Australian Energy Market Commission

RULE DETERMINATION

National Electricity Amendment (Recovery of Network Support Payments) Rule 2013

Rule Proponent

SP AusNet

31 October 2013

For and on behalf of the Australian Energy Market Commission

RULE CHANGE

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About the AEMC

The Council of Australian Governments (COAG), through its then Ministerial Council on Energy (MCE), established the Australian Energy Market Commission (AEMC) in July 2005. In June 2011, COAG established the Standing Council on Energy and Resources (SCER) to replace the MCE. The AEMC has two main functions. We make and amend the national electricity, gas and energy retail rules, and we conduct independent reviews of the energy markets for the SCER.

Summary

The Australian Energy Market Commission (AEMC or Commission) has determined not to make a rule in response to SP AusNet's (the proponent) rule change request regarding the recovery of network support costs. The Commission considers the current National Electricity Rules (NER or rules) provide appropriate cost recovery mechanisms for network support costs.

Network support service arrangements

A network support service arrangement is a type of non-network solution, which defers the need for traditional network investment. Under this arrangement local (or embedded) generation could be contracted by the network service provider (NSP) to provide a service to address a network constraint. In certain circumstances, a NSP may find it more cost effective to implement a non-network solution to maintain system reliability than expanding its network. Since the cost of a non-network solution is recovered through operating expenditure this may involve substituting capital expenditure for operating expenditure. The network support costs would be agreed between the network support provider and NSP.

SP AusNet's rule change request relates to network support costs for services that defer:

- distribution network augmentations; and
- investment in transmission-distribution connection assets.[1]

With respect to services that defer investment in transmission-distribution connection assets, SP AusNet considers this is particularly an issue relevant to Victoria. Under the Victorian electricity distribution licence obligations, Victorian distribution network service providers (DNSPs) are responsible for planning transmission-distribution connection assets.[2]

Cost recovery for network support service arrangements

SP AusNet’s rule change request relates to the way in which NSPs recover network support costs. In general, NSPs are able to recover from consumers the NSP’s efficient costs of supplying regulated network services. The amount that is able to be recovered is determined through incentive-based regulation. A revenue allowance is determined at the beginning of a regulatory control period and NSPs are rewarded or penalised with respect to the allowance to encourage efficient performance.

1 For example, instead of the DNSP undertaking a distribution network augmentation to maintain distribution system reliability, a DNSP could enter into an alternative non-network arrangement with an embedded generator to provide network support for this.

2 Each Victorian DNSP must comply with the Victorian Electricity Distribution Code under its electricity distribution licence. As part of its licence subject to this Code, the Victorian DNSP is responsible for planning, and directing the augmentation of, transmission-distribution connection assets.

In some circumstances, costs or projects can be difficult to predict and there can be difficulty in determining an accurate revenue allowance. As a consequence, a stronger form of incentive-based regulation may not work as well. In those specific cases, it may be appropriate to adjust the revenue allowance after it is set. The adjustment is known as a cost pass through. Although the Australian Energy Regulator (AER) still assesses the efficiency of the cost pass through, it can be regarded as a weaker form of incentive-based regulation.

SP AusNet's rule change request seeks to include a new specific pass through in the rules as a cost recovery mechanism for network support costs. This would be in addition to its current cost recovery mechanism through the existing revenue allowance.

Under SP AusNet's proposal, NSPs would be able to seek to recover the above network support costs during a regulatory control period via the specific network support pass through. Currently, specific network support pass throughs are only applicable to the transmission network service providers (TNSPs) for network support service arrangements that defer transmission network augmentations.

Commission's rule determination

In deciding not to make a rule, the Commission considers that the current regulatory determination process provides an appropriate basis for the recovery of network support costs. This is consistent with incentive-based regulation, which benefits consumers in the long term.

In addition to the regulatory determination process, the rules already provide opportunities to recover certain types of cost pass throughs. Some cost pass throughs are currently specified in the rules, and others can be nominated by a DNSP and accepted by the AER as part of the DNSP's regulatory determination process (referred to in this rule determination as "nominated pass throughs"). The existing cost pass through provisions could potentially apply to network support costs. The Commission acknowledges that this is subject to the discretion of the AER.

If the proponent's rule change request were made, it would have had the effect of increasing the number of specific pass throughs that are listed in the rules. Introducing additional cost pass throughs into the rules would weaken the overall incentive-based approach to regulation. The Commission does not consider that treating such costs as a cost pass through, as opposed to relying on the existing cost recovery mechanisms in the rules, would provide sufficiently strong incentives for efficient cost recovery consistent with the National Electricity Objective (NEO) and revenue and pricing principles.

The Commission notes that the AER is able to consider the balance of the incentives between network and non-network solutions, and substitution between capital expenditure and operating expenditure, when determining the appropriate cost recovery. The AER could use its discretion to adjust these incentives to counter any distortions that might discourage network support service arrangements.

In Victoria, neither the TNSP nor the DNSPs have received a capital expenditure (capex) allowance in the current period for the purpose of transmission-distribution connection asset augmentation. Therefore, there is no capex allowance to substitute for an opex allowance for the purpose of undertaking a non-network solution to transmission-distribution connection asset augmentation. This could be addressed in the next regulatory period when the TNSP or the DNSPs in Victoria could seek a capex allowance in respect of transmission-distribution connection asset augmentation.

The Commission notes that SP AusNet proposes a more preferable rule in its submission to the draft determination. This more preferable rule is similar to the original rule change request, except that it only deals with the transmission-distribution connection assets component. This does not affect the requirement for the Commission to consider the entirety of the original rule change request.

The Commission considers it remains appropriate for network support costs for services that defer investment in distribution network augmentation and transmission-distribution connection assets to be included as part of the overall revenue allowance. That is, any request to recover these costs would be assessed by the AER at the time of the regulatory determination for a given regulatory control period. This means that such costs will be subject to a strong incentive-based framework which best meets the NEO.

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1 SP AusNet's rule change request

1.1 The rule change request

On 17 December 2012, SP AusNet (proponent) made a rule change request to the Australian Energy Market Commission (AEMC or Commission) in relation to recovery of costs for network support service arrangements that defer investment in:

- the distribution network; and
- connection assets used to connect a transmission network to a distribution network ("transmission-distribution connection assets").[3]

SP AusNet seeks to be able to recover these network support costs via specific network support pass throughs. It considers this would provide more certainty to network service providers (NSPs) that they can recover these costs, especially during a regulatory control period, and remove bias against the uptake of non-network solutions. It proposes for this rule change to commence immediately so that it can be applied to its existing regulatory determination during the current 2011-2015 regulatory control period.

A network support service arrangement is a type of non-network solution, which defers the need for a traditional network investment. For example, under this arrangement local (or embedded) generation could be contracted by the NSP to provide a service to address a network constraint.

For instance, the network support service arrangement might take the place of augmentation of either the network (such as building additional transmission lines) or transmission-distribution connection assets. Network support costs are costs for providing this service. The network support costs would be agreed between the network support provider and NSP.

1.2 Current arrangements

In respect of costs of providing regulated services, NSPs recover these through one of four main mechanisms:

Cost recovery mechanism	Description
1. Regulatory determination process	• The NSP forecast costs as part of its regulatory proposal • The Australian Energy Regulator (AER) assesses and approves revenue according to criteria in the National Electricity Rules (NER or rules)

3 For the purposes of this rule determination, costs for these network support service arrangements will be referred to as "network support costs", unless indicated otherwise.

Cost recovery mechanism	Description
	• The NSP recovers revenue over the regulatory control period
2. Specific pass through	• Pass through events listed in the rules • If a pass through event occurs during a regulatory control period, the NSP can apply to the AER to recover costs incurred • The AER assesses according to criteria in the rules
3. Nominated pass through	• The NSP may consider an event should be defined as a pass through event and propose this as part of its regulatory proposal • The AER determines whether to accept the pass through event • If the pass though event occurs during a regulatory control period, the NSP can apply to the AER to recover additional costs and the AER must assess according to criteria in the rules
4. Pricing process (distribution network service providers (DNSPs))	• Occurs annually • The AER approves prices which enable DNSPs to recover their allowed revenues under mechanisms 1 to 3 above • Certain specified costs can be included

With respect to network support costs for services that defer transmission network augmentations,[4]there are currently specific pass through arrangements that allow transmission network service providers (TNSPs) to recover these costs, subject to AER approval (mechanism 2 above). However, unlike other specific pass throughs, these costs are not subject to a materiality threshold.[5]

Associated with this specific network support pass through for TNSPs, there is an operating expenditure (opex) roll forward arrangement.[6] This mechanism only applies if a TNSP has made payments under a network support service arrangement in the previous regulatory control period and must continue to make payments under that arrangement in the relevant regulatory control period. Here, the AER must accept the forecast of required opex included in a regulatory proposal in relation to the remainder of costs required to meet obligations under that network support service arrangement in the relevant regulatory control period.

4 These particular network support costs for services that defer transmission network augmentations are referred to as "network support payments" in the rules.

5 With the exception of the specific network support pass through for TNSPs, a materiality threshold currently applies to cost pass throughs. Unless costs incurred due to an event reach this threshold, they cannot be recovered as a cost pass through. The materiality threshold is set at one per cent of the annual revenue requirement (for distribution) or maximum allowed revenue (for transmission).

6 NER clause 6A.6.6(c1).

In relation to network support costs for services that defer distribution network augmentations and transmission-distribution connection assets, these costs may be included in a NSP's regulatory proposal as part of its forecast of expenditure required to provide regulated services (mechanism 1 above). Alternatively, where a network support service is required to respond to a cost pass through event, the AER could consider whether these costs should be recovered as a cost pass through (mechanism 2 or 3 above). The regulatory determination process and nominated pass throughs are discussed further in section 5.3.1.

1.3 Rationale for the rule change request

There are two specific issues that the proponent raises:

- DNSPs are unable to recover network support costs for services that defer distribution network augmentations during a regulatory control period in the same way TNSPs can for services that defer transmission network augmentations. That is, DNSPs cannot recover costs associated with network support arrangements via a specific network support pass through (including the opex roll forward arrangement); and
- neither DNSPs nor TNSPs are able to recover network support costs for services that defer transmission-distribution connection assets via specific network support pass throughs.

1.3.1 Recovery of network support costs for services that defer distribution network augmentations

With respect to the first issue, the proponent considers:

- DNSPs are not afforded the same level of certainty to recover efficient network support costs as TNSPs;
- the nature of the network support costs makes it difficult for DNSPs to forecast these costs at the beginning of the regulatory control period;
- the current rules are biased towards network solutions over non-network solutions (that is, network support services), and do not treat non-network solutions on an equal footing;
- DNSPs have less incentive to contract network support service arrangements until the next regulatory control period even if these are the lowest cost solutions; and
- DNSPs cannot recover efficient network support costs initiated within the current regulatory control period.

1.3.2 Recovery of network support costs for services that defer transmission-distribution connection assets

With respect to the second issue, this is of particular interest to Victorian DNSPs who are responsible for transmission-distribution connection planning. The proponent considers that DNSPs in Victoria would be more likely to consider non-network alternatives to transmission-distribution connection assets. This includes entering into network support service arrangements that defer investment in these assets.

The proponent considers that similar issues described in section 1.3.1 with respect to network support costs for services that defer distribution network augmentations can also apply to services that defer transmission-distribution connection assets.

1.4 Solution proposed in the rule change request

The Rule Proponent proposes that the Commission address the issues referred to above by making a rule that seeks to:

- allow DNSPs to recover the network support costs for services that defer distribution network augmentations during a regulatory control period via specific network support pass throughs equivalent to that currently available to TNSPs;
- apply the opex roll forward arrangement to DNSPs where network support service arrangements extend beyond one regulatory control period; and
- extend the scope of specific network support pass throughs (which includes the opex roll forward arrangement) to allow for TNSPs and DNSPs to recover network support costs for services that defer transmission-distribution connection assets.

The proponent requests that the rule change commences immediately after the rule is made so that it would apply during the proponent's current 2011-2015 regulatory control period. This would potentially allow an adjustment to its existing revenue allowance for that period.

1.5 Relevant strategic priority

This rule change request is relevant to the AEMC's strategic priority relating to market arrangements that encourage efficient investment and flexibility. It affects how NSPs can recover their costs which in turn has an impact on NSPs' incentives to invest.

1.6 Commencement of rule making process

On 11 April 2013, the Commission published a notice under section 95 of the National Electricity Law (NEL) advising of its intention to commence the rule making process and the first round of consultation in respect of the rule change request. A consultation paper prepared by the AEMC identifying specific issues or questions for consultation was also published with the rule change request. Submissions closed on 10 May 2013.

The Commission received four submissions on the rule change request as part of the first round of consultation. They are available on the AEMC website[7].

1.7 Extension of time

On 27 June 2013, the Commission published a notice under section 107 of the NEL advising of the extension of the period of time for publication of the draft rule determination to 8 August 2013. The extension of time was to allow for further policy analysis to address the issues raised in the rule change request and submissions.

1.8 Publication of draft rule determination

On 8 August 2013 the Commission published a notice under section 99 of the NEL and a draft rule determination in relation to the rule change request (draft rule determination). The Commission's draft determination was to make no rule.

Submissions on the draft rule determination closed on 19 September 2013. The Commission received four submissions on the draft rule determination. They are available on the AEMC website[8]. A summary of the issues raised in submissions, and the Commission’s response to each issue, is contained in Appendix A.1.

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7 www.aemc.gov.au

8 www.aemc.gov.au

2 Final Rule Determination

2.1 Commission’s determination

In accordance with section 102 of the NEL the Commission has made this final rule determination in relation to the rule proposed by SP AusNet. The Commission has determined not to make a rule.

The Commission's reasons for making this final rule determination are set out in section 2.4.

2.2 Commission’s considerations

In assessing the rule change request the Commission considered:

- the Commission’s powers under the NEL to make the rule;
- the rule change request;
- the revenue and pricing principles;[9]
- submissions received during first and second round of consultation; and
- the Commission’s analysis as to the ways in which the proposed rule will or is likely to, contribute to the achievement of the National Electricity Objective (NEO).

There is no relevant Ministerial Council on Energy (MCE) statement of policy principles.[10]

2.3 Commission’s power to make the Rule

The Commission is satisfied that the proposed rule falls within the subject matter about which the Commission may make rules. The proposed rule falls within the matters set out in section 34 of the NEL as it relates to regulating the activities of persons (including registered participants) participating in the National Electricity Market (NEM) or involved in the operation of the national electricity system (section 34(1)(a)(iii) of the NEL).

9 Under section 7A of the NEL, the AEMC must have regard to the revenue and pricing principles.

10 Under section 33 of the NEL, the AEMC must have regard to any relevant MCE statement of policy principles in making a rule. In September 2011, the Council of Australian Governments created the Standing Council of Energy and Resources, which includes Ministers responsible for energy. These Ministers comprise the membership of the legally enduring MCE.

2.4 Rule making test

Under section 88(1) of the NEL the Commission may only make a rule if it is satisfied that the rule will, or is likely to, contribute to the achievement of the NEO. This is the decision making framework that the Commission must apply.

The NEO is set out in section 7 of the NEL as follows:

> "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.""

The key aim of this rule change request is to enable NSPs to recover network support costs during a regulatory control period via specific network support pass throughs. These network support costs relate to services that defer distribution network augmentations and transmission-distribution connection assets.

The Commission is not satisfied that the proposed rule will, or is likely to, contribute to the achievement of the NEO. This is because the Commission considers that the regulatory determination process provides an appropriate cost recovery mechanism for network support costs. The Commission notes that there is also potential for a nominated cost pass through. However, this is subject to the AER's discretion and there are considerations listed in the rules, which must be taken into account by the AER when it exercises this discretion.

2.5 Other requirements under the NEL

In applying the rule making test in section 88 of the NEL, the Commission has taken into account the revenue and pricing principles as required under section 88B of the NEL. The proposed rule relates to matters specified in items 15, 20, 25 and 26D of Schedule 1 to the NEL.

The revenue and pricing principles are set out in section 7A of the NEL. They set out a number of principles that concern matters such as the recovery of efficient costs and incentives to promote economic efficiency.[11]

Under the current regulatory determination process, the NSP is subject to a strong incentive-based framework as part of the overall revenue allowance. This encourages the NSP to forecast as accurately as possible and manage its costs, including network support costs, within its overall revenue allowance. In addition, where a network support service is required to respond to a cost pass through event, then the NSP could

11 NEL sections 7A(2)(a), (3)(a)-(b).

apply to the AER to have these costs recovered as a cost pass through. These mechanisms provide sufficient opportunities for NSPs to recover efficient costs consistent with the NEO and revenue and pricing principles.

In particular, the current cost recovery mechanisms:

- provide NSPs with a reasonable opportunity to recover at least the efficient costs that they incur in the provision of regulated services; and
- aim to promote efficiency with respect to the provision of regulated services through the application of effective incentives.

3 Commission's assessment approach

This chapter describes the analytical framework that the Commission has applied to assess the rule change request in accordance with the requirements set out in the NEL (and explained in Chapter 2).

In assessing the rule change request against the NEO, we have considered the appropriateness of the current arrangements under the rules.

The fundamental principle of the existing network regulatory arrangements is that an incentive-based regulatory determination process best meets the NEO. Notwithstanding this, there may be circumstances where weaker forms of incentive-based regulation are more appropriate.

With this in mind, in assessing the rule change request against the NEO, the Commission has considered the following factors:

- **Effective incentives**
  - efficiency - incentive-based regulation provides incentives for NSPs to minimise costs, promoting efficient and timely investment, and ultimately lower prices for consumers; and
  - risk management - risks should be allocated to those parties who are best placed to manage them through appropriate financial incentives;
- **Recovery of efficient costs**
  - NSPs should be able to recover costs where they are efficient having regard to the need to incur the costs, given the expected benefits, and minimising the actual costs to deliver a particular benefit; and
- **Proportionality**
  - the implementation and administration costs of the solution needs to be proportionate to the benefits of the solution; and
  - where the current rules appropriately address the problem identified in the rule change request, a rule change would be unnecessary.

The network regulatory framework set out in the rules is designed such that NSPs face incentives to incur only efficient costs associated with providing regulated services. When NSPs meet their service obligations at least cost, productive efficiency is maximised and costs to consumers are minimised.

The NSP’s choice on whether to undertake network augmentation to meet its expenditure objectives, or seek network support service arrangements to locate embedded generation on its network for example, will affect the cost of meeting those objectives. This in turn will therefore impact upon productive and dynamic efficiency.

The extent to which the NSP can choose alternative options for meeting its objectives at potentially lower costs will increase this level of efficiency and minimise costs to consumers.

The NSP may need to trade-off the risk between long term solutions with higher costs and short term solutions with lower costs. A question arises as to whether the current cost recovery arrangements appropriately balance between capital expenditure (capex) incentives for network solutions and opex incentives for non-network solutions.

Regulation should only allow for an "efficient" level of costs to be recovered by NSPs (including a reasonable profit). This is in contrast to allowing all expenditure to be recovered from customers, without any review of whether the level of costs incurred is efficient. Costs are efficient when they are minimised and lower than the value of the benefit they provide. In the case of network investment, the benefit provided may include increased reliability, security, quality or safety of electricity supply.

In addition to providing effective incentives and allowing for recovery of efficient costs, the rule needs to be proportionate in its implementation. A rule that imposes significant additional administrative costs on NSPs and the regulator may not be justified.

4 Approach to recovery of costs for regulated services

In this chapter, the Commission considers the role of incentive-based regulation and how it should be balanced against regulation that provides regulated businesses with different strengths of incentives in respect of the recovery of their costs. Chapter 4 underpins the Commission's approach to chapter 5, which addresses the recovery of network support costs in greater detail.

4.1 Incentive-based regulation

Incentive-based regulation is an approach that is often applied to regulate natural monopoly businesses, including electricity network businesses in Australia. These electricity businesses became subject to incentive-based regulation which was, in part, to address information asymmetries associated with cost of service regulation.[12]

Under incentive-based regulation, regulated businesses can be rewarded or penalised to encourage efficient performance. This is achieved by specifying the level of performance and a revenue allowance at the beginning of a regulatory control period. The regulated business is therefore funded to meet that level of performance over the duration of that regulatory control period.

If the regulated business outperforms the revenue allowance during the regulatory control period, it can retain a proportion of its efficiency savings. The remaining benefits would be passed to consumers in the form of lower prices in the long term. As a result, incentive-based regulation allows the regulated business to recover efficient costs and receive a commercial return.

A fundamental part of incentive-based regulation is that the regulator does not approve specific projects. Instead, the regulated business is provided with the discretion to determine which projects it undertakes during the regulatory control period within its maximum allowed revenue.

For example, the regulated business can decide how it manages and reprioritises its expenditure for the provision of services to its customers, such as meeting reliability standards. This encourages the regulated business to become more accountable to its customers, searching for efficiencies that ultimately benefit the regulated business and its customers.

The Commission considers that incentive-based regulation offers a range of benefits which should be preserved in the rules wherever possible. These include:

- accountability - the regulated business has the responsibility to manage how it delivers its service obligations within its allowed revenue;

12 Cost of service regulation involves reimbursing a regulated business for its realised costs.

- efficiency - the regulated business will be financially incentivised to find more efficient ways to operate as it retains some of the savings, while customers benefit from more efficient business practices in the long term;
- efficient risk allocation - the regulated business should bear the risk when forecasting expenditure as it would be in a better position to manage those risks;
- avoiding information asymmetries - since the regulator does not approve individual projects, the regulator has less need to access the regulated business's information; and
- lowering regulatory burden - the regulator has a guiding role for business decision-making and enforcing compliance, without the need for regulatory intervention and detailed project-by-project assessments.

The above benefits of incentive-based regulation promote the NEO. This is because the regulated business is incentivised to make efficient investment decisions and be rewarded for managing its expenditure, while consumers receive some of the benefits. This leads to efficient investment in the provision of services and recovery of efficient costs which would be in the long term interests of consumers.

This approach to incentive-based regulation underpinned the rule changes made by the AEMC in 2012, which are discussed further in section 4.3 below.

4.2 Different degrees of incentive-based regulation

In some cases, it may be appropriate to apply a weaker form of incentive-based regulation. For example, some costs are outside the control of the regulated business, such as taxes or other costs imposed by legislation.

In addition, where costs or projects are difficult to predict, such as projects that depend on an external trigger, there would be difficulty in determining an accurate revenue allowance. As a consequence, a stronger form of incentive-based regulation may not work as well.

In those specific cases, it may be appropriate to reduce the incentives to provide investment certainty. This may involve a greater use of project-by-project assessments and an adjustment of the regulator’s regulatory determination during a regulatory control period to apply cost pass throughs.

However, we consider lowering the strength of the incentives should be done only where absolutely necessary so as to not dilute the overall benefits of incentive-based regulation. This is because weakening the effect of incentives would approach a more cost of service based regulatory framework. This outcome would reduce the focus on rewarding the business for its efficiency gains or innovation.

Lowering the effect of incentives would also mean consumers have to bear more of the risk of actual costs differing from the forecast. Regulated businesses would have less of an incentive to manage their expenditure within their overall revenue such as by reprioritising expenditure between regulatory years.

Another drawback of reducing the incentives is that the regulator would have a greater role in determining whether specific projects can proceed, which is not ideal. Among other things, the regulator would be disadvantaged by information asymmetries. This would require it to second guess the regulated business's individual engineering and asset management decisions.

Finally, increasing the number of regulatory decisions for cost pass throughs outside of the regulatory determination process could increase the administrative burden placed upon the regulator. Adjusting the regulatory determination for cost pass throughs would also lead to a greater degree of uncertainty and variability in annual prices for both regulated businesses and consumers.

4.3 Network regulation rule changes in 2012

The AEMC made rule changes in 2012 that enhanced the approach to incentive-based regulation that has developed over many years in the NEM.[13] Part of these rule changes involved giving the AER greater flexibility to develop incentives for regulated businesses to achieve efficiency. For instance, the AER now has a greater ability to create effective capex incentives and determine an appropriate cost of capital consistent with these incentives.[14]

Relevant to this particular rule change, the AER is able to consider the balance of the incentives between network and non-network solutions and substitution between capex and opex. To facilitate this, the AER is required to consider principles and factors that it must apply when designing capex incentives through a capex sharing scheme.[15] This involves the AER considering how the scheme would interact with other incentives the business may have, and allows the AER to adjust the relative balance of capex and opex incentives.

The approach that the AER intends to apply under the new network regulation rules made by the AEMC in 2012 will be set out in its guidelines which will be published later in 2013. The AER has stated in the course of its work on these guidelines that it will aim to address any imbalances between capex and opex incentives.[16] For example, it notes that if incentives towards opex were too strong then this could inefficiently result in the use of opex-based non-network solutions in preference to capex-based network solutions.[17] This in turn would lead to inefficient investment decisions.[18] The

13 AEMC, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final rule determination, 29 November 2012.

14 Ibid, pp. 116-117.

15 NER clauses 6A.6.5A and 6.5.8A.

16 AER, Better Regulation: Expenditure incentives guidelines for electricity network service providers, Issues paper, March 2013, pp. viii, 30.

17 Ibid.

18 Ibid.

AER could therefore use its discretion to adjust these incentives to counter such distortions.

5 Cost recovery of network support service arrangements

In this chapter, the Commission considers whether the current cost recovery arrangements for network support service arrangements that defer distribution network augmentations and transmission-distribution connection assets are appropriate.

5.1 Rule Proponent's view

5.1.1 The Rule Proponent's view on the consultation paper

In addition to its rule change request, SP AusNet has provided additional comments in its submission on the consultation paper.

With respect to the current arrangements, SP AusNet considers that a non-network option for the Cranbourne Terminal Station could not be selected in 2011.[19] It considers that the rules would have prevented it from recovering these network support costs.[20]

In particular, it interprets from a past AEMC rule determination that these costs could only be recovered through the regulatory determination process and, in certain circumstances, cost pass throughs.[21] Therefore, it considers that Victorian DNSPs will be prevented from recovering these costs during the current regulatory control period and will only able to recover these costs from the next regulatory determination process in 2015.[22]

For similar reasons, it does not support nominated pass throughs as a cost recovery mechanism for network support costs.[23] That is, it would not be provided with sufficient certainty of being able to recover these costs during a regulatory control period.[24]

In relation to the Victorian arrangements, it notes that the Victorian DNSP has the impetus to fund network and non-network projects associated with transmission-distribution connection assets.[25] This is especially the case in Victoria because the TNSP does not receive ex ante revenue to fund those projects.[26]

19 SP AusNet, Submission on the rule change request, 10 May 2013, p. 2.

20 Ibid.

21 Id, pp. 3-4.

22 Id, pp. 3-4, 6.

23 Id, p. 5.

24 Ibid.

25 Id, pp. 6-8.

26 Ibid.

5.1.2 The Rule Proponent's view on the draft determination

In its submission on the draft determination, SP AusNet notes its agreement with the Commission in relation to the benefits of incentive-based regulation.[27] However, while it acknowledges that cost recovery through the regulatory determination process is the strongest form of incentive-based regulation, it considers that this mechanism does not appropriately balance the incentives between network and non-network solutions in respect of investment in transmission-distribution connection assets.[28]

In order to address the imbalance of incentives between network and non-network solutions for transmission-distribution connection asset augmentation, SP AusNet proposes a more preferable rule. Its more preferable rule would introduce a specific pass through relating to network support costs associated with the deferral of transmission-distribution connection asset augmentation only.[29] SP AusNet states that the more preferable rule would provide sufficient certainty over the recovery of opex to allow consideration of network and non-network solutions on an equivalent basis.[30] It no longer seeks a specific pass through for network support costs that defer augmentation of the distribution network.

In relation to the current arrangements, SP AusNet argues that it is difficult to include an allowance for network support costs in its regulatory proposal as the nature of these costs mean that it is difficult to accurately forecast them at the time of the regulatory determination process.[31] As such, it considers that it will not always be possible or reasonable for network support costs to be included in an estimated opex allowance.[32]

According to SP AusNet in Victoria, neither the TNSP nor the DNSPs have a capex allowance for the augmentation of transmission-distribution connection assets.[33] Rather, in Victoria, the DNSP contracts the TNSP to augment the asset and recovers the cost of this contract through the annual pricing process.[34] For this reason, NSPs in Victoria do not have capex allowances to redirect for the purpose of funding network support service arrangements.[35]

With respect to nominated pass throughs, SP AusNet does not consider that this mechanism is a reliable avenue for the recovery of network support payments.[36] It does not consider that there is sufficient certainty that network support payments

27 SP AusNet, Submission on the draft determination, 19 September 2013, p. 2.

28 Id, pp. 2, 5.

29 Id, p, 5.

30 Id, pp, 5-6.

31 Id, p. 4.

32 Ibid

33 Id, p. 3.

34 Ibid.

35 Ibid.

36 Id, pp. 4-5

would meet all necessary criteria in order to qualify as a nominated cost pass through event.

5.2 Other stakeholder views

5.2.1 Other stakeholder views on the consultation paper

Jemena, CitiPower and Powercor provided submissions on the consultation paper. They are supportive of SP AusNet's rule change request for specific network support pass throughs, including the opex roll forward arrangement, and provided similar comments.[37]

They note Victorian DNSPs were previously able to recover network support costs under the Essential Services Commission of Victoria (ESCV) regime.[38] However, under the current arrangements, they consider the regulatory determination process and nominated pass through arrangements lack certainty for network support costs to be recovered.[39]

The Victorian DNSPs consider it may be difficult to forecast these arrangements or costs at the beginning of the regulatory control period.[40] There is also not sufficient certainty the AER would approve these, particularly if they span over multiple periods.[41] Further, it would be uncertain that NSPs can recover these costs at all if they fall below the materiality threshold for nominated pass throughs.[42]

Jemena considers efficient costs would only be known later at the regulatory investment test for transmission (RIT-T) or regulatory investment test for distribution (RIT-D) stage.[43] It suggests the rule change would complement the RIT-D process on encouraging non-network options.[44]

Jemena considers that the number of network support service arrangements will continue to be low into the future and therefore recovering network support costs via specific network support pass throughs would not be administratively burdensome.[45]

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37 CitiPower and Powercor, Submission on the rule change request, 3 May 2013, p. 1; Jemena, Submission on the rule change request, 10 May 2013, pp. 4-6.

38 CitiPower and Powercor, Submission on the rule change request, 3 May 2013, p. 1; Jemena, Submission on the rule change request, 10 May 2013, p. 6.

39 CitiPower and Powercor, Submission on the rule change request, 3 May 2013, p. 2; Jemena, Submission on the rule change request, 10 May 2013, pp. 1, 4.

40 Ibid.

41 Ibid.

42 Ibid.

43 Jemena, Submission on the rule change request, 10 May 2013, pp. 1, 3-4.

44 Ibid.

45 Id, pp. 4-5.

Further, it suggests the AER would still have sufficient regulatory scrutiny of these costs.[46]

On the other hand, CitiPower and Powercor consider that these network support service arrangements will grow and become recurrent.[47] This in turn would necessitate specific network support pass throughs.[48]

The AER has no strong view as to the precise mechanism that should be used for recovery of network support costs.[49] It observes that cost recovery mechanisms currently exist, such as the regulatory determination process and nominated pass throughs.[50] If these mechanisms are deemed ineffective in achieving efficient use of network support, the AER considers the proposed rule may need to be made.[51]

5.2.2 Other stakeholder views on the draft determination

Jemena, CitiPower and Powercor provided submissions on the draft determination, noting support of SP AusNet's more preferable rule as proposed in its submission on the draft determination. These submissions raise similar issues to those raised by SP AusNet.

Jemena notes that the materiality threshold of the nominated cost pass through mechanism means that this mechanism is not able to be used to recover the costs of a non-network solution where these costs are less than one per cent of the annual revenue requirement.[52] According to Jemena, this could change the outcome of the RIT-D process so that the network solution is selected, even if this option is not as efficient.[53]

The AER supports lowering the barriers to the use of non-network solutions to reduce the level of inefficient traditional network investment.[54] The AER considers the Commission's approach to be sound.[55]

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46 Ibid.

47 CitiPower and Powercor, Submission on the rule change request, 3 May 2013, pp. 1-2.

48 Ibid.

49 AER, Submission on the rule change request, 17 May 2013, pp. 1-2.

50 Ibid.

51 Ibid.

52 Jemena, Submission on the draft determination, 19 September 2013, p. 2.

53 Ibid.

54 AER, Submission on the draft determination, 2 October 2013, p. 1.

55 Ibid.

5.3 Commission's analysis

5.3.1 Mechanisms for recovery of costs for network support service arrangements

Currently, there are two general mechanisms that are available for NSPs to recover costs associated with network and non-network solutions under the rules:

- regulatory determination process; and
- potentially, cost pass throughs.[56]

This section 5.3.1 covers the following issues:

- whether the two existing cost recovery mechanisms referred to above currently allow for recovery of network support costs associated with services that defer distribution network augmentations and transmission-distribution connection assets; and;
- if so, whether these mechanisms are appropriate in light of our approach described in chapter 4 of this rule determination.

Regulatory determination process

NSPs are subject to regulatory control periods, which are usually five years. For each period, the AER makes regulatory determinations on the annual revenue requirements that DNSPs are entitled to for providing standard control services and TNSPs for providing prescribed transmission services. These services may be sourced from network or non-network solutions.

As part of the regulatory determination process, the NSP submits its regulatory proposal which includes forecast expenditure that it estimates it would need in order to meet its expenditure objectives over that regulatory control period. The AER considers the NSP's forecast expenditure and assesses whether it reasonably reflects efficient and prudent costs based on realistic estimates of forecast demand and cost inputs. As a result of the regulatory determination process, the AER approves the total revenue allowance which the NSP can recover over the regulatory control period.

With respect to network support costs for services that defer network augmentations and transmission-distribution connection assets, all NSPs including Victorian DNSPs can currently seek to recover these costs, provided they meet the expenditure objectives. These would be recovered as part of their total revenue allowance determined at the beginning of the regulatory control period under the regulatory determination process. The AER must assess the NSP's proposal based on criteria under the rules. If the revenue is approved, the NSP may decide to use this to fund a network support service arrangement during the regulatory control period.

56 With respect to cost pass throughs, we specifically consider the nominated pass through as it has been raised in submissions.

Victorian DNSPs claim that these network support costs can be difficult to forecast and lack certainty that the AER would approve them at the beginning of the regulatory control period.[57] We consider that these costs are not sufficiently different to other costs which can be difficult to forecast at the time of the regulatory determination. Therefore, we do not consider that the network support costs should be treated differently and recovered outside of the usual regulatory determination process.

Inclusion of these costs as part of the revenue allowance creates incentives for NSPs to achieve efficiency throughout the regulatory control period. Such an approach promotes the NEO.

Nominated pass throughs

As part of the regulatory determination process, the AER can approve categories of events nominated by NSPs as cost pass throughs.

In making its decision on whether a proposed category of event should be a cost pass through event, the AER must consider certain factors listed in the rules:[58]

- whether the event proposed is an event covered by a category of cost pass through event specified in the rules;
- whether the nature or type of event can be clearly identified at the time the determination is made for the NSP;
- whether the NSP could reasonably prevent an event of that nature or type from occurring or substantially mitigate the cost impact of such an event;
- whether the NSP could insure against the event, having regard to:
  - the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or
  - whether the event can be self-insured on the basis that:
    - (i) it is possible to calculate the self-insurance premium; and
    - (ii) the potential cost to the NSP would not have a significant impact on the NSP's ability to provide network services; and
- any other matter the AER considers relevant and which the AER has notified NSPs is a nominated pass through event consideration.

57 CitiPower and Powercor, Submission on the rule change request, 3 May 2013, p. 2; Jemena, Submission on the rule change request, 10 May 2013, pp. 1, 4.

58 Definition of "nominated pass through event considerations", Chapter 10 of the NER; AEMC, Cost pass through arrangements for Network Service Providers, Final rule determination, 2 August 2012, p. 20.

If a particular category of event proposed by the NSP is defined by the AER as a cost pass through event, then the NSP may apply for a cost pass through in respect of costs incurred as a result of such an event during the regulatory control period. If the costs meet the materiality threshold,[59] the AER is required to undertake an economic assessment of these applications within a specified timeframe.[60] If the AER decides to approve these costs, then these costs would be passed onto the NSP's customers in subsequent regulatory years.

Where the AER approves costs as a result of a cost pass through event occurring, these should represent a change in costs compared to what the AER allowed in the most recent regulatory determination. That is, where the NSP already recovers for some of the costs this should be taken into account. This is particularly relevant where a NSP originally sought to address a network constraint through a network solution and was allowed to recover for capex as a result. If the NSP subsequently decides to address the constraint through a non-network solution such as network support, it will continue to recover the original capex regardless of whether the AER approves a cost pass through amount for costs associated with the non-network solution.

5.3.2 Victorian arrangements

We recognise that the Victorian electricity distribution licence obligations create a specific arrangement in Victoria in which Victorian DNSPs are responsible for transmission-distribution connection planning. On this basis, SP AusNet considers Victorian DNSPs are the appropriate bodies to fund network and non-network solutions associated with these types of projects.[61]

Despite these Victorian arrangements, we consider that the current cost recovery mechanisms discussed above apply in an equivalent way to Victorian DNSPs. That is, if a Victorian DNSP expects to enter into a network support service arrangement, it should seek recovery of the associated network support costs through the regulatory determination process, or possibly as a solution to a cost pass through event.

5.3.3 Response to the issues raised by stakeholders to the draft determination

In relation to SP AusNet's more preferable rule regarding a specific network support cost pass through for transmission-distribution connection assets only, this was one element of the original rule change request.[62] Despite SP AusNet's more preferable rule, the Commission is still required to consider all elements of the rule change. As

59 The materiality threshold in transmission is one per cent of the maximum allowed revenue (MAR), while in distribution it is one per cent of the annual revenue requirement.

60 The AER has a standard 40 business days (with the ability to extend this time for complex matters) to confirm the cost pass through event and the amount to be passed through to consumers.

61 SP AusNet, Submission on the rule change request, 10 May 2013, pp. 6-8.

62 The other elements of the rule change request related to a specific network support cost pass through for network augmentation generally and an opex roll forward mechanism.

such, all elements of the rule change request have been considered in this final determination.

The Commission acknowledges that network support costs may be difficult to forecast as part of the regulatory determination process. However, these costs are not sufficiently different to other costs which can be difficult to forecast at the time of the regulatory determination. Further, the regulatory determination process does not require DNSPs to provide an exact estimate of the costs it will occur, a reasonable estimate of expected costs is sufficient and will provide appropriate incentives to only enter network support service arrangements where it is efficient to do so.

As noted in section 5.3.2, there are specific arrangements in Victoria whereby DNSPs are responsible for planning the augmentation of transmission-distribution connection assets. However, the Commission does not agree that this obligation warrants specific network support pass through arrangements. The Victorian DNSPs have a reasonable opportunity to recover costs associated with network support service arrangements that defer augmentation of transmission-distribution connection assets through the regulatory determination process. Introducing a new specific network support cost pass through would weaken the overall incentive-based approach to regulation. Therefore, it is not appropriate to make SP AusNet's more preferable rule.

In other jurisdictions, as part of the regulatory determination process, TNSPs receive a capex allowance to undertake expected augmentation of transmission-distribution connection assets during the regulatory control period. According to SP AusNet this has not been the case in Victoria to date.[63] The Commission understands that the Victorian DNSPs have been recovering capex spent on transmission-distribution connection asset augmentation directly through the annual pricing process. The Commission considers the costs of such augmentations could instead be considered as part of a TNSP's capex allowance set during the regulatory determination process. However, this may not occur in practice in Victoria because DNSPs plan and direct the augmentation of transmission-distribution connection assets in that jurisdiction.

Alternatively, the planning DNSP, subject to the AER's classification of distribution services in Victoria, could seek a capex allowance to cover the cost of the contract for the TNSP to build the asset. The DNSP would then recover this cost as part of its general recovery of capex.

The rules do not prevent TNSPs or DNSPs in Victoria from receiving a capex allowance in respect of augmentation of transmission-distribution connection assets provided that the expenditure is required in order to meet the relevant capex objectives. Under this approach, cost recovery of transmission-distribution connection asset augmentation through a capex allowance would be consistent with the cost recovery mechanism for network asset augmentation more generally.

As discussed in the previous section, as part of the regulatory determination process, the AER can approve categories of events nominated by NSPs as cost pass throughs.

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63 SP AusNet, Submission on the draft determination, 19 September 2013, p. 3.

The Commission recognises the concerns of SP AusNet and Jemena that under the rules, network support costs may not meet the necessary criteria to qualify as a nominated cost pass through event. However, the acceptance of a nominated cost pass through event is subject to the discretion of the AER exercised taking into account the relevant considerations listed in the rules.

With respect to the materiality threshold of the nominated cost pass through mechanism, the Commission acknowledges that smaller network support service arrangements may not qualify for this mechanism due to the requirement that costs incurred equate to at least one per cent of the annual revenue requirement. However, the primary mechanism for cost recovery is the regulatory determination process; the nominated cost pass through mechanism should be seen as a secondary cost recovery mechanism for events nominated by the NSP as part of its regulatory proposal.

The Commission notes that SP AusNet considers that its consideration of the rule change request to be inconsistent with developments in other aspects of demand side management.[64] The Commission does not agree with this summation. This final determination relates to the strength of the incentive-based regulatory determination process and the appropriateness of cost pass through mechanisms for network support costs. It is appropriate that adjustments be made elsewhere in the regulatory regime to balance the incentives between network and non-network solutions. Cost pass throughs are not an optimal solution to addressing this imbalance.

However, the Commission acknowledges that in the current regulatory period in Victoria, there may be little incentive for Victorian DNSPs to undertake non-network solutions to defer augmentation of transmission-distribution connection assets because they are unable to recover the costs of such solutions but can recover capex spent in augmenting the relevant assets. While the Commission acknowledges that this is an issue in the current regulatory period, it considers that it can be addressed in the next regulatory control period (which commences in Victoria on 1 January 2016) without making the proposed rule.

5.3.4 Conclusion

We consider that the regulatory determination process is the primary and most appropriate mechanism for NSPs to seek to recover network support costs for services that defer distribution network augmentations and transmission-distribution connection assets.

The regulatory determination process encourages NSPs to forecast costs to the extent possible at the beginning of the regulatory control period and to manage their expenditure within their allowed revenue during the regulatory control period. In other words, NSPs are incentivised to make efficient investment decisions and recover efficient costs, which benefit consumers in the long term. As such, recovering these costs under the regulatory determination process is consistent with the NEO.

64 Id, p. 5.

In some circumstances, it may be appropriate for NSPs to recover network support costs outside of the regulatory determination process. These would be subject to AER approval as cost pass throughs. The AER may require such cost pass throughs to be based on events which are unforeseeable at the time of the regulatory determination. If this is the case, network support costs would more appropriately constitute a response to an event, rather than the entry into the network support service arrangement itself being the relevant cost pass through event. Recovering these costs in this way would be at the AER's discretion and subject to certain criteria set out in the rules.

On the basis that there are appropriate mechanisms available to NSPs to recover the costs which are the subject of the rule change request, we do not consider that there should be an additional specific network support pass through as proposed by the proponent.

In addition, we note that the rule change request seeks to allow Victorian DNSPs to recover these types of costs in the current regulatory control period; that is, before the next regulatory determination in 2016. We are generally cautious in making rule changes that would have the effect of revisiting specific decisions made by the AER in regulatory determinations during an existing regulatory control period. If a rule change was to be made and commence immediately as requested, it would detract from the certainty of having a revenue allowance determined for a given regulatory control period.

5.4 Commission's assessment of the current arrangements

Consideration of the assessment criteria identified in chapter 3 indicates that making the proposed rule would not contribute to the NEO. In particular:

- the regulatory determination process provides appropriate incentives for NSPs to minimise their expenditure, including determining the efficient trade-off between opex and capex. Under this process, NSPs are financially rewarded in forecasting their expenditure as accurately as possible, bearing the risks of uncertainty and inaccurate forecasting, and managing their expenditure within their allowed revenue during a regulatory control period. This allows efficient costs to be recovered, while incentivising NSPs to minimise their costs, which benefits consumers in the long term;

- the NSP's ability to choose an appropriate network or non-network solution and make efficient investment decisions is not hindered by the current cost recovery arrangements. Under the incentive-based regulatory determination process, the AER has the discretion to balance incentives for capex-driven network solutions and opex-driven non-network solutions; and

- as the regulatory determination process allows for appropriate recovery of network support costs, it would not be proportionate to create new mechanisms. If the rule change were made, it would also create additional administrative costs.

5.5 Commission's decision

We have decided that making the proposed rule would not contribute to the achievement of the NEO. This is because the current rules provide the appropriate framework for recovery of network support costs for services that defer distribution network augmentations and transmission-distribution connection assets.

Abbreviations

AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
capex	capital expenditure
Commission	See AEMC
DNSPs	distribution network service providers
ESCV	Essential Services Commission of Victoria
MAR	maximum allowed revenue
MCE	Ministerial Council on Energy
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
NER	National Electricity Rules
NSP	network service provider
opex	operating expenditure
proponent	SP AusNet
RIT-D	regulatory investment test for distribution
RIT-T	regulatory investment test for transmission
rules	See NER
SCER	Standing Council on Energy and Resources
TNSPs	transmission network service providers

A Summary of issues raised in submissions

A.1 Second round of consultation

Stakeholder	Issue	AEMC response
AER	Agrees with the objective of minimising barriers to the use of network support. DNSPs may be more aware of the ability to request a nominated pass through as part of their regulatory proposals as a result of the AEMC decision on this rule change request. (p. 1)	We note that it is within the discretion of the AER, exercised taking into account the relevant considerations listed in the rules, to determine whether an event should be classified as a nominated cost pass through event.
CitiPower and Powercor	The rules are flawed as DNSPs are not provided with an opportunity to recover efficient costs for a non-network solution to transmission-distribution connection asset augmentation.	We do not accept this. We consider that the regulatory determination process and nominated pass throughs provide appropriate cost recovery mechanisms for DNSPs.
CitiPower and Powercor	Ideally, all network support payments would be recovered through the regulatory determination process, consistent with an incentive based regulatory framework. However, it is not always possible to forecast these costs during the regulatory determination processes and alternative mechanism is needed to allow for recovery of these costs in such instances so that the regulatory determination process does not become a barrier to non-network solutions. (p. 2)	With respect to the issue of forecasting network support costs during the regulatory determination process, we do not consider that network support costs are sufficiently different from a number of other costs which can be difficult to forecast at the time of the regulatory determination process.
Jemena	Network support costs are difficult to identify in advance and are dependent on the outcome of commercial negotiations. This makes forecasting in	As noted in response to CitiPower and Powercor, we do not consider that network support costs are sufficiently different from a number of other costs

Stakeholder	Issue	AEMC response
	advance difficult. (p. 2)	which can be difficult to forecast at the time of the regulatory determination process.
Jemena	There is no certainty that the AER would approve the value of network support contracts across regulatory control periods. (p. 2)	We do not consider that network support arrangements are any different to any other contractual arrangement that the DNSP may enter into with funding subject to the regulatory determination process.
Jemena	The materiality threshold of the nominated cost pass through mechanism may prevent DNSPs from recovering network support costs. This could impact on the outcome of the RIT-D process so that a network solution is selected, even if the non-network solution is more efficient. Jemena would like the AEMC to acknowledge that the materiality threshold of the nominated cost pass through mechanism limits it applicability to the recovery of network support costs. (p. 2)	With respect to the materiality threshold of the nominated cost pass through mechanism, we acknowledge that smaller network support arrangements will not qualify under this criteria. However, we note that the most appropriate mechanism for the recovery of network support payments is the regulatory determination process.
Jemena	Whilst, the regulatory determination process is the most appropriate mechanism for the recovery of network support service arrangements that defer network augmentation, it is not workable for the recovery of network support costs for transmission-distribution connection asset augmentation in Victoria. (p. 3)	We consider that the existing cost recovery mechanisms available to DNSPs are appropriate.
SP AusNet	Appropriate incentives are not in place for non-network solutions to transmission-distribution connection asset augmentation in Victoria. (p. 2)	We do not consider that a specific cost pass through is the appropriate mechanism to balance the incentives between network and non-network solutions.

Stakeholder	Issue	AEMC response
SP AusNet	In Victoria, neither the TNSP nor the DNSP receive a capex allowance for augmenting transmission-distribution connection assets. The DNSP contracts the TNSP to augment the transmission-distribution connection asset and recovers the costs of this contract through the annual pricing process. Therefore, Victorian DNSPs do not have a capex allowance to redirect for the purpose of funding network support service arrangements. (p. 3)	We consider that the costs of transmission-distribution connection asset augmentation could be recovered as part of a capex allowance set at the beginning of the regulatory control period. In Victoria, either the TNSPs or DNSPs could receive a capex allowance, provided the expenditure is required to meet the capex objectives. Recovering the costs of transmission-distribution connection asset augmentation through a capex allowance would be consistent with the cost recovery mechanisms for network asset augmentation more generally.
SP AusNet	If DNSPs could recover the costs of network support service arrangement through the annual pricing process, as it does with network solutions to transmission-distribution connection assets, Victoria would have an equivalent cost recovery mechanism to other jurisdictions. (p. 3)	There are no equivalent cost recovery mechanism for network support service arrangements for transmission-distribution connection assets in other jurisdictions. We note that the TNSP network support cost pass through under chapter 6A, does not apply to network support that defers augmentation of transmission-distribution connection assets.
SP AusNet	Where it is possible to accurately forecast network support costs, the AER may approve these as part of an opex allowance. However, it is difficult to forecast network support costs as these depend on factors outside the DNSP's control, such as whether an amount of network support is available at a certain location and the outcome of commercial negotiation. These factors will determine whether the network support service arrangement is more efficient than the network solution. (p. 4)	As set out above, we do not consider that network support payments are sufficiently different from a number of other costs which can be difficult to forecast at the time of the regulatory determination process. Therefore, there is no reason why these costs should not be recovered through the regulatory determination process.

Stakeholder	Issue	AEMC response
SP AusNet	Victorian DNSPs will be unable to fund network support service arrangements where no opex allowance has been made for these costs. As such, DNSPs will be disincentivised from entering into non-network solutions and will always chose network solutions to transmission-distribution connection asset augmentation. (p. 5)	As set out above, the regulatory determination process provides the most appropriate mechanism for the recovery of costs relating to network support payments. Further, we consider that DNSPs are able to prioritise and direct their regulated revenue as they see appropriate. A DNSP could redirect a portion of its regulated revenue to fund a network support payment if it considered that this was efficient. This could apply even if the DNSP has not sought a specific opex allowance for network support payments.
SP AusNet	Apart from the regulatory determination process, Victorian DNSPs could recover network support costs through a nominated cost pass through. In practise, this is unlikely to be effective for the recovery of network support costs because of the necessary conditions that must be satisfied for costs to passed on through this mechanism are not likely to be satisfied. Firstly, it is not clear on what criteria the AER would accept a nominated pass through event. Secondly, the majority of network support costs would be unlikely to meet the materiality threshold of one percent. (pp. 4-5)	The Commission acknowledges that there are barriers to the use of the nominated cost pass through mechanism for the recovery of network support payments. However, we note that this is subject to the discretion of the AER exercised taking into account the relevant considerations listed in the rules.
SP AusNet	The AEMC's consideration of this rule change proposal is not consistent with other developments in the regulatory framework on facilitating demand side management and encouraging the use of non-network solutions. (p. 5)	The Commission does not agree that its consideration of this rule change request is inconsistent with other developments in demand side management. The Commission considers that a cost pass through is not an efficient incentive for the adoption of demand side measures.