COAG
Energy Council
Chair

Mr John Pierce
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Dear ~~Mr Pierce~~ John

Non-controversial rule change proposal
Making the AER responsible for values of customer reliability

The COAG Energy Council requests that the Australian Energy Market Commission (AEMC) considers changes to the National Electricity Rules to allow the Australian Energy Regulator (AER) assume responsibility for establishing values of customer reliability (VCRs). This is to support the setting of reliability requirements for the next round of regulatory determinations commencing in mid-2019. The Council notes that the changes are non-controversial and therefore requests that this rule change proposal be processed as expeditiously as possible.

The attached rule change request will establish nationally consistent and updated VCRs to assist in setting appropriate network reliability standards, network planning, and economic regulation of network services, as well as informing wholesale market settings such as market price caps.

I note that the AEMC's final report for the review of the national framework for distribution reliability provides that the AER's responsibility for the VCR should be specified in the Rules. The Energy Council agrees that a rule change would establish a formal mechanism for the AER to update and review VCRs on an on-going basis.

This rule change request has been developed by officials in consultation with the AER and is enclosed for your consideration.

Yours sincerely

The Hon Josh Frydenberg MP
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COAG Energy Council
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1. New rule proposal

This proposal is to amend the National Electricity Rules (the Rules) to make the Australian Energy Regulator (AER) responsible for establishing values of customer reliability (VCRs) for use in the setting of reliability requirements in regulatory determinations.

VCRs provide estimates of customers' willingness to pay for the reliable supply of electricity. They are proxy values and can be used for economic regulation, planning, and operational purposes.

The Senior Committee of Officials (SCO) considers that making the AER responsible for determining VCRs will promote transparency, consistency and stakeholder confidence in VCR estimates. It may also facilitate wider use of VCRs by network service providers and jurisdictional governments and regulators.

SCO considers that the proposed VCR function is consistent with the AER's statutory functions, as it will inform economic regulation activities, including setting of economic incentives schemes, performance reports for network businesses and monitoring the regulatory investment test assessment.

At present, no single body is responsible for reviewing and updating VCR estimates on a regular basis. In the absence of clear national guidance on VCRs, there may be over or under-investment in the network, resulting in reliability levels that are above or below the value consumers actually place on reliability. In these circumstances, the cost consumers pay for network services will not be efficient.

Making the AER responsible for determining VCRs would reduce the risk of inconsistencies in VCR estimates between jurisdictions due to methodological variations. This will allow the AER and customers to better compare network reliability performance. It could also result in less duplication of VCR estimations and lower costs on network planners, systems operators, regulators and policy makers.

Because VCR estimates can be used to identify the efficient level of reliability for a network, it is important they are determined by an independent body. Assigning ongoing responsibility for maintenance of VCR estimates to the AER will ensure consistent and systematic approach over time. This would lead to better understanding of the drivers of VCRs and provide greater surety that the benefits to customers of network investments to increase reliability exceed the costs.

2. AER's responsibilities regarding the value of customer reliability

The proposed rules will assign the AER an on-going responsibility to regularly review, update and publish the VCR methodology and estimates across the NEM.

In particular, it is proposed that amendments to the Rules be made requiring the AER to:

- develop a single methodology including direct customer engagement, such as through surveys, that can be used for estimating VCRs on a consistent basis across the NEM;
- develop VCRs to reflect the range and geographic locations of customers in each network;
- update VCRs at least every five years to align with the standard setting process and revenue determination process for each network business, where possible;
- in between five yearly updates, adjust VCRs by an appropriate methodology each year;
- undertake public consultation in making any changes to the VCR methodology to allow stakeholder views to be taken into account;
- publish any changes to VCRs following any updates, annual adjustments in VCRs, and reviews.

In undertaking this responsibility, the AER is expected to take into account the Australian Energy Market Operator's (AEMO's) 2014 Value of Customer Reliability Review. In the first instance the AER is initially expected to review AEMO's methodology and consider whether any improvements should be made, taking account of timing and other factors.

In making decisions about updating VCR estimates and reviewing the methodology, the proposed rules should require the AER to have regard to the current and potential uses of VCRs. This includes applications in the setting of transmission and distribution reliability standards and targets; network investment planning; informing wholesale market settings such as market price caps; and the economic regulation of network service providers.

3. Background to the proposal for a new rule

In 2013, the Australian Energy Market Commission (AEMC) provided its final reports on its review of the national framework for reliability standards for both distribution and transmission to the former COAG Standing Council for Energy and Resources (SCER) (now the COAG Energy Council (Energy Council)). These two reviews recommended that the AER be responsible for the VCR measures as this would be consistent with its role as the economic regulator including designing the Service Target Performance Incentive Scheme (STPIS) and monitoring the regulatory investment test assessments.

At SCER's request, AEMO conducted a NEM-wide review into the value of customer reliability. The review developed a methodology and approach to derive VCRs and produced a range of VCR values for different customers in different locations across the NEM.

On 13 December 2013, SCER agreed to make the AER responsible for determining VCRs for use in the setting of reliability requirements for the next round of regulatory determinations, commencing in mid-2019.

4. Statement of issues

The basic function of an electricity transmission and distribution system is to meet its customers' energy demand at the lowest cost possible to its customers, while maintaining acceptable levels of reliability.

Reliability refers to the extent to which customers have a continuous supply of electricity. Networks facilitate the supply of electricity to end use customers within each jurisdiction of the NEM.

The level of investment and maintenance expenditure undertaken by network businesses affects both the level of reliability that the networks provide and the cost paid by customers for network services.

The VCR estimates the amount in dollars per kilowatt hour that customers in a specified area are prepared to pay in the network component of their electricity bill for improving or maintaining the reliability of the supply of electricity. The VCR is a key input for determining the reliability that provides the most value to customers.

The VCR has only been estimated a limited number of times in Australia. It has been estimated for Victoria, NSW and the ACT by different organisations at different times. The estimates vary significantly between those jurisdictions. Such variety can have a negative impact on transparency and comparisons of network reliability performance.

AEMO's Value of Customer Reliability Review in 2014 was the first comprehensive national examination of VCR levels in the NEM. AEMO's VCR estimates are being used by the AER in undertaking its economic regulation functions, and by AEMO in its role as the Victorian and national transmission network planner. AEMO also uses these estimates when advising on reliability standards in Victoria and South Australia.

In NSW, the VCR was used to set the transmission reliability standards to apply from 1 July 2018. These standards were developed by the Independent Pricing and Regulatory Tribunal using a model that optimises an unserved energy allowance to minimise the combined total of the costs to customers of an outage (using the VCR), and the costs of the infrastructure to avoid unserved energy.

The VCR does not appear to play a significant role in determining the level of reliability in Queensland.

The proposed rule change will give the AER an on-going role to review and update VCRs for each regulated network. This would allow the AER to improve the methodology over time using the experience gained through repeated applications.

Nationally consistent and updated VCRs will assist the AER to better:

- design the STPIS;

- monitor the regulatory investment test assessments;
- analyse and report network service provider's reliability performances; and
- assess a network's capex forecast as part of its consideration of a network's revenue (reset) proposal

Under the current regulatory framework, network businesses are subject to incentives for reliability performance under the AER transmission and distribution STPIS. Under the Rules, the AER has flexibility to adjust the operation of the transmission and distribution STPIS to be consistent with the VCR. The level of reward and penalty payments under the STPIS could be based on VCRs to encourage network businesses to transition to the efficient level of reliability.

The regulatory framework allows network businesses to consider the most efficient option to meet the reliability standard, whether that is a network or non-network solution. Network businesses are required under the Rules to apply the regulatory investment test to certain network investment projects. The AER could use VCRs to assess regulatory investment tests carried out by network service providers.

Under the Rules, the AER must prepare and publish a network service provider performance report (an annual benchmarking report) the purpose of which is to describe the relative efficiency of each network service provider in providing network services over a 12 month period. Nationally consistent VCRs could assist the AER to benchmark reliability performance across the NEM.

The Rules require regulated network businesses to periodically apply to the AER to assess their revenue requirements (typically, every five years). In determining the revenues that a network business can earn, the AER must forecast the revenue requirement of a business to cover its efficient costs (including capital expenditure). Nationally consistent and updated VCRs could assist the AER to assess a network's capital expenditure forecast as part of its consideration of a network's revenue proposal.

Nationally consistent VCRs would also be useful in other contexts. For example, they could improve existing jurisdictional arrangements for setting network reliability standards by enabling a transparent assessment of the trade-off between the costs of reliability and the level of reliability delivered, and a comparison between the reliability standard adopted and the value customers place on reliability. Also they could inform network planning and network augmentation capital expenditure in each jurisdiction.

The AEMC's final report provides that the AER's responsibility for the VCR should be specified in the Rules.[1]

SCO agrees that a rule change would establish a formal mechanism for the AER to update and review VCRs on an on-going basis.

5. Contribution to the National Electricity Objective

[1] AEMC Final Report, Review of the national framework for distribution reliability, page 140

The National Electricity Objective (NEO) is set out in section 7 of the National Electricity Law. The NEO states:

> "The objective of this 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."

SCO considers the proposed rules will contribute to the NEO as they will allow more efficient decision making to occur. The proposed rules will help maximise consumer welfare by allowing for a more accurate and transparent assessment of the trade-offs between costs and reliability.

6. Regulatory and administrative burden

There is likely to be an increase in administrative costs for the AER in reviewing and updating VCRs. AEMO's VCR review took about 18 months to complete. AEMO conducted surveys, held stakeholder workshops, and engaged a consultant to advise on survey design and methodology for calculating VCR values.

However, network businesses and jurisdictional agencies are likely to face reduced costs by drawing on AER's VCR values instead of having to separately develop and resource their own VCR estimates.