

9 August 2013

John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Via website: www.aemc.gov.au

Dear Mr Pierce,

Consultation Paper: Review of the National Frameworks for Transmission and Distribution Reliability

SP AusNet welcomes the opportunity to make this submission on the Australian Energy Market Commission's (Commission's) Consultation Paper on its proposed frameworks for distribution and transmission reliability in the NEM.

This submission focusses on the standards setting process proposed by the Commission, in relation to its application to electricity distribution. SP AusNet does not support a framework centred on prescriptive reliability standards, and this submission advances the relative benefits of an alternative, incentive driven, reliability framework.

Prescriptive standards are not an effective basis for a national framework reliability framework for distribution

SP AusNet has made submissions into earlier phases of the Commission's work for the distribution sector, including a submission on the Issues Paper (9 August 2012) and a submission in response to the Commission's Draft Report to the Standing Council on Energy and Resources (25 January 2013). In these submissions SP AusNet noted its support for a level of consistency in the national framework for reliability – to the extent that this is beneficial to the National Electricity Objective.

SP AusNet does not support the approach proposed by the Commission, imposing a target setting process inconsistent with the use of incentives to drive reliability outcomes. Imposing a target setting process, and one which is prescriptive and resource intensive, increases the administrative burden while severely depressing the incentive driver for 'least cost' reliability improvement. As such the approach is likely to raise the cost for customers in jurisdictions where the incentive driven reliability framework already applies, such as in Victoria, without compensating benefits.

The Consultation Paper retains and builds on the standards setting approach set out in the Commission's previous work. Accordingly, SP AusNet does not support the approach

as it does not present an advancement of the incentive-driven regime currently being rolled out across the NEM, but would be a retrograde step. This would be inconsistent with the National Electricity Objective.

The Commission's proposed approach is based on the approach it applied in early 2013 in revising the NSW reliability standards. The approach was appropriate for that purpose, as a detailed analytic exercise was necessary to assess the mandated standards in force and required recalibration. The approach is also more applicable for the setting of transmission reliability standards, where input measures form the basis of the standards.

For electricity distribution, a framework built around the use of prescribed standards would have a number of undesirable effects, including the following:

- Significant levels of duplication in network planning activity, creating resource and cost burdens, and potentially issues arising from different outcomes in the phases. The Consultation Paper acknowledges that the proposed process would be costly
- Incompatibility with the reliability improvement incentive regime, due to step-change divergence between 5 yearly re-established standards and reliability performance improvement trending which would ideally be driven by the Service Target Performance Incentive Scheme (STPIS). Quite likely the incentive scheme would need to be one sided, i.e. applying penalty for deteriorating performance would be problematic
- The lag between investment decisions and resulting reliability outcomes would undermine the ability to monitor achievement of prescribed output standards
- In setting standards, broad network development plans developed to align with chosen scenarios would tend toward solutions that the industry (including engineering consultants) has experience and confidence with. Plans and costs would therefore be comparatively conservative. It is unlikely that a reliability setting arising from the process could be efficient
- The approach neglects dynamic efficiency factors. There is a lack of clarity on longer term reliability expectations and incentive properties due to the regular resetting of standards. The potential efficiency improvements through the opex / capex trade-off is ignored
- The regulatory framework contains a number of mechanisms to facilitate efficient investment. The regulatory investment test for distribution (RIT-D) places a discipline on network businesses to ensure that investments deliver net benefit to customers. The imposition of prescribed standards would consign this test, conducted on a per project basis, to a 'lowest cost' test. As an 'economic benefits' test the RIT-D is capable of determining the value of a network / service enhancement at a much nearer point in time to the investment commitment

As a result of factors such as those described above outcomes for customers would be less efficient under a prescriptive reliability performance framework.

When reliability can be monitored via output measures an incentive based performance framework is superior

Where output measures are able to form the basis for measuring and monitoring reliability performance an incentive-based approach forms both the most administratively cost effective approach and is superior in efficiently driving the economic reliability thresholds upward, to the benefit of consumers. This has been the conclusion drawn by the Productivity Commission (PC), which recommended an incentive-based reliability framework for distribution in its Report on its inquiry in Electricity Networks Regulation. The PC's primary recommendation on distribution reliability is:

All jurisdictions should adopt the Australian Energy Regulator's Service Target Performance Incentive Scheme as the basis for setting efficient reliability requirements for distribution businesses. The Scheme should replace all existing jurisdiction-specific distribution reliability requirements¹.

The Commission has also previously identified an incentive-based reliability framework for distribution as warranting consideration. In the Issues Paper for the preceding phase of this review the Commission made the following statement:

'Given that the AER's STPIS already provides for a consistent framework for incentive schemes and GSL payments, a third approach would be for jurisdictions to remove at least some of their current jurisdictional reliability requirements and rely instead on the AER's STPIS. As discussed in Chapter 4, there are costs and risks of inconsistent incentives if there is duplication between jurisdictional requirements and the requirements of the STPIS. A significant degree of consistency could be achieved relatively easily by simply removing some of the existing jurisdictional requirements that may no longer be needed once the STPIS is in place².

For electricity distribution, an incentive-based reliability framework would avoid the issues listed in the preceding section, and offer a number of significant benefits, including the following:

- Reliability improvement is driven by innovation. As there is no expenditure provision in the revenue path for the regulatory period the network service provider (NSP) relies on financial incentives from subsequent reliability performance improvement (where valued by customers) to fund investment.
- The efficiency at which reliable service is provided to customers is enhanced. Significant investment risk is borne by the NSP, and research to develop

¹ Productivity Commission 2013, *Inquiry into Electricity Network Regulatory Frameworks*, page 579, Report No 62

² Australian Energy Markets Commission 2012, *Review of Distribution Reliability Outcomes and Standards, Issues Paper – National Workstream*, page 41

innovative, high benefit / cost ratio projects accordingly predominate. The benefits pass through to customers.

- The economic frontier of reliability is pushed upward. Customers receive an increasing level of reliability, within the value they place on reliability, for which the impetus would not be present within a prescribed standards based reliability framework.

An incentive-based reliability framework is consistent with the SCER objectives for the Commission's review

The Standing Council on Energy and Resources (SCER) terms of reference for the development of a national framework foremost require that the approach be economically efficient. The terms of reference state:

In undertaking this work, the AEMC will ensure that the approach taken to setting reliability requirements reflects economically efficient outcomes in the long term interests of consumers, based on the value customers place on the reliability of electricity supply.

The SCER objective in effect requires a best practice framework. The approach that is assessed to deliver the more efficient outcomes, and only this approach, will satisfy the SCER objective. The assessment of the two approaches provided in this submission would indicate that this is an incentive-based reliability framework. This includes the analysis and conclusions of the Productivity Commission.

The Consultation Paper recognises that the PC has recommended an incentive-based framework, and that the government response provides in-principle support to the applicable PC recommendations. However the Consultation Paper seems otherwise to disregard the potential of the approach and provides no comparative analysis. This will be necessary to meet the SCER request that the Commission provide indicative costs of implementation and the costs and benefits of application.

The SCER terms of reference require a framework that would be consistently applied whether administered by a jurisdictional minister or the Australian Energy Regulator (AER). The terms of reference state:

...directs the AEMC to:

- *develop a nationally consistent framework and methodology ...that can be adopted by a relevant jurisdiction and/or applied by the Australian Energy Regulator*

The approach proposed in the Consultation Paper would not readily meet this objective. The Consultation Paper indicates that when applied within a jurisdiction some discretion in trading off costs and benefits may arise, whereas this would not be the case when

applied by the AER. The potential for different implementation by jurisdictions severely weakens the national consistency that is sought by SCER. Mechanisms to deal with special circumstances may be warranted but this should not be at the expense of consistency and efficiency in the base regime. This is discussed further in the next section.

The implementation of a consistent approach, transparently, will enable comparative analysis of network performance and responsiveness to the regulatory regime to be conducted most effectively.

A criticism levelled at the incentive-based reliability framework is that it is not transparent. We think this completely misrepresents the relative circumstances, for the following reasons:

- Reliability outturn performance is reported annually and therefore observed.
- The incentive regime that drives reliability performance management is established through a consultative process by the AER
- Investment is required by the regulatory framework to be economically justified, and all major investment is subject to a net benefit test (RIT-D)
- The reliability targets for a regulatory period are by default set on the basis of the trend over the preceding period. This is perfectly transparent. It also maintains the tracking of the reliability performance efficiency frontier and therefore provides an efficient setting.

The SCER terms of reference also require the framework to consider options for taking into account local circumstances. This is discussed in the following section.

There are options available to all key stakeholders whereby local circumstances can be accommodated in service reliability management in the presence of an incentive-based reliability framework

The Productivity Commission report, experience with operation of an incentive-based reliability framework in Victoria, and developing consumer consultation obligations in the National Electricity Rules reveal how local circumstances may be effectively taken into account in the regime. These include the following:

- Provisions to ensure security of supply for critical loads, such as capital city CBD. In such circumstances a higher level of reliability may be deemed warranted than is justified through the prevailing methodology for economic assessment. In Victoria the Electricity Distribution Code provides for jurisdictional approval (via the Essential Services Commission) of a reliability management plan for the Melbourne CBD. This becomes a regulatory obligation for the NSP to manage. Importantly, jurisdictional intervention is the exception, and so increased attention

would expect to be drawn to the exercise of this practice. This should encourage its use only when clearly necessary

- Management plans and reporting for worst performing feeders. Annual Planning Reports may require the NSP to identify worst performing feeders, and to develop and report against management plans. Increased focus on consumer consultation by businesses, and as is increasingly being established through the regulatory framework, provides the opportunity for local communities and NSPs to engage on local reliability issues. SP AusNet can provide an example of where it has worked with the local community to gain mutual understanding and develop an effective outcome
- Weightings on feeder classes in the STPIS. In designing the incentive regime the AER has the ability to adjust the incentive rate for the various feeder classes (long rural, short rural, urban etc). The AER would consider allocative efficiency factors in making such decisions, having regard to the performance trends
- The application of guaranteed service levels (GSLs). GSLs provide a level of compensation to customers where systemic system poor reliability performance occurs. The STPIS includes a GSL component. GSLs are not currently effectively applied to NSPs in all jurisdictions.

SP AusNet's conclusion is that an incentive-based reliability framework can be designed to contain a range of methods whereby local circumstances can be addressed, including through jurisdictional intervention where this is warranted.

A transition path to a more efficient, national incentive-based reliability framework is necessary

As noted earlier, the SCER terms of reference requires that the framework be capable of being adopted by either the jurisdiction or the AER. This does not preclude an incentive-based framework being subject to jurisdictional oversight. However this would be transitional, since once it is settled and confidence attained, the on-going functional roles for the jurisdiction and the regulator in the framework design would be expected to be assumed. This should be the ambition of the national framework.

To ensure there is a path toward adoption of a more efficient, national framework SP AusNet would recommend that the Commission develop a transition path, taking into account the prevailing frameworks in the various jurisdictions and the confidence they require to adopt alternative arrangements. New South Wales has already completed an initial stage, by having the Commission establish output reliability targets for its NSPs. We suggest the following generic steps for the consideration of the Commission:

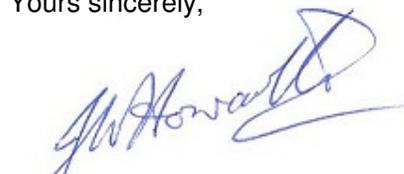
- Jurisdictions that have set standards in the past would transition into the regime by establishing transition targets

- Where the jurisdiction has previously applied output measures as targets consistent with STPIS a seamless transition is possible
- Where the jurisdiction has previously applied input based standards then new output measure targets would need to be derived. This would be a one-off exercise, typically applying the AEMC approach
- STPIS may require provisions to respond to step-change in targets
 - If reliability target is lower than inherent reliability level, a dead band may be necessary to avoid penalty over period that reliability reduction takes place
 - Or the penalty could be tailored to encourage cost saving to move to efficient point
 - By default transfer to regular STPIS should be complete after 1st regulatory period. The AER may confirm readiness as part of its Framework and Approach for the 2nd regulatory period.

SP AusNet's conclusion is that an incentive-based reliability framework is more reflective of 'best practice' and should underpin the establishment of a nationally consistent reliability framework. The Commission's final report to SCER should provide an assessment of the relative benefits of this approach for a sustainable, efficiency driving regime. This may require further analysis to be undertaken and certainly the opportunity for further stakeholder engagement.

We would be pleased to support our submission through further discussion of the issues with the Commission. We look forward to working with the Commission in the further development of the framework. Please contact Kelvin Gebert, our Manager Regulatory Frameworks, on 03 9695 6603.

Yours sincerely,



John Howarth
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