Australian Energy Market Commission
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ERC0355 – Recovering the cost of AEMO's participant fees

The Australian Energy Council (AEC) welcomes the opportunity to make a submission to the Australian Energy Market Commission's (AEMC) *Recovering the Cost of AEMO's Participant Fees* Directions Paper (the Paper).

The Australian Energy Council is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. AEC members generate and sell energy to over 10 million homes and businesses and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 per cent emissions reduction target by 2035 and is committed to delivering the energy transition for the benefit of consumers.

As stated in our submission to the Consultation Paper, the AEC does not support the Rule Change as it:

- is contrary to the principles of incentive regulation;
- removes the incentive on networks to assist in reducing Australian Energy Market Operator (AEMO) costs;
- encourages cost shifting from networks to AEMO; and
- undermines AEMO's fee determination that Transmission Network Service Providers (TNSP) should pay fees as reflective of their involvement with AEMO; and
- is inconsistent with the treatment of market participants where AEMO has expressly designed the fee structure to inhibit pass through.

The AEC is pleased that the AEMC has published the Paper and provided for an additional round of submissions. The issues raised by objectors and submitters to the first round, and in the Paper itself, suggest the proposed rule change was incorrectly categorised as "non-controversial".

Assessment Framework

The AEC supports the additional two assessment criteria of cost efficiency and appropriate risk allocation. As stated in AEC's earlier submission, the Consultation Paper's initially limited criteria (cost and simplicity) under-estimated the proposal's significance. In particular, its consistency with the fundamental construct of incentive-based regulation, in that regulated monopolies must be exposed to operating cost fluctuations between regulatory resets.

The Paper did not however respond to the AEC's suggestion of including a further criterion:

> **Consistency with the "Reflective of Involvement" Principle** of Participant Fees enshrined in NER 2.11.1(b)(3).

One of the AEMC's key functions when contemplating Rule changes is to consider consistency of a new rule with the rest of the existing Rules. The AEC considers it is important, when considering this rule change, that the AEMC consider how it interacts with this Participant Fees principle, which, in the AEC's mind, the proposed rule contradicts.

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If made, the AEC's view is that the new 2.11.3(bb) will conflict with the existing 2.11.1(b)(3). If 2.11.3(bb) is progressed, then the AEMC needs to consider the appropriateness of retaining 2.11.1(b)(3) in its current form. This is the basis of the Network of Illawarra Consumers of Energy's (NICE) suggested consequential rule change.

For the avoidance of doubt, AEC supports retaining the existing "Reflective of Involvement" principle with its resulting allocation of fees to TNSPs. However, the AEC agrees with NICE that if the proposed 2.11.3(bb) is made, then 2.11.1(b)(3) requires consequential adjustment to recognise the AEMC has concluded that TNSPs are to be exempted from the "Reflective of Involvement" principle.

Allocation of fees to TNSPs is Reflective of Involvement

In its March 2021 determination on the periodic Review of the Structure of Participant Fees[1] AEMO determined to allocate some 17.5% of direct allocated costs to TNSPs, equating to around $20m per annum and increasing. This was a natural consequence of the NER 2.11.1(b)(3) participant fee allocation principle that the allocation be reflective of involvement. This does not seem to be in dispute in submissions to the Consultation paper.

The NER requires fees to be allocated "reflective of involvement" for good reason. This "user pays" model is intentionally designed to encourage users of AEMO services to identify efficiencies, i.e. minimise the cost burdens that their participant class places upon AEMO.

TNSPs can influence AEMO costs in two ways:

- In the boundary of activities carried out between TNSPs and AEMO. Each are jointly responsible for overseeing the grid's security, and, since market start, progressively more security functions have shifted from TNSPs to AEMO. TNSPs continuously engage with AEMO individually and collectively to agree responsibilities around a necessarily vague boundary. In doing this, TNSPs are aware of their own cost drivers (which are subject to incentive-based regulation), and, since the 2021 determination, AEMO fees.

- Through regulatory engagement with AEMO via governance oversight of its budgeting and expenditure. The AEC is pleased to observe a very active engagement by TNSPs, and indeed the ENA itself, in such activities over the last two years, particularly in the Financial Consultative Committee (FCC) and AEMO's "Regulatory Roadmap" consultation. It is clear that TNSP interest in these activities have very much increased since they have been allocated AEMO fees.

Of course, the cost implications of these on-going TNSP engagements with AEMO, either in its operations or budgeting, cannot be traced to any specific accounting line item. But to suggest that this renders futile the allocation of fees to TNSPs would misunderstand the intent of "Reflective of Involvement".

The expectation and implementation of 2.11.1(b)(3) has always been that since the vast majority of AEMO costs that cannot be linked to an individual participant, but where possible they should at least be allocated to the reflective participant *class*. Participants commonly engage with AEMO (and other stakeholders) as a class. Often this is through its industry associations. For example, the AEC

[1] https://aemo.com.au/en/consultations/current-and-closed-consultations/electricity-market-participant-fee-structure-review

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has always engaged with AEMO with respect to its generator-involved systems, aware that the costs that it is imposing upon AEMO will, in time, be reflected in the fees that the class has to absorb[2].

Passing through fees contradicts AEMO Fee Determinations
Since 2005, fee structures have been expressly designed to discourage passing through fees immediately to customers. The National Electricity Market Management Company (NEMMCO) received advice[3] from Allen Consulting Group (ACG) in 2005 that this should be done in order to create the incentives described above, i.e. to make participants "own" the cost burden they place on the market operator.

For generators and retailers, this is done by applying historical market share quantities rather than current shares. And for generators, costs are charged 50% on historical registered capacity, 50% on historical energy. These features were intentionally designed to inhibit passing through of fees, for example by raising generators' bid prices.

This "lagged" allocation of fees according to historical quantities is analogous to the current rules for TNSPs. In the current rules, TNSPs must forecast AEMO fees in their 5-yearly reset, with subsequent variations absorbed by the business.

With an identical motivation as Energy Networks Australia's (ENA) in this rule change, generators have sought to change this structure at each re-determination. In response, AEMO obtained additional advices from ACG in 2010 and 2016[4]. In these advices, ACG have twice repeated the argument for discouraging participant fees from being structured so that they can simply be passed through to customers. For example, AEMO stated:

> "The allocation of Generator fees on a fixed historical basis, as recommended by ACG, intentionally makes the fees difficult for Generators to pass-through, in order for the fees to be ultimately incurred at the involved activity."[5]

The AEC considers that if this argument applies to generators, it should equally apply to TNSPs. The AEC submits that the ENA's rule change contradicts AEMO's historical positions in two ways:
- By being inconsistent with the allocation of fees to TNSPs in 2021 as reflective of involvement; and
- By directly contradicting its long-term position on passing through participant fees as repeatedly expressed in ACG advice.

Incentive Regulation versus Cost-of-Service Pass Through Allowances
This rule change contradicts the incentive-based monopoly regulation regime that the Rules are based on. Incentive-based regulation requires, at the five yearly regulatory reset, TNSPs to propose to the Australian Energy Regulator (AER) a forecast of efficient operational expenditure (opex) for

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[2] Note that the allocation of fees according to generators' historical registered capacities was intentionally designed to stop generators passing through costs to other parties, thereby retaining this cost minimisation incentive.
[3] Report to NEMMCO on economic issues relating to Participant Fee structure, 22 December 2005, Allen Consulting Group
[4] https://aemo.com.au/-/media/files/stakeholder_consultation/consultations/electricity_consultations/structure-of-fees/allen-consulting-group-letter--2010.pdf
https://aemo.com.au/-/media/files/stakeholder_consultation/consultations/electricity_consultations/structure-of-fees/acil-allen-advice-update-2016.pdf
[5] AEMO 2016 Participant fee determination page 24

the coming five years. This would include any expected costs such as AEMO fees at the level that they are presently forecast by AEMO.

Then, to the extent that actual opex varies from the forecast within the period, changes from the forecast must be retained by the business. In time, sustained changes will ultimately be passed to customers through subsequent reviews. Unlike pass-through regulation, incentive-based regulation:

- provides an incentive for the monopoly to seek to minimise its opex in the short-term; and

- attempts to replicate competitive productivity in that innovation and efficiency is initially driven by the profit motive but is eventually competed downstream to benefit consumers.

The proposed rule change, being an automatic pass-through, regressively introduces a cost-of-service regulatory approach, the result being that TNSPs lose their incentive to minimise AEMO costs in the ways described in the preceding section.

Monopoly financial risks under incentive-based regulation
Ever since incentive-based regulation began, monopolies subject to it have claimed that it introduces a business risk that is ultimately harmful to consumers. The AEMC is advised to set this argument aside.

The typical argument is put that if an opex is not entirely predictable at the time of the regulatory reset, then it gives the monopoly a higher risk profile. This will then affect its cost of capital which will be passed through to customers at a future review.

There are numerous logical fallacies in this claim:

- The National Electricity Market adopted incentive-based regulation very much aware of this issue. Other things being equal, a cost-of-service monopoly has marginally less financial risk than a cost-of-service monopoly. However, the incentive advantages of the former were considered to vastly outweigh this claimed risk-minimisation advantage.

- Monopolies making the claim will often purport to support incentive-based regulation, but only for those costs that are fully predictable. This misunderstands incentive-based regulation. Costs that do not change are already fixed in the regulatory reset and thus are, in substance, already passed through. To suggest that only variable costs need be passed through is implicit endorsement of a cost-of-service regulatory approach.

- The variation caused by retaining AEMO fees within incentive-based regulation is very small compared to the size of operating a full TNSP business, therefore it is unreasonable to suggest that it introduces a material change to the risk profile of the business. The ENA acknowledges this when it argues the rule is necessary because TNSPs will not be able to pass variations through under the 1% of Maximum Allowable Revenue (MAR) threshold. This 1% MAR pass-through rule was introduced in response to monopolies prosecuting the “risk profile” argument. The pass-through rule attempts to remove the material risk of large changes, whilst retaining incentives for smaller ups and downs. The 1% variation threshold represents a judgement thoughtfully taken around this trade-off of incentive versus risk. It should therefore remain the sole judge of whether a variation can be passed through, rather than cherry-picking specific items such as AEMO fees.

- TNSP dislike of absorbing variations in AEMO costs is in fact beneficial. AEMO, which is in effect a pass-through monopoly, has a poor recent record of forecasting its own costs. One of the valuable incentives the current rules create is for TNSPs to pressure AEMO to better forecast these costs so that they can reasonably be incorporated into a TNSPs revenue reset claim. The process of TNSP's obtaining and justifying these forecasts before the regulator in itself requires some much-needed structure and control in AEMO budgeting.

National Transmission Planner fees

As noted in our earlier submission, the AEC considers the existing pass through of National Transmission Planner (NTP) a poor precedent that arose without consultation and that should not be followed for other AEMO costs.

The AEC considers that NTP fees would also be better exposed to incentive-based regulation rather than simply passed through. To the extent that consistency is desired by the AEMC, the AEC suggests as an improved rule, deleting the existing 2.11.3(ba) rather than replicating it.

AEMO support for Rule Change

As AEMO's NEM expenditure is unregulated and its ownership is highly diffuse, the only pressure to manage its expenditure comes about through informal advocacy, such as via the forums listed previously. These are labour-intensive, and whilst consumer and market participant representatives have always engaged with these processes, they struggle to devote the resources that the AEMO budget would justify.

In the first round of submissions, the only support outside the network sector for the rule change came from AEMO itself.

AEMO's intervention in this rule change is peculiar. Applications for regulatory pass-throughs are relatively common matters of contested consultation but the AEC is unaware of AEMO previously engaging in them. Furthermore, the proposal to expediently pass-through participant fees runs counter to the three ACG advices AEMO received and cited in 2005, 2010 and 2016.

Thus it is worth considering why AEMO has chosen to depart from its historical positions on this occasion.

The AEC suggests that this unusual development has arisen because, in the period since they have been allocated fees, networks have emerged as the most effective voice with respect to containing AEMO costs. Naturally any body would seek to lower such scrutiny, which the rule change will achieve.

Whilst this may be expedient for AEMO, the loss of this scrutiny upon them will be a poor outcome for the market as a whole.

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