets that consumers will be paying for over many years. EUAA members are happy for a slight increase in NSPs administrative costs if this saves millions on bad investments.

Question 6

- (a) Should all assets be reported on by NSPs in their annual planning report or are only certain asset types relevant?*
- (b) What types of asset should be subject to reporting requirements by NSPs and what should not?*

Question 7

- (a) Is the proposed AER network replacement reporting guideline the appropriate means of requiring NSPs to report on certain asset types and not others or would an alternative mechanism be more appropriate?*
- (b) If an AER guideline is appropriate, what should it contain and how should the AER be guided in its development?*
- (c) In addition, what would be the appropriate process be to make and review the AER guideline?*

Question 8

- (a) Should the AER guideline also set out principles and a broad approach that NSPs must follow in deciding whether to plan to retire assets?*
- (b) What should these principles and the broad approach be?*

The EUAA supports the AER's view that all assets should be included. Technological change will inevitably mean that assets that currently do not have a non-network alternative do have one in the future.

This will be facilitated by the proposed flexible AER guideline. The process to develop the guideline should be carefully managed to ensure it is completed efficiently and not become overly influenced by networks seeking to protect the existing biases in network regulation towards network solutions.

The RIT exemption report process will give networks flexibility to follow technology change as it impacts on potential non-network options.

We also think consideration should be given to expanding the test to cover non-network capex which is subject to relatively little AER scrutiny. This is a rising and potentially significant component in the total capex budget e.g. the AER accepted all the Powerlink proposed "non-network" capex of \$105.8m for the 2017-2022 regulatory period simply based on a trend analysis of the previous 5 years without any detailed analysis of projects. This category represented 14% of total accepted capex.

Question 9

Compared to the current requirements, how much additional reporting by NSPs would be required under the AER's proposal? What would be the impact on NSPs?

We would be surprised if the additional reporting would bring a significant increase in costs to the NSPs. A lot of the base information required to present the analysis proposed by the AER should already be within the NSPs. On a cost benefit basis, given the costs consumers are now bearing for the networks not being required to report this way in the past, we expect that the likely savings for consumers will be many multiples every year of any costs incurred through increased reporting.

Application of regulatory investment tests to replacement expenditure

Question 10

Will extending the regulatory investment tests to replacement capital expenditure benefit energy market stakeholders, including non-network service providers, network service providers and the AER, and why?

Yes. It is inconsistent to apply regulatory investment tests to new and not replacement capital for both transmission and distribution. As the former decreases and the latter increases as a proportion of total network spend, both should have to pass the regulatory test. Not applying the test to replacement expenditure risks a significant increase in inefficient investment decisions. It is central to increased transparency and stakeholder engagement. If the networks are so confident about their recommendations meeting the NEO, then they should embrace the application of the regulatory test to enable them to convince the AER and consumers of the merits of their investment proposals in meeting the NEO.

Question 11

Should the regulatory tests also apply to maintenance and refurbishment expenditure or should categories of expenditure continue to be exempt from the tests?

The question is somewhat confusing given the rule change is about capex, not opex, although it is not clear how a network might differentiate between “replacement” and “refurbishment” e.g. the latter could include sustaining capital expenditure component in which case it should be covered by the proposed rule change.

To the extent that “maintenance and refurbishment expenditure” is opex., our preferred approach with opex is the application of comprehensive benchmarking.

Question 12

Should the cost thresholds for asset replacement projects be the same as the cost test for network augmentation projects?

In principle, we can understand the reasoning for having the same threshold for replacement as augmentation capital from an administrative view e.g. it avoids the complexity of where a project involves both replacement and augmentation components. However:

- No justification is provided on why \$6m for transmission and \$5m for distribution are the “right” thresholds, and
- No information on the relative importance in the total proposed capital budget of projects that are above and below the threshold e.g. what percentage of a transmission networks’ replacement capex is covered by projects individually above \$6m?

We do not want a situation where a significant proportion of replacement capex projects are under the threshold and hence escape scrutiny.

Conceptually we would favour a lower threshold e.g. \$3m for transmission and \$2m for distribution given the transparency benefits.

We need to be careful not to place too much importance on the level of the so-called “regulatory burden” at the expense of increased transparency and ability of consumers and non-network providers to critically evaluate network proposals. The costs of a lower threshold should be low given best practice planning would require networks to consider all possible options for this level of capital expenditure independently of any AER guidelines.

Poor investment decisions in the past have resulted in huge costs being imposed on consumers. Even if there is a cost increase from the lower threshold, consumers given a choice between paying for a small increase in regulatory compliance costs for networks or paying for a bad investment decision for the next 30 years, will always favour the former. Consumers want the choice of making that decision.

Question 13

Is it appropriate for the regulatory test to not be required where an NSP considers a like-for-like replacement of the asset is the only option to address the problem?

We have two concerns with this proposal:

- (a) Given that it only applies to projects that meet the RiT thresholds, we would not support the removal of the application of the regulatory test in a like for like situation if projects above the threshold are not a significant part of the total proposed capital spend, and
- (b) We are unsure of the level of scrutiny that projects that are above the threshold and networks “reasonably believe” are like for like, will receive through the exemption report process

We understand the AER’s intention to cover investment under the threshold with, for example, improved implementation of benchmarking and APR information. We remain to be convinced given the relative success of the networks so far in resisting the application of benchmarking.

Question 14

- (a) Is the proposed requirement for NSPs to publish an exemption report where there is no alternative to a like-for-like replacement appropriate?*
- (b) Do the benefits of this mechanism outweigh the administrative costs that it may require?*
- (c) Is there an alternative mechanism which would be more appropriate?*

Question 15

- (a) What information should NSPs be required to provide in an exemption report?*
- (b) Is it appropriate that an NSP has to provide a summary of an exemption report to AEMO within five business days and to interested parties, on request, within three business days?*
- (c) Do stakeholders agree that AEMO must publish the exemption report on its website within three business days?*

Question 16

- (a) Is it appropriate that parties can raise a formal dispute with the AER on the conclusions of an exemption report published by an NSP?*
- (b) In 30 business days, as proposed, the appropriate timeframe for allowing interested parties to raise a dispute with the AER?*
- (c) Is 31 business days after publication of an exemption report the appropriate timeframe for an NSP to wait to undertake a like-for-like replacement where no dispute is raised?*
- (d) If an exemption report is determined by the AER to be non-compliant, should the NER explicitly exclude an NSP from (being) relying on the report to carry out a like-for-like replacement?*

The EUAA supports the concept of a RIT exemption report for those projects that meet the RIT test but the network believes there is no option other than a like for like replacement. Assuming the networks meet the AER’s internal best practice planning standard discussed above, the exemption report should be a completed pre-feasibility study of the level that would be presented to the network’s internal investment review committee.

This pre-feasibility study would evaluate all the likely options and recommend one – the like for like option – to be further examined in the detailed feasibility study prior to a final investment decision. The level of detail in this pre-feasibility will accord with the level of proposed expenditure. It is usual practice in large organisations that the pre-feasibility study would include a detailed examination of the options considered, a risk analysis and NPV/IPP analysis within say a ±20% costs band.

This type of pre-feasibility study should be a normal part of current network business practice so the only additional costs under the proposed AER process will be minor, associated with publishing what should already be an internal company document.

It is appropriate that interested parties can raise a formal dispute process with the AER on an exemption report. If an exemption report is considered non-compliant by the AER then the NER should explicitly exclude an NSP from relying on the report to carry out a like for like replacement.

The Consultation Paper is confusing on the publication process. We assume it is:

- Network publishes the full exemption report on its website and then provides a summary to AEMO
- AEMO then publishes the summary on its website – to assist in information dissemination
- Interested parties can request the full report from AEMO or the network and then have 30 days to raise a formal dispute with the AER

If this is a correct understanding, then we would recommend that the summary report is also published on the AER website simply to improve information dissemination.

The time periods proposed seem reasonable.

The EUAA's concern is around the role of the AER in this process. We noted in our recent submission to the RiT-T review that the AER role seems to be little more than a "tick the box" exercise. While we now understand the AER is devoting more resources to actually reviewing RIT-D projects, there are issues around:

- Will the AER have sufficient resources to properly fulfil its review role?
- How the AER balances its many roles – writer of guidelines, reviewer of specific projects and overall economic regulator?
- What options are open to the AER if it decides the exemption report is non-compliant?

We understand the only sanction is that the AER can seek an injunction in the Federal Court to stop the like for like project proceeding. This is a very inefficient and inappropriate process. Given this is a common issue for the current RiT-T review, we recommend that a consistent approach be taken across the various reviews.

In our submission on the RiT-T review we recommended considering extending of the AER Consumer Challenge Panel process to cover RiRT-T proposals. We would make a similar recommendation here for the CCP to have a role in the AER review of exemption reports which would be a valuable contribution towards achieving the NEO.

Issues specific to Victoria

Question 17

- (a) Would AEMO or AusNet Services be the most appropriate body to report on the proposed additional annual reporting requirements at the transmission level in Victoria and why?*
- (b) Would AEMO or AusNet Service be the most appropriate body to apply the RiT-T for replacement expenditure in Victoria and why?*

There is a balance to be struck here between:

- AusNet Services having the detailed knowledge of the maintenance profiles and asset conditions but having a vested interest in proposing network solutions to increase the RAB, and
- AEMO not have the detailed information but not having the vested interest

We consider that AEMO has fulfilled its planning role very well with regard to augmentation capital. On the balance of the two issues above, we consider that AEMO being the appropriate body is the preferred outcome in terms of the NEO.

Other NER changes proposed by the AER

Question 18

- (a) Are the additional changes proposed by the AER appropriate and useful to stakeholders?*
- (b) What compliance burden would arise for NSPs*
- (c) As these requirements currently apply in a limited way in the NER, how useful have they been to date?*

We agree with the AER proposals on these matters.

Transitional Arrangements

Question 19

What transitional arrangements should be put in place to allow NSPs and the AER to be able to comply with the proposed rule if it were to be made?

Given the large potential benefits in terms of the NEO, the EUAA believes that the transitional arrangements should ensure the changes are implemented as quickly as possible.

If the AEMC proposes a date by which the guidelines should apply then this should be calculated applying the minimum times set out for AER consultation processes in Chapters 6/6A of the Rules.

The networks should have no concerns with their ability to meet the guidelines assuming, as noted above, they have best practice planning procedures already in place in their organisations. For example, they already should be considering non-network options simply from a governance point of view, let alone any requirement under the rules or an AER guideline.

Once again, thank you for the opportunity to participate. As always we would welcome further consultation should it be required.

Regards



Andrew Richards
Chief Executive Officer

24 November 2016