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John Pierce
Chairman
Australian Energy Market Commission
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Dear Mr Pierce

Submission on AEMC consultation paper—Review of national frameworks for transmission and distribution reliability

Please find attached the Australian Energy Regulator's (AER) submission regarding the Australian Energy Market Commission's (AEMC) consultation paper.

The AER welcomes the opportunity to comment on the substantial potential reforms to the energy market framework. We have provided submissions to earlier AEMC issues papers and draft reports published as part of these reviews.

In this paper we:

- set out our general support for the AEMC's proposals
- suggest further enhancements to improve the interactions between the reliability setting process and the revenue determination process
- outline our concerns regarding the proposed mechanism for updating reliability standards and the revenue determination within a regulatory control period, and
- set out our views regarding the proposals that potentially affect the future effectiveness of the distribution service target performance incentive scheme (STPIS).

Greater consistency in reliability setting and enhanced consumer focus

As noted in previous submissions, the AER broadly supports the AEMC's proposed reliability framework for distribution and transmission. In particular, we support:

- the move towards more consistently defined standards
- greater emphasis on developing output based reliability standards
- greater consideration of the value that customers place on reliability and the costs that are likely to arise under different reliability scenarios during the standard setting process
- the enhanced consumer engagement requirements.

These proposals, combined with the new rules arrangements for the economic regulation of network businesses are likely to support a robust framework for efficient investment in networks. If appropriately applied, the proposals will support the development of efficient and consistently defined standards with a greater focus on providing services that are valued by customers.

Consistent reliability setting and reporting framework

We support proposals that will aid consistency, such as the development of the national reference standards template and a common reliability setting framework. As noted in our earlier submissions, there are significant benefits associated with moving towards a consistent national framework. Clearly expressed and consistently defined standards will facilitate comparisons between NSPs performance. Greater consistency across standards may assist the AER to more effectively compare DNSPs' cost forecasts and identify discrepancies. Consistency in standard definitions will also aid in the on-going development of performance incentive schemes.

Output based reliability standards

The proposals incorporate output based reliability targets for distribution, with additional scope for jurisdictional ministers to determine whether additional measures, such as worst served customers should be applied. It is proposed that transmission standards will be set on an N-x basis, but there will be some flexibility to incorporate additional parameters, including output based reliability standards.

As noted in our earlier submissions, we support the use of output based reliability standards as they are more effective in ensuring the regulatory regime rewards NSPs for delivering services valued by consumers rather than simply rewarding building assets. An outputs based regime will give NSPs the ability to decide how to deliver the required reliability outputs in the most efficient manner—including through non-network solutions—without having to conform to prescriptive standards about how those targets should be met. We also support the flexibility in the frameworks to ensure that the needs of worst served customers can be met. For example, minimum performance standards (or similar) for DNSPs will ensure the needs of all customers connected to the network are considered.

With respect to transmission, we support the approach whereby the N-x standards are determined on a probabilistic basis, however we still consider that there could be greater scope to explore whether redundancy standards could be expressed in a more flexible way. Our earlier submission provided a possible example where a TNSP could be required to provide an N-1 standard of reliability within 30 minutes, 99.95 per cent of the time, based on a 10 per cent probability of exceedance (POE) demand forecast. We consider this approach could support greater utilisation of non-network options. AEMO could be given scope to consider these types of standards further in the development of the transmission national standards template.

Economic cost benefit framework

If appropriately applied, the standard setting process will be effective in placing greater emphasis on ensuring NSPs deliver services that are most valued by customers. Incorporating an economic cost benefit analysis in the standard setting process is likely to result in more efficient targets. We support the establishment of a formal mechanism for considering customer preferences by incorporating the outcomes of value of customer reliability (VCR) studies. VCR studies should perform a key role in the national reliability framework. We recognise, however, that the VCR is not a measure which can be readily tested by objective evidence. Given the increased significance of the VCR in the proposed framework, it is also important that the arrangements for determining the VCR are robust. The arrangements should support a cycle of continuous improvement in VCR estimation to allow the VCR methodology to develop and improve overtime.

Enhanced consumer engagement

The proposed requirements on both transmission and distribution NSPs to consult with consumers during the standard setting process are also positive developments. Increased engagement with consumers early on in the standard setting process may assist NSPs to better understand the needs of their consumers as well as increase awareness among consumer groups and others of the

potential costs associated with particular levels of reliability. This also complements the new requirements on NSPs to fully engage with customers as part of the development of their revenue/price proposals to the AER.

Potential AER roles

The consultation paper sets out a range of proposed roles for the AER. In principle we support the proposed roles for the AER. These roles are broadly consistent with what might be expected of an economic regulator, such as the AER. However, we note that these roles are likely to be resource intensive.

Interaction between the reliability setting process and the revenue determination process

Depending on how the states decide to implement the proposed frameworks, there may be up to three separate bodies involved in the reliability setting and revenue determination processes—the standard setter, the economic advisor on the standard and the revenue/economic regulator (the AER). Jurisdictions may decide to delegate the economic advisor and standard setting roles to the AER. In this case the AER will perform these roles in addition to its existing economic regulation functions.

The AER argued in its earlier submissions that there is a need for mechanisms which strengthen the links between the reliability setting process and the revenue determination process. As noted in our earlier submissions, our preference is that where a state has delegated the standard setting process to the AER, there should be a single integrated process for determining reliability standards and forecast expenditure.

We note, however, that the AEMC is not proposing an integrated process, but has instead incorporated mechanisms which attempt to strengthen the links between the separate processes. In particular, the proposals include:

- requirements on NSPs to explain any differences in forecast costs between the two processes to limit opportunities for 'gaming' the separate regulatory processes, and
- providing the AER with access to forecast costs submitted during the standard setting process (where the AER is not the economic adviser).

While noting these improvements, we consider that there are opportunities to further strengthen the incentives on NSPs to submit robust cost information to both the standard setter and the AER. This could be achieved by requiring NSPs to submit the same cost information in both processes unless there are valid reasons for departing from this.

In our view, there should only be extremely limited circumstances in which a NSP's cost forecasts should change significantly between the standard setting process and the regulatory determination process. Under the AEMC's proposals there is only a lag of nine months between the economic assessment of the reliability standard and the NSP submitting its regulatory proposal. This is a relatively short period in the context of a five year regulatory control period, and given this it would be unlikely for there to be any major differences in cost forecasts between the two processes.

Requiring NSPs to submit the same information in both the standard setting and revenue determination processes would provide a strong incentive on NSPs to develop accurate cost forecasts from the outset. This would streamline the two processes and allow the AER to more effectively target its assessments of an NSP's regulatory proposal.

Updating reliability standards and revenue determinations

The proposals include a mechanism which permits an NSP to apply to the standard setter for an update to the reliability standard where the assumptions (such as expected costs) have changed significantly during the regulatory control period. The AEMC considers that this proposal could lead to

more efficient investment decisions by NSPs as it could have its standards updated where it is no longer efficient to meet them.

We have previously noted that there may be benefits that could arise from a regime that allows NSPs to defer projects that are higher cost than initially considered when determining the reliability standard. We consider however that the better approach it reduce the risk of inconsistency by having robust processes for determining the reliability standards and revenue allowances at the outset.

As noted above we consider that the AEMC's proposals regarding the standard setting process will provide a sound basis for establishing reliability standards and targets prior to the commencement of a regulatory control period. We also consider that the new rules framework for the economic regulation of NSPs provides stronger discipline on NSPs and will lead to more efficient expenditure outcomes. Refinements to the regulatory framework facilitated by the revised rules and proposed by the AER include a capital expenditure incentive scheme whereby a proportion of costs and benefits of any overspend or underspend are carried by the NSP, and an ex-post review of overspends, with the potential for exclusion of inefficient over-expenditure from the regulatory asset base. While there may have been some concerns in the past associated with over-building (either due to inefficient reliability settings or inefficient over-spending by NSPs) the AEMC's recent reforms and the current proposals effectively respond to this issue. Limiting the cost estimates that can be provided to the AER during the regulatory reset to those that are provided to the standard setter (as suggested above) will further strengthen the integrity of these separate processes.

In light of these developments, we do not consider that a mechanism to adjust the reliability standard and revenues within a regulatory control period is warranted. In combination the proposed standard setting process and the revised framework for economic regulation provide a robust framework for efficient investment in networks. There are also several existing mechanisms for seeking revenue adjustments within period, including the contingent project regime, the existing cost pass through arrangements and the revenue reopener provisions. These mechanisms already reduce some of the risks an NSP faces associated with uncertainty.

Given this, it is likely that there will be only minimal benefits associated with providing an additional adjustment mechanism. There is, however, potential for significant costs. With respect to the particular mechanism proposed, we consider that there is a high risk that:

- it will undermine the incentives on NSPs to manage expenditure allowances efficiently, and
- it will inappropriately shift the risk of cost over-runs onto consumers.

The ex-ante expenditure allowance is intended to provide an incentive on NSPs to manage expenditure throughout the regulatory control period across a range of different capital and operating expenditure programs and projects. The proposed adjustment mechanism undermines this incentive by providing NSPs with an ability to seek an adjustment to the reliability standard and/or revenue determination if there has been an overrun in forecast costs. The mechanism applies even if these costs could have been avoided or managed more effectively. This ultimately undermines the incentives the building block model provides for efficient investment.

The regime also has the potential to lead to a project by project approval process, which moves the regime away from an incentive based approach and closer towards a cost-plus regulatory approach. This is a significant change in regulatory approach which can lead higher costs being passed back to customers.

We are also concerned that the proposals are likely to shift the risk of cost overruns on to consumers, who are less able than NSPs to manage this risk. The ability of an NSP to apply for a reconsideration of the reliability standard where there has been a cost overrun could result in the same level of reliability with an unexpected increase in revenues. We consider that the regime is likely to favour NSPs, as while it is possible that the standards could be changed if there was an unexpected under run in costs, this is less likely than the opposite occurrence of an over-run due to the information asymmetries between the standard setter and the NSP. For these reasons we are not in favour of a mechanism which adjusts reliability settings and revenues within a regulatory control period.

Interactions with the distribution service incentive scheme

As noted in our earlier submissions, we support the use of financial incentives to encourage DNSPs to provide an appropriate level of reliability. We have some concerns, however, with proposals that effectively restrict our ability to develop and modify the various incentive schemes over time.

The proposals provide for a more significant role for the distribution STPIS than is currently the case in many jurisdictions. The proposals will rely on the STPIS as the primary mechanism for encouraging DNSPs to meet their reliability targets. It is unclear, however, whether this will implicitly restrict the types of measures the AER can incorporate into the STPIS to those that are included in a DNSP's reliability targets (such as unplanned SAIDI and SAIFI). The AER would be concerned by any proposals which would restrict the application of the STPIS to only cover these types of measures of a DNSP's performance.

While the distribution STPIS has applied to many NSPs since it was developed in 2008, the AER has not yet undertaken a thorough review of the operation and effectiveness of the regime. It is anticipated this would occur after the current Better Regulation program is completed. Any future review may reveal a need for additional measures or incentives, such as operational based incentives or the incorporation of additional performance measures such as lead indicators of reliability or worst served customer measures. These measures may be necessary, for example, to provide sufficient incentives on DNSPs to reduce the risk of catastrophic failures, manage sub-transmission assets effectively or to provide minimum service levels to all customers.

We also have a number of concerns with the proposal to require targets to be set at the level of the reliability standard. While we do not have in principle concerns with this approach, there are a number of implementation issues which could affect the operation of this approach. Performance targets are currently set by reference to historical performance. There is a potential for a step change in reliability targets under the new regime and therefore windfall gains or losses for some DNSPs. Similarly the approach should also recognise that there is likely to be a significant time lag between a revision to NSPs' reliability targets and performing at this level. This is because it will take some time for the benefits associated with capital expenditure projects to deliver improvements in performance, or alternatively it will take some time before a NSP's performance level declines to a lower level of the target level.

We consider that these types of issues indicate that there is a need for on-going flexibility in how the STPIS is applied and developed. This is consistent with our experience with the transmission STPIS. We completed a review of the transmission STPIS recently and have made a number of significant changes. This included a minor change to the market impact component of the scheme, which was only introduced in 2009. The review found that although the new component drove improved performance, minor changes were needed to its design. This highlights the difficulty in designing effective incentive schemes at the outset, and typically such schemes are developed, tested, reviewed and modified over time as part of a continuous improvement process. We will continue to monitor the effectiveness of our revised approach and will likely refine it further in the future.

The AER would be pleased to provide further assistance to the AEMC on this area of work. If you would like to discuss any aspect of this submission please contact Kate Murphy on 02 6243 1086 in the first instance or alternatively to Chris Pattas, General Manager, Network Operations and Development, on 03 9290 1470.

Yours sincerely

Andrew Reeves
Chairman
Australian Energy Regulator