SCER
Standing Council on Energy and Resources
Senior Committee of Officials

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

RECEIVED
8 OCT 2012

John

Dear Mr Pierce

Maintenance of reliability levels under the capital and operating expenditure objectives

I refer to the recommendations of the Australian Energy Market Commission (AEMC) in its final report on the New South Wales workstream of the Review of distribution reliability outcomes and which was published on 31 August 2012. The report identified a potential limitation in the current National Electricity Rules which may require Distribution Network Service Providers (DNSPs) and Transmission Network Service Providers (TNSPs) to request sufficient expenditure to maintain historical levels of reliability.

The purpose of this letter is to formally request, on behalf of the Standing Council on Energy and Resources, that the AEMC initiate a Rule change process to ensure TNSPs and DNSPs are only able to include sufficient expenditure in their regulatory proposals to comply with applicable regulatory obligations or requirements that relate to the reliability of their transmission and distribution services and systems.

The rule change request (**Attachment A**) and the proposed rule to amend the National Electricity Rules (**Attachment B**) provide additional information in support of this request.

Should you have any further enquiries, please contact Ms Kristen Palmer, Manager SCER Secretariat, on (02) 6213 6107.

Yours sincerely

Drew Clarke
Chair
Standing Council on Energy and Resources Senior Committee of Officials

28 September 2012
Enc.

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Attachment A

Maintenance of reliability levels under the capital and operating expenditure objectives

Rule change request

September 2012

1) Name and address of rule change request proponent

Standing Council on Energy and Resources
SCER Senior Committee of Officials
Standing Council on Energy and Resources Secretariat
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Canberra ACT 2601

2) Description of the proposed rule

The proposed rule seeks to clarify the level of operating and capital expenditure that Distribution Network Service Providers (DNSPs) must include in developing their regulatory proposal to the Australian Energy Regulator (AER) under Chapter 6 of the National Electricity Rules (NER). Specifically, the proposed rule seeks to amend the NER so that if there are any applicable regulatory obligations or requirements that relate to the reliability of the supply of standard control services or the distribution system, DNSPs are only able to include sufficient expenditure in their regulatory proposals to comply with those regulatory obligations or requirements. This proposed change to the NER would affect the operating expenditure objectives and the capital expenditure objectives in clauses 6.5.6(a)(3), 6.5.6(a)(4), 6.5.7(a)(3) and 6.5.7(a)(4) of the NER.

The proposed rule also seeks to make corresponding amendments to the operating expenditure objectives and the capital expenditure objectives for electricity transmission determinations under Chapter 6A of the NER (clauses 6A.6.6(a)(3), 6A.6.6(a)(4), 6A.6.7(a)(3) and 6A.6.7(a)(4)). The current operating expenditure objectives and capital expenditure objectives for prescribed transmission services are expressed in the same way as those for distribution. As a result, the proposed rule seeks to clarify the potential issue for both electricity distribution and transmission determinations.

The objective of the proposed rule is to clarify that DNSPs and Transmission Network Service Providers (TNSPs) are only able to include sufficient operating expenditure and capital expenditure in their regulatory proposals to comply with applicable regulatory obligations or requirements that relate to the reliability of their services (referred to as standard control services for distribution and prescribed services for transmission) or systems.

A draft of the proposed rule is attached to this proposal for consideration.

3) Background to the proposed rule

The Australian Energy Market Commission (AEMC) is undertaking a review of distribution reliability outcomes and standards, at the request of the Standing Council on Energy and Resources (SCER).[1] As part of the New South Wales (NSW) workstream for this review, the AEMC provided advice on the costs and benefits of alternative distribution reliability outcomes in NSW, which has included the consideration of the impact of lower levels of distribution reliability.

The AEMC published its draft report for the NSW workstream of the review in June 2012, and its final report in August 2012. The AEMC recommended that should the NSW Government want to reduce distribution reliability outcomes in NSW, a rule change request should be submitted as soon as possible to clarify the level of operating and capital expenditure that DNSPs may include in their regulatory proposals to the AER.[2]

The AEMC noted in its reports that the current operating and capital expenditure objectives in the NER could be interpreted as allowing DNSPs to include expenditure they consider necessary to "maintain" historical levels of reliability from one regulatory control period to the next.[3] Such a strict interpretation of the NER would defeat the purpose of any reduction in jurisdictional reliability requirements. The AEMC also noted the application of the NER in this manner may also be an issue if DNSPs are currently over-performing against the level of reliability required under their regulatory obligations or requirements.[4] This could also be an issue for TNSPs given the expenditure objectives are currently expressed in the same way for transmission.

This potential issue has previously been raised by the AER in its September 2011 "*Economic regulation of transmission and distribution network service providers rule change request*".[5] In that rule change process, the AEMC noted that this issue falls outside of the scope of the issues raised by the AER and, consequently, would need to be addressed through a separate process.[6]

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[1] Further details on the AEMC's Review of distribution reliability outcomes and standards can be found at: http://www.aemc.gov.au/market-reviews/open/review-of-distribution-reliability-outcomes-and-standards.html

[2] AEMC, 2012, Review of distribution reliability outcomes and standards, Draft Report- NSW workstream, June, p. 102.

[3] AEMC, 2012, Review of distribution reliability outcomes and standards, Draft Report- NSW workstream, June, p. 99.

[4] AEMC, 2012, Review of distribution reliability outcomes and standards, Draft Report- NSW workstream, June, pp. 99-100.

[5] AER, 2011, *Economic regulation of transmission and distribution network service providers rule change proposal*, September, p. 33.

[6] AEMC, 2012, Review of distribution reliability outcomes and standards, Draft Report- NSW workstream, June, p. 101.

4) Nature and scope of the issues the proposed rule will address

Summary of issues the proposed rule will address

The issue that the proposed rule seeks to clarify is the potential risk of a strict interpretation of the term "maintain" in the current operating and expenditure objectives in Chapters 6 and 6A of the NER as it applies to reliability levels. A strict interpretation of the NER could result in DNSPs and TNSPs including, amongst other things, sufficient operating and capital expenditure in their revenue proposals to maintain historical reliability levels delivered in previous regulatory control periods.

This could occur even where the required jurisdictional reliability standards or targets are lowered, or even if a DNSP or TNSP wishes to reduce the level of reliability it provides from one regulatory control period to the next while still meeting jurisdictional standards or targets.

Consequently, reductions in expenditure that may arise from reducing the level of reliability required under an applicable regulatory obligation may not be passed through to end use consumers.

There is also the potential for a conflict between the requirements in the NER and jurisdictional obligations. For example, if jurisdictional reliability standards or targets are lowered, it could be interpreted that under the NER, DNSPs and TNSPs are required to include sufficient expenditure in their proposals to the AER to maintain historical higher levels of reliability.

Nature and scope of issues

Under the existing operating and capital expenditure objectives for electricity distribution and transmission determinations, DNSPs and TNSPs are required to include in their proposals the total forecast expenditure that they consider is required to achieve each of the following objectives for standard control services for distribution and prescribed services for transmission:

1) meet the expected demand for these services over the regulatory control period;
2) comply with all applicable regulatory obligations or requirements associated with the provision of these services;
3) maintain the quality, reliability and security of supply of these services; and
4) maintain the reliability, safety and security of the distribution or transmission system through the supply of these services.[7]

[7] Clauses 6.5.6(a), 6.5.7(a), 6A.6.6(a), 6A.6.7(a) of the National Electricity Rules.

The AER is required to accept a DNSPs' or TNSPs' forecast expenditure where it is satisfied that the expenditure reasonably reflects the operating expenditure criteria and the capital expenditure criteria. These criteria include:

1) the efficient costs of achieving the operating expenditure objectives and the capital expenditure objectives;
2) the costs that a prudent operator in the circumstances of the relevant DNSP or TNSP would require to achieve the operating expenditure objectives and the capital expenditure objectives; and
3) a realistic expectation of the demand forecast and cost inputs required to achieve the operating expenditure objectives and the capital expenditure objectives.[8]

Under the current wording in the NER, the need to "maintain" the reliability of standard control services in the distribution system may have potential implications if jurisdictional requirements are amended to require DNSPs to provide a lower level of reliability compared to the previous regulatory control period.

The AER and the AEMC have identified that there is a degree of uncertainty as to how the maintenance of reliability should be interpreted, as the word "maintain" is not defined in the NER. However, the AEMC has noted that it considers that "maintain" could potentially be interpreted as the maintenance of historical levels of reliability from the previous regulatory control period.[9]

Under this strict interpretation, the current wording in the NER could potentially allow DNSPs to include the total capital and operating expenditure they consider necessary to maintain the level of reliability they achieved in the previous regulatory control period, despite any new (lower) jurisdictional requirements. A similar issue also applies in relation to maintaining the reliability of prescribed transmission services and the transmission system in the operating and capital expenditure objectives in Chapter 6A of the NER.

The reference to the maintenance of reliability under Chapters 6 and 6A of the NER also creates uncertainty for DNSPs and TNSPs in preparing their proposals for the AER, as it conflicts with the objective of complying with all applicable regulatory obligations and requirements (which under the NEL definition includes jurisdictional regulatory obligations).

This conflict could lead to a situation where DNSPs and TNSPs could interpret the NER as requiring them to include sufficient expenditure in their proposals to

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[8] Clauses 6.5.6(c), 6.5.7(c), 6A.6.6(c), 6A.6.7(c) of the National Electricity Rules.
[9] AEMC, 2012, Review of distribution reliability outcomes and standards, Draft Report- NSW workstream, June, p. 99.

maintain (higher) historical levels of reliability. However, in practice, they are only required to provide a level of reliability under applicable jurisdictional standards or targets, which can be amended by jurisdictional governments and due to the current attention on the costs of maintaining reliability levels could potentially be reduced.

Another potential conflict is that DNSPs or TNSPs could potentially be required to continue to include a higher level of expenditure in their forecasts to maintain historical levels of over- performance. This result could occur despite a lower level of expenditure being sufficient to comply with its relevant jurisdictional reliability standards or targets.

Additional Issues

The primary purpose of this rule change request is to clarify the interpretational issue identified by the AEMC in Chapter 6 and 6A of the NER in relation to the maintenance of reliability. The AEMC considers this interpretational issue could preclude achievement of appropriate pricing outcomes if Network Service Providers (NSPs) strictly interpret the NER as allowing them to seek capital and operational expenditure to maintain historical levels of reliability.

In theory, there is the possibility that similar issues could also occur under the NER in relation to the expenditure proposed by TNSPs and DNSPs in their regulatory proposals to maintain the quality, safety and security of their services and systems. Although, the AEMC is yet to investigate and identify any practical problems that might arise from interpretation of these other aspects (as they are governed by separate requirements including jurisdictional energy safety laws that do not ordinarily merit outcomes being traded off against the costs of provision in the same manner as reliability) it is requested the AEMC examine whether there is a similar need for clarification around this objectives in progressing this rule change request.

If the AEMC determines, as a result of the consultation process, that similar interpretational issues could also occur in relation to quality, safety and security, SCER considers any such clarification in the NER should not compromise the security, safety or quality of transmission and distribution services and systems.

Application of the proposed rule across the National Electricity Market jurisdictions

Each jurisdiction in the National Electricity Market (NEM) continues to maintain responsibility for the level of reliability that should be provided by DNSPs and TNSPs in their jurisdiction.

In all jurisdictions in the NEM there are jurisdictional distribution reliability standards or targets which DNSPs are required to comply with or use their "best

endeavours" to achieve.[10] In the NEM, distribution reliability standards generally include requirements relating to the outputs or performance levels they must achieve or seek to achieve.

In Victoria, DNSPs are able to set their own performance targets as there are no minimum targets or standards determined by the jurisdictional regulator or Government. Victorian DNSPs are required to publish their reliability targets each year and have an obligation to use their best endeavours to comply with these targets.[11] For 2012, the published targets have been the same as those determined under the AER's Service Target Performance Incentive Scheme (STPIS).[12]

In relation to transmission, existing jurisdictional reliability standards are predominately input based and are focused around the level of security (or level of redundancy) that TNSPs must plan to in developing their networks. In all NEM jurisdictions, jurisdictional reliability requirements for transmission are set out in jurisdictional codes or legislation.

Although jurisdictional reliability requirements for transmission and distribution differ across the NEM, in all jurisdictions there are published jurisdictional reliability standards and targets which DNSPs and TNSPs are either required to comply with or use their best endeavours to achieve. Therefore, as the proposed rule refers to compliance with regulatory obligations or requirements that relate to the reliability of standard control distribution services and prescribed transmission services or transmission and distribution systems, it is considered that this rule would be able to accommodate the current arrangements for electricity distribution and transmission reliability across the NEM.[13]

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[10] For example, in Queensland, South Australia, Tasmania and the Australian Capital Territory, DNSPs are required to use their best or reasonable endeavours to comply with jurisdictional reliability performance standards. In New South Wales, DNSPs must be as compliant as "reasonably practicable" with security standards by 1 July 2014 and fully compliant by 1 July 2019, and have an absolute obligation to comply with performance standards.

[11] Victorian Electricity Distribution Code, 2011, clause 5.2.

[12] AER, 2010, Victorian electricity distribution network service providers, Distribution determination 2011-2015, Final, October, p. 695.

[13] In some cases, jurisdictional regulatory obligations or requirements relating to reliability may not include requirements applying to all components of a distribution or transmission system. For example, some regulatory obligations or requirements do not include requirements relating to the low voltage component of distribution networks. However, despite this, DNSPs and TNSPs may still need to undertake expenditure on these parts of their network to provide an acceptable level of reliability to customers. The proposed rule seeks to address this by including a reference to regulatory obligations or requirements that relate to the reliability of regulated services or parts of the distribution or transmission system that are subject to that regulatory obligation or requirement. If regulated services or parts of the system are not subject to any regulatory obligations or requirements, the existing capital and operating expenditure objectives related to maintaining reliability would apply.

How the proposed rule would address the issues identified

As discussed above, the issue that has been identified with the current NER is that there is the potential for the term "maintain" in the operating and capital expenditure objectives in Chapters 6 and 6A of the NER to be strictly interpreted to require historical maintenance of reliability levels. This may occur even where jurisdictional reliability standards or targets have been lowered. It could also occur where a DNSP or TNSP seeks to reduce its level of over-performance by reducing the level of reliability they provide compared to the previous regulatory control period, while still meeting relevant jurisdictional standards and targets.

The proposed rule would address this issue by amending the operating and capital expenditure objectives for distribution determinations and transmission determinations. These amendments would require DNSPs and TNSPs to only include sufficient expenditure in their proposals to the AER to comply with any relevant regulatory obligation or requirement that relates to the reliability of standard control distribution services or prescribed transmission services and the distribution or transmission system. The proposed amendments would remove the conflict that may arise between the requirement in the NER to include sufficient expenditure to maintain reliability levels, and jurisdictional obligations that only require DNSPs and TNSPs to comply with the applicable (and potentially lower) jurisdictional reliability standards or targets.

This proposed change to the NER would also remove any potential barriers to any savings in expenditure associated with reduced reliability standards being passed through to end use consumers.

5) How the proposed rule will or is likely to contribute to the achievement of the National Electricity Objective

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."[14]

[14] Section 7 of the National Electricity Law.

The proposed rule would contribute to the achievement of the NEO as it is likely to promote efficient investment in, and the efficient operation of, electricity distribution and transmission services.

This would occur as it would be clear that DNSPs and TNSPs would only be able to include sufficient expenditure in their regulatory proposals to comply with relevant regulatory obligations or requirements relating to the reliability of standard control distribution services or prescribed transmission services and distribution or transmission systems, rather than potentially being able to include expenditure to maintain reliability at a higher level than required. This would provide for more efficient investment, and in effect services, as only expenditure that is considered necessary by the AER as efficient and prudent to meet the relevant reliability standards or targets would be approved through the determination process.

In addition, clarifying the expenditure that DNSPs and TNSPs are able to seek in their regulatory proposals would improve regulatory certainty, which should provide for more efficient investment decisions and service provision. It would also remove any potential conflict between requirements in the NER and jurisdictional obligations to comply with jurisdictional reliability standards or targets.

It is considered that the proposed rule would be in the long term interests of consumers as it would ensure that the prices that end use consumers pay reflect the level of reliability set out in relevant regulatory obligations or requirements. This would allow any savings in expenditure that may arise from a lowering of distribution or transmission reliability standards or targets to be passed through to the network prices paid by end users.

For example, the AEMC has identified there would be potential cost savings to consumers from reducing the level of distribution reliability in NSW in its report for the NSW workstream of the *"Review of Distribution Reliability Standards and Outcomes"*.[15] However, if the NSW Government reduced the level of reliability that NSW DNSPs were required to provide, there is a risk that the cost savings from this reduction in reliability may not be able to be passed through to NSW consumers under the current NER.

6) Australian Energy Market Operator's Declared Network functions

This proposed rule change will not affect the Australian Energy Market Operator's declared network functions.

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[15] AEMC, 2012, Review of distribution reliability outcomes and standards, Draft Report- NSW workstream, June, p. iv

7) Expected costs, benefits, and impacts of the proposed rule

Broadly, the rule is expected to provide net benefits as a result of clarifying the intent of the expenditure objectives under Chapters 6 and 6A of the NER. Notable anticipated benefits include:

- reducing the risk of DNSPs and TNSPs over-investing in reliability (i.e. beyond the investment required to satisfy jurisdictional levels and targets); and
- ensuring potential costs savings associated with any lowering of reliability standards can be reflected in revenue determinations and retail electricity prices.

Apart from ensuring that relevant groups, including the AER, are aware of the impact of the clarification, the rule change is not expected to attract any material implementation costs.

At a detailed level this proposed rule is expected to impact DNSPs, TNSPs, jurisdictional governments and regulators, the AER and end use consumers. The impact on each of these stakeholders is discussed below in turn.

DNSPs and TNSPs

For DNSPs and TNSPs, the proposed rule should reduce uncertainty in relation to how they must apply the NER in forecasting capital and operating expenditure relating to meeting reliability obligations for their proposals to the AER. The proposed rule would require DNSPs and TNSPs to only include sufficient expenditure to comply with regulatory obligations or requirements relating to the reliability of standard control distribution services or prescribed transmission services and the distribution or transmission system in their proposals.

The proposed rule would then, in turn, affect the investments and operational expenditure that the AER could approve and that DNSPs and TNSPs could undertake. DNSPs and TNSPs would still have incentives to improve the level of reliability they provide compared to previous regulatory control period under the AER's STPIS.

As a result, while the proposed rule would ensure that DNSPs and TNSPs are only able to request sufficient expenditure to meet jurisdictional reliability standards and targets, they would still have an incentive to improve the level of reliability they provide through the STPIS.

Jurisdictional governments and regulators

As discussed above, each jurisdiction currently maintains responsibility for the level of reliability that should be provided by DNSPs and TNSPs in their jurisdiction. The proposed rule should ensure that where jurisdictional governments or regulators have determined that the level of reliability that is provided by DNSPs or TNSPs should be reduced, there is greater certainty that decisions are able to be implemented in practice and can flow through to the investments made by DNSPs and TNSPs and the network prices paid by end use consumers.

The AER

For the AER, the proposed rule will clarify how it must apply the NER in making transmission and distribution determinations. In particular, the proposed rule should remove any uncertainty that may exist for the AER in considering proposed expenditure for reliability based investments where jurisdictional reliability standards or targets have been reduced.

End use consumers

For end use consumers, the proposed rule should ensure that consumers are only required to fund efficient and prudent investments that are necessary to comply with regulatory obligations and requirements relating to the reliability of standard control distribution services or prescribed transmission services, and the distribution or transmission system. This should allow any benefits of lower levels of reliability related network investment to flow through to the network prices paid by end use consumers, where regulatory obligations or requirements have been amended to reduce the required level of reliability that is to be provided by DNSPs or TNSPs.

8) Summary of Consultation

Stakeholder consultation on the potential issues associated with a strict interpretation of "maintain" has occurred through the AEMC's *"Review of Distribution Reliability Outcomes and Standards"* – NSW Workstream and the AEMC's Economic Regulation of Network Service Providers Rule change process.

Submissions from Energy Networks Association, Jemena and the AER on the AEMC Directions Paper for the rule change supported changes to the NER to clarify the intent of the expenditure objectives as set out in this rule change application.

Representatives of NEM jurisdictions were consulted during preparation of this rule change application and also support clarifying the intent, in the context of current reviews of reliability frameworks and potentially changing jurisdictional standards.

9) Timing

To capture any potential decision by the NSW Government to lower distribution reliability standards as a result of the AEMC's recent reliability review, ideally any changes to the NER would need to be made no later than the anticipated date for submission of the regulatory proposals by the NSW DNSPs.

This would allow any changes to the operating and capital expenditure objectives to be taken into account when the NSW DNSPs prepare their expenditure forecasts.

The NSW DNSPs are currently required to submit their regulatory proposals to the AER for the next regulatory control period by the end of May 2013. However, in its draft consultation paper on savings and transitional arrangements for the *Economic Regulation of Network Service Providers rule change proposal* the AEMC has proposed delaying all NSPs, including NSW DNSPs, regulatory determinations by one year and requiring the AER to prepare a transitional one year determination for the interim year. Under this approach, this would require the NSW DNSPs to submit a regulatory proposal for the transitional determination by the end of September 2013 and a regulatory proposal for the next NSW distribution determination by the end of May 2014.

Proposed rule to amend the National Electricity Rules on the level of operating and capital expenditure for regulated services

The following proposed rule is based upon version 50 of the National Electricity Rules (NER).

Proposed rule to amend the National Electricity Amendment Rule [Year]

1 Title of Rule

In the event that the Australian Energy Market Commission receives a request to make a rule which relates to this proposed rule, the Commission may make the title of that the rule the *National Electricity Amendment (Level of operating and capital expenditure) Rule [year]*.

2 Commencement

In the event that the Australian Energy Market Commission is requested to make this proposed rule, the commencement date of the rule will be specified in the procedure for the making of a rule by the Commission under the National Electricity Law.

3 Amendment of the National Electricity Rules

The National Electricity Rules is proposed to be amended as set out in Schedule 2.

Schedule 1 Amendment of the National Electricity Rules

(Clause 3)

[1] Reference to paragraph (a1) in various clauses

In clauses 6.5.6(a)(3), 6.5.6(a)(4), 6.5.7(a)(3), 6.5.7(a)(4), 6A.6.6(a)(3), 6A.6.6(a)(4), 6A.6.7(a)(3), and 6A.6.7(a)(4) before "maintain", insert "subject to paragraph (a1)".

[2] Reference to regulatory obligation or requirement in forecast operating and capital expenditure In Chapter 6

After clauses 6.5.6(a) and 6.5.7(a), insert:

(a1) If a *Distribution Network Service Provider* is required to comply with a *regulatory obligation or requirement* that relates to reliability associated with the provision of *standard control services*, then for the purposes of paragraph (a), the amount that the *Distribution Network Service Provider* includes in its *building block proposal* to achieve each of the objectives in subparagraphs (a)(3) and (a)(4) as those objectives relate to reliability of the supply of those *standard control services* or those parts of the *distribution system* that are subject to that *regulatory obligation or requirement*, must be no more than an amount it considers is required to comply with that *regulatory obligation or requirement*.

[3] Reference to regulatory obligation or requirement in forecast operating and capital expenditure In Chapter 6A

After clauses 6A.6.6(a) and 6A.6.7(a), insert:

(a1) If a *Transmission Network Service Provider* is required to comply with a *regulatory obligation or requirement* that relates to reliability associated with the provision of *prescribed transmission services*, then for the purposes of paragraph (a), the amount that the *Transmission Network Service Provider* includes in its *Revenue Proposal* to achieve each of the objectives in subparagraphs (a)(3) and (a)(4) as those objectives relate to reliability of the supply of those *prescribed transmission services* or those parts of the *transmission system* that are subject to that *regulatory obligation or requirement*, must be no more than an amount it considers is required to comply with that *regulatory obligation or requirement*.

In the procedure for making a rule under the National Electricity Law, the AEMC will consider the need for any other amendments, including the need to make saving and transitional provisions in Chapter 11.