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Ms Anna Collyer
Chair
Australian Energy Market Commission
GPO Box 2603
SYDNEY, NSW, 2001

Dear Ms Collyer

Re: Improving the cost recovery arrangements for non-network options (NNOs) – consultation paper

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) *Improving the cost recovery arrangements for non-network options (NNOs)* consultation paper. The issues and solutions assessed under this rule change focus on the cost recovery framework for any NNOs used as an efficient alternative to investment in network assets other than for system security purposes.

The rule change proponent, Transgrid, argues that regulatory barriers currently act as a barrier to the selection of NNOs as an alternative to network capex when looking to address network needs. The proposal seeks to change both initial and ongoing cost recovery methodologies, and the timing of cost recovery, in order to be able to assess both network and non-network options on an even basis.

This proposal follows changes to the cost recovery framework for NNOs for system security purposes through the AEMC’s *Improving security frameworks for the energy transition* (ISF) final rule. The ISF final determination introduced a common approach for Transmission Network Service Provider (TNSP) cost recovery of non-network system strength, inertia and network support and control ancillary services (NSCAS) costs (collectively non-network system security), but excluding non-network services other than for system security purposes.

Within the ISF final determination the AEMC noted that there may be a future need for cost recovery for NNOs more broadly to include investment by TNSPs in non-network support services as an efficient alternative to capex. The proponent, Transgrid, has concerns with the certainty and timing of cost recovery for NNOs compared to network options and aims to put NNOs identified as an alternative to network capex on a similar footing with network expenditure.

The AER notes that there are some benefits for the AER and TNSPs in terms of regulatory simplicity and efficiency in aligning the frameworks. However, the AER has some issues with aspects of this proposal, and its impacts on the broader incentive based regulatory framework. These are dealt with below in the context of the consultation paper questions.

Is initial and ongoing revenue uncertainty a material barrier to NNO projects?

We consider the existing framework accommodates NNO projects given existing arrangements for direct pass through of network support costs on a dollar for dollar basis through annual network support pass through arrangements. Additionally, we consider that under the existing framework, where costs have been approved either as part of a periodic revenue determination or ex-post pass through, there is little ongoing revenue uncertainty as the framework provides for costs associated with ongoing network support contracts to continue to be passed through in future revenue determinations without reassessment.

However, we recognise that these pass through arrangements operate on an ex-post basis and create a lag in the timing of cost recovery. This acts ex antas a potential source of uncertainty with regard to cost recovery and can present cash flow issues for TNSPs, which could act as a disincentive to pursuing NNO projects if these projects are not already accounted for in five yearly revenue determinations.

While the introduction of an ex-ante determination may increase confidence in TNSP cost recovery, we consider there will still need to be some room for regulatory discretion to ensure ex-post assessments have a meaningful purpose (e.g. for applying NER clause 6A.7.2(i)(2)). This discretion does not fully remove the uncertainty around cost-recovery that the rule change proponent seeks to address.

Should the NNO cost recovery frameworks for network augmentation and system security be aligned?

We consider that any arrangements to align the NNO cost recovery frameworks for network augmentation and system security need to consider whether the regulatory framework imposes discipline on TNSPs to undertake efficient investment and find the lowest cost solutions that meet system requirements and the long-term interests of consumers. There are strong ex-ante incentives and processes in place for capex, which ensure investments are in the long-term interests of consumers. These include scrutiny of forecast costs through a revenue determination and contingent project assessment processes; application of the Capital Expenditure Sharing Scheme; and the potential for ex-post reviews of inefficient expenditure. Reflecting the rigour imposed by these processes should be a key design consideration to create a level playing field.

There are benefits for the AER and TNSPs in terms of regulatory simplicity and efficiency in aligning the frameworks. However, the AEMC should consider whether the driver for levelling the playing field between network and non-network options requires the approach taken in the ISF rule change, given that implementation of network options (i.e. capex) remains subject to the existing incentive-based framework.

The AER notes that the ISF rule change implements annual processes for TNSPs projecting and recovering costs under system security network support contracts. This includes a new process for the AER considering ex-ante whether expenditure under significant contracts meets the NER criteria for efficient and prudent expenditure.

Prudency is based on establishing the necessity of expenditure. This is primarily determined by whether the payment, or payment methodology, in the contract is for a service required to meet a prescribed service standard, or a service, including non-security services, identified as a preferred option in the RIT-T process.

Efficiency is assessed against the standard opex criteria (and relevant factors for a network support pass-through) on the basis that a proposed payment or method for payment reflects the efficient market rate for a service, or is the least cost achievable.

Currently there is a potential risk for TNSPs not being able to recover all costs, as noted above. However, the TNSPs are best placed to manage this risk in how they undertake network planning and investment, as well as how they operate their network (e.g. in order to reduce the frequency or duration of system security events on their network, or potential network outages leading to reliability issues).

The AER is concerned about the risk to consumers of removing more expenditure from the incentive framework and reducing the incentives of TNSPs to minimise costs. If cost recovery is guaranteed, there is no incentive for the TNSP to avoid high costs being passed through, shifting this risk of higher than expected costs to the AER to manage through ex-ante approval of the expenditure. Without the ability to reject costs through an ex-post determination, the AER would have no leverage to manage the risk of higher than expected costs which then re-introduces that uncertainty on cost recovery. Therefore, this action is somewhat circular, and reintroduces the risk that the proposal is seeking to mitigate.

Finally, we note that the proposal involves a new function for the AER in making ex-ante determinations for NNOs. The implementation of this rule change proposal should recognise the resourcing implications for the AER and the need to allow for sufficient time to resource and implement these new functions.

The AER appreciates the opportunity to provide feedback on the consultation paper and we look forward to continued engagement as the AEMC progresses this rule change proposal.

Yours sincerely

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Policy