ElectraNet

2 May 2018

John Pierce
Chair
Australian Energy Market Commission
Level 6, 201 Elizabeth Street
SYDNEY NSW 2000

Contact: kate.reid@aemc.gov.au

Dear John,

Re: Electricity Network Economic Regulatory Framework Review 2018 (EPR0062)

ElectraNet appreciates this opportunity to respond to the AEMC's request for input on its annual review of the economic regulatory framework for electricity networks, following the stakeholder forum in which ElectraNet participated in Sydney on 23 April 2018.

ElectraNet understands that the AEMC will consider any further stakeholder input before delivering its final report for the 2018 review to the COAG Energy Council in late June 2018. ElectraNet therefore offers the following observations and input as the AEMC finalises its advice and recommendations on the way forward.

Capex Bias

The AEMC's first annual report, published in July 2017, noted concerns from stakeholders that network service providers (NSPs) have an inherent bias to prefer capital expenditure (capex) over operating expenditure (opex) and that its 2018 review would include an assessment of the financial incentives for NSPs in providing economically regulated services.

As part of its 2018 review, the AEMC commissioned Cambridge Economic Policy Associates (CEPA) to assess the regulatory incentives (and other non-regulatory incentives) that NSPs face under the current regulatory framework. CEPA's draft report, published on 16 April 2018, makes a number of key findings, but ultimately concludes:

> *"While we are unable to prove the presence of a systematic capex bias, we are similarly unable to conclude that the incentives provided by the current regulatory framework are balanced across capex and opex."*[1]

1 Cambridge Economic Policy Associates Pty Ltd, 'Incentives faced by network service providers: Draft Report', 16 April 2018, p.64 (CEPA Draft Report).

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Based on the conclusions of CEPA's draft report and stakeholder input to date, there appears to be no clear finding of capex bias emerging from the review.

Notwithstanding this, some specific elements of the economic regulatory framework for transmission warrant further attention at this time to ensure efficient outcomes are being delivered for customers, as discussed further below.

Non-network solution incentives

Leaving aside any question over capex bias more generally, ElectraNet has consistently observed that the current transmission regulatory framework provides no positive commercial incentive for TNSPs to pursue and procure non-network solutions. Non-network solutions can be a cost-effective substitute for network augmentation, and may include local generation, cogeneration, energy storage and demand-side response services.

This lack of incentive arises due to the 'lumpy' nature of such services at a transmission level, and the manner in which contracted costs are recovered as network support payments under the opex cost pass through arrangements under the Rules.

These pass through arrangements are an essential feature of the transmission regulatory framework, and recognise the fact that actual network support payment amounts may differ from year to year because the amount of contracted service required is dependent on factors that are outside the control of a TNSP, such as weather conditions, demand levels and electricity usage patterns.

These cost recovery arrangements leave TNSPs in a position whereby, at best, the incurred service costs of contracted non-network services are fully recovered, often in arrears. However, unlike capital expenditure which attracts a risk based return on investment, these arrangements deliver no commercial upside and bring considerable potential downside through potential cost recovery risk, cash flow risk, contractual risk and compliance risk, recognising that the TNSP retains service delivery accountability whereas contractual arrangements can never perfectly contract - and nor are counterparties willing to accept - this risk in full.

While this issue has been raised and acknowledged during the course of a number of recent AEMC reviews and rule change processes[2], there remains a lack of appropriate incentives for contractual delivery of such services as an operating expenditure cost pass through under the current regulatory framework, even when demonstrated to be the most efficient solution.

Potential solutions

We encourage further examination of this issue and potential solutions under the regulatory framework, and the current review provides an important opportunity to consider a way forward.

With the emergence of new technologies and the stable peak demand outlook at a transmission level, it is expected that the potential range and importance of non-network options as enduring solutions will continue to grow.

2 This includes for example the Demand Management Incentive Scheme Rule 2015, Annual Monitoring of Electricity Network Regulation Report 2017, Managing Power System Fault Levels Rule 2017 and Managing the Rate of Change of Power System Frequency Rule 2017.

Efficient development and delivery of such solutions, supported by balanced incentives on transmission businesses, is an important objective in the long-term interests of customers.

The AEMC's August 2015 Demand Management Incentive Scheme rule determination focused on balancing the incentives on DNSPs to make efficient decisions in relation to network expenditure, including investment in demand management, and introduced a two-part demand management incentive framework: the Demand Management Incentive Scheme (DMIS) and the Demand Management Innovation Allowance (DMIA).

During consultation, a number of stakeholders (both NSPs and non-NSPs) suggested that the scope of the rule change process be expanded to include consideration of the regulatory framework for demand management by TNSPs.

While the AEMC recognised the importance of this issue, noting that TNSPs "can, and do, contribute to effective demand management", the AEMC's final rule determination concluded that the extension of a demand management incentive scheme and innovation allowance to transmission businesses was beyond the scope of that particular Rule change process.[3]

Given the ongoing importance of this issue, ElectraNet suggests the AEMC consider the potential role for improved incentives for TNSPs to undertake efficient demand management and other activities to deliver system benefits across the NEM in the context of its current review.

Ahead of any broader changes to the regulatory framework which may develop in time, the introduction of non-network and demand management incentives for TNSPs modelled on those recently implemented for DNSPs would represent an appropriately targeted and proportionate reform in the interim. This would not require any changes to the current opex cost pass through arrangements which would remain an important cost recovery mechanism, even with demand management incentives for TNSPs in place.

We propose that the extension of the DMIS to include TNSPs would provide one potential solution to strengthen incentives for non-network contract solutions that are subject to opex cost pass through.

Indeed, one of the key findings of CEPA's draft report was that:

> *"The DMIS provides an incentive, for specific projects, to favour opex demand management over capex. The DMIS can, depending on the specific requirements of the project, more than fully offset the financial bias in the underlying framework of the EBSS and CESS."*[4]

As indicated in earlier submissions, while the scale of non-network solutions required to address transmission network constraints may be greater than that for the distribution network, the potential benefit of deferred network investment may also be commensurately larger.

Appropriate demand management incentives for TNSPs would also serve to achieve greater alignment of incentives across both transmission and distribution solutions and help maximise total system benefit, to the long-term benefit of all consumers.

3 AEMC, 'Rule Determination: National Electricity Amendment (Demand Management Incentive Scheme) Rule 2015', 20 August 2015, p.28.

4 CEPA Draft Report, pp. 62-3.

ElectraNet welcomes further engagement with the AEMC on this issue, and would be happy to discuss any aspects.

Please direct any queries in relation to this submission to Simon Appleby in the first instance on (08) 8404 7324.

Yours sincerely

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