AUSTRALIAN ENERGY COUNCIL

Australian Energy Market Commission
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Lodged online: www.aemc.gov.au

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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* Consultation Paper (the Consultation 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.

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.

The Rule Change proposal is being expedited as a non-controversial Rule Change. The AEC considers the proposal contentious, however the AEC chose to not oppose the status as the matters it is raising are not complex and can be dealt with adequately within an expedited timeframe. The AEC understands that this choice has not prejudiced its ability to raise substantive objections to the proposal via submission.

Assessment Framework

The draft assessment framework has listed only matters of cost, complexity, simplicity and transparency. It appears that the AEMC has interpreted the rule proposal as entirely administrative and has failed to realise its significance with respect to the regulatory model of Australian monopoly networks and principles of fee allocations as required by the National Electricity Rules (NER).

The preceding section of the Consultation Paper, 2.12, notes:

> "The Commission must take into account the revenue and pricing principles set out in section 7A of the National Electricity Law (NEL) in making certain rules."

These principles include that

> "A regulated network service provider should be provided with effective incentives in order to promote economic efficiency with respect to direct control network services the operator provides. The economic efficiency that should be promoted includes…..the efficient provision of electricity network services."

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The draft assessment framework has not engaged at all with the key question of efficiency in the provision of network service that is fundamental to the objective of the existing incentive based regulatory model.

The assessment Framework needs to also deal with the "Allocation of Involvement" principle in the setting of participant fees. This intentionally applies a user-pays basis to the collection of AEMO costs, and the AEMC needs to ensure it is not undermined.

The AEC suggests the Assessment Framework include:

- **Consistency with the "Reflective of Involvement" Principle** of Participant Fees enshrined in NER 2.11.1(b)(3);
- **Promotion of efficient operational expenditure** through the application of Incentive Based Regulation; and
- **Appropriate risk sharing between industry and consumers.**

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.

It is quite clear that much of AEMO's functions are heavily involved with TNSPs, which AEMO noted in its final report:

> "(Charging TNSPs) is consistent with the reflective of involvement principle as initial survey results and verification of those results indicate TNSPs' material involvement with AEMO's revenue requirements for operational activities."
>
> "AEMO's interaction with TNSPs has increased through the operational activities AEMO now performs for this participant class."[2]

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 their cost burdens upon AEMO.

This is particularly relevant to TNSPs, as AEMO and TNSPs are jointly responsible for overseeing the grid's security. There are many tasks that could be performed by either and boundaries are inevitably uncertain.

At NEM start, the vast majority of technical management of the grid's security was handled by TNSPs, with the National Electricity Market Management Company (NEMMCO) performing an oversight role. Over time more and more functions have transferred across to the market/system operator, which has lowered operating costs for TNSPs whilst increasing AEMO's. This is the trend AEMO identifies in the second quote above.

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

[2] Ibid pg 16 & 17

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TNSPs were allocated AEMO fees for the first time in recent years and as a direct result, networks have begun to show interest in the efficiency of AEMO costs[3]. This is an intended and beneficial outcome of the "reflective of involvement" participant fee principle.

To retain this beneficial outcome, it is necessary for TNSPs to remain substantively exposed to these fees. Automatically passing-through these fees to other parties defeats the purpose of allocating TNSPs fees in the first place, and is, indirectly, a breach of the "reflective of involvement" fee principle enshrined in the NER.

Incentive Regulation versus Cost-of-Service Pass Through Allowances

The NEM's monopoly regulation is intentionally incentive based. At the five yearly regulatory reset, TNSPs propose to the Australian Energy Regulator (AER) a forecast of efficient operational expenditure (opex) for 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 are retained by the business. Subject to a carry-over mechanism, sustained changes will ultimately be passed to customers after subsequent reviews. This approach has the well-known advantages of:

- Providing incentives for the monopoly to seek opex efficiencies within the period;
- Revealing to the regulator true efficient costs that will feed into the following review;
- Replicating competitive business activity, where profit from efficiencies is first retained by the business but over time finds its way to customers as competitors match these efficiencies; and
- Fairly sharing risks between industry and consumers, in that short-term variations are internally absorbed, with only sustained changes phased-in to consumers over time.

Networks, through their constructive engagement in AEMO's Financial Consultative Committee and other activities, are already demonstrating the first of the above dot points.

Incentive-based regulation should be contrasted with cost-of-service regulation where monopolies seek regulatory approval for direct pass through of current costs. It is well accepted that such arrangements fail to provide incentives to manage and reduce opex. The proposed rule change, being an automatic pass-through, regressively introduces a cost-of-service regulatory approach.

The only situation where a cost-of-service approach may be appropriate is where an expense is entirely exogeneous, i.e. the business has no ability to influence. This is the case for some taxes, for example a land tax. However this is not the case for AEMO fees. As discussed above, network businesses do have influence on the level of AEMO fees, particularly as AEMO functions are partially substitutable with their own. And, during the short period that they have been allocated fees, thanks to the incentive-based model applicable to their recovery, are now actively and effectively encouraging AEMO to seek efficiencies.

TNSPs own operational costs are subject to the incentive-based regulation and there is a strong incentive to reduce them. One way to reduce these costs is by moving the costs to another party. Noting the earlier comments that TNSPs and AEMO are jointly responsible for managing grid security, we observe that:

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[3] For example, by participating in AEMO's Financial Consultative Committee and in collaborating with market participants in investigating ways to improve AEMO's financial governance https://www.energynetworks.com.au/resources/reports/2021-reports-and-publications/cepa-report-on-aemos-proposed-budget-and-finance-committee/

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- For the majority of the NEM's history, TNSPs have had no exposure to AEMO fees, therefore they have had an incentive bias to progressively shift grid management tasks to AEMO; and
- As AEMO explain in their fee determination, AEMO is taking on an ever-greater range of tasks in managing grid security from the TNSPs.

To avoid repeating the bias toward cost-shifting as was experienced prior to the allocation of AEMO fees to TNSPs, it is necessary for both own costs *and* AEMO fees to be equally treated within the same incentive-based opex model.

Minimum threshold for pass through

One of the rationales put forward for the rule change is that it is likely that the allocation of AEMO participant fees to TNSPs will fall below the 1% of Maximum Allowable Renewable (MAR) on which TNSPs may make an application for the pass through of a new exogenous cost. Thus, without this rule change, TNSPs will not be able to apply to the AER for pass-through.

This argument ignores the purpose of the threshold and directly undermines it. The threshold intentionally expects monopoly businesses to absorb the typical financial variations, up and down, that any non-monopoly businesses would face. At the same time, a pass-through arrangement is provided, but is limited only to those exogenous costs of such large magnitude that they would materially increase the risk profile of a network. This threshold has therefore been consciously set at a trade-off between financial risk and incentive-based regulation.

The acknowledgement that the allocation of AEMO fees are below this threshold implies that, to be consistent with section 7A of the NER, that they should not be passed-through. They should instead remain part of the incentive-based regulatory model and retained in normal regulated opex rather than automatically and annually passed through.

National Transmission Planner fees

The Rule Change proposal also argues for pass-through on the basis of precedent: that National Transmission Planner (NTP) fees already have an automatic pass-through mechanism and so core AEMO fees should similarly be passed through.

The AEC considers NER 2.11.3(ba) a poor precedent that should not be followed. In relation to that existing clause:

- It was introduced directly by the Energy Security Board in order to quickly implement the much expanded role of the NTP as producer of the Integrated System Plan (ISP) without impacting on networks mid-period. During that introduction there was no opportunity to discuss the long-term implications of deviating from incentive-based regulation; and
- The ISP was a new activity that does not directly substitute for historical TNSP activities and therefore its costs are arguably more exogenous than core NEM fees.

Nevertheless the AEC considers, for similar reasons to those argued earlier, 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.

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Any questions about this submission should be addressed to me directly, by email to ben.skinner@energycouncil.com.au or by telephone on (03) 9205 3116.

Yours sincerely,

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