

02 July 2020

Mr John Pierce AO
Chair
Australian Energy Market Commission

Submitted online

Dear Mr Pierce,

Energy Networks Australia's submission to the AEMC's Electricity Network Economic Regulatory Framework 2020 Review (ERP0085) – Approach Paper

Energy Networks Australia appreciates the opportunity to provide feedback on the Australian Energy Market Commission's (AEMC or the Commission) Approach Paper for the Electricity Network Economic Regulatory Framework (ENERF) 2020 Review.

Energy Networks Australia is the national industry body representing Australia's electricity transmission and distribution and gas distribution networks. Our members provide more than 16 million electricity and gas connections to almost every home and business across Australia.

Key Messages

- » This review process is an important process to ensure the framework continues to remain fit for purpose, and ENA agrees with the three priority and emerging issues that the AEMC has identified for consideration in the 2020 review.
- » Clear and coherent risk allocation across the entire framework is critical to efficiently priced and financed network infrastructure for customers. All aspects of risk allocation – including in relation to extreme events – should be taken into account when examining the risk allocation between NSPs and consumers.
- » The existing regulatory framework is not fit for purpose for the upcoming large, discrete, non-recurrent transmission investments that are scheduled under the ISP, and needs to be improved.
- » The regulatory framework should be sufficiently flexible to ensure that consumers' preferences drive regulatory outcomes. The joint ENA/ECA/AER New Reg project has highlighted areas where more regulatory flexibility may assist in better outcomes for consumers.

The annual ENERF review is an important process to ensure that the regulatory framework continues to remain fit for purpose. Energy Networks Australia welcomes the Commission's continued focus on the integration of distributed energy resources,

and agrees with the three additional priority issues that the Commission has identified for consideration during the 2020 review, including:

1. dealing with large transmission investment and contingent projects in the context of the Integrated System Plan (ISP),
2. risk allocation between distribution networks and consumers, and
3. need for enhanced consumer engagement.

Transmission investment and the ISP

The ISP is a cost-based engineering optimisation plan that forecasts the overall transmission system requirements for the National Electricity Market over the next 20 years.

The Draft 2020 ISP identifies actionable ISP projects by triggering the process for the regulatory investment test for transmission. The ISP Rules provide that actionable ISP projects that meet an identified trigger are automatically defined as contingent projects in relation to a transmission provider's revenue determination (NER 5.16A.5).

These actionable ISP transmission projects are significant in scale and size, and total at least \$8 billion over the next decade. The scale of the upcoming transmission project rollout is unprecedented, and it is challenging to accurately forecast the project costs for a number of reasons including:

- material economy-wide demand for the required infrastructure labour and construction resources,
- unfamiliar environmental, geotechnical, land access, biodiversity and indigenous heritage risks resulting from the location of the proposed projects, and
- the risks surrounding the availability of the required natural resources as a result of environmental considerations including the drought and bushfires.

Incentive regulation, in force in Australia and administered by the Australian Energy Regulator, is designed to replicate the forces of a competitive market and encourage monopoly businesses to further reduce costs and improve efficiency, without compromising the standard of service to customers. It is recognised as a powerful form of regulation as it drives businesses to reveal their efficient costs to serve customers.¹ This information then helps a regulator set even more challenging benchmarks for performance in the future.

However, the existing regulatory framework is not fit for purpose for these upcoming large, discrete, non-recurrent transmission investments and therefore causes investability concerns for transmission businesses.

Given the sheer scale and size of these projects, the transmission business has limited flexibility to manage its capital expenditure within the incentive framework, which

¹ Energy Networks Australia, Rewarding Performance: How customers benefit from incentive-based regulation, July 2019.

causes the transmission business to take significant risk in relation to capital expenditure forecasts. Transmission businesses are required to identify costs upfront without contracts locked in, with all the forecasting limitations outlined above, and therefore bear the full overspend risk with little ability to mitigate that risk through the reprioritisation of their capital program in the context of actionable ISP projects.

Energy Networks Australia strongly supports improvements to the regulatory framework to ensure that it is able to support the transmission investment identified as required under the ISP.

Risk allocation between NSPs and consumers

Incentive regulation as applied in Australia has proven to provide significant benefits to consumers, notwithstanding the specific concerns of its application to the particular characteristics of ISP transmission investment outlined above.² The Commission's Approach Paper has highlighted a need to further review the allocation of risks that underpin this regulatory framework.

Energy Networks Australia supports a structured collaborative process of regulatory evaluation on the robustness of the regulatory framework and application to extreme events and risk allocation issues. In doing so, consideration should be given to the development of core principles to assess and guide risk allocation consistently through the framework and its application, and a subsequent mapping of the location and allocation of the current risks.

Development of a clear and transparent risk allocation framework would assist all market participants by providing a common understanding of where the risk allocation lies. It would also facilitate a considered and proactive approach to responding to future extreme events, and ensure that risks are not unintentionally shifted without due consideration of the costs of such a shift.

Energy Networks Australia considers that the following risk allocation issues should be taken into account during this review:

1. **Changing market environment around insurance relating to network infrastructure and natural catastrophe events.** In recent years, both the local and global insurance markets have experienced significant loss claims activity driven by increasing natural catastrophe events. As a result, networks are reporting that as the insurance capacity market reduces and existing insurers charge material premium increases, access to insurance coverage is becoming increasingly difficult to obtain.

It is expected with extreme climate conditions and more insurance losses, premiums will further increase into the future and the insurance capacity market will reduce as insurers continue to exit the market. These developments have the

² Energy Networks Australia's *Rewarding Performance: How customers benefit from incentive-based regulation* report found that regulated energy networks operating under incentive schemes over the past 13 years will deliver an estimated \$6.3 billion of additional benefit to Australian energy customers.

significant potential to impact the risks and costs borne by current and future electricity customers.

2. **Risk between current and future consumers around the recovery and future economic lives of network assets.** The current regulatory approach effectively presumes that future consumers will meet a substantial, and effectively deferred, proportion of the capital costs of long-lived network investments made today. However, changes in demand, technology and cost conditions make this historic presumption less certain and the current approach potentially unsustainable.

Continuation of the current path of not addressing the issue risks an avoidable regulatory failure with adverse outcomes for the long-term interest of consumers.

3. **The resilience of the network to respond to extreme events.** Energy Networks Australia supports the development of a fit for purpose regulatory framework that enables the efficient distributor-led rollout of technology, such as stand alone power systems, to build network resilience.

In addition, cost pass through provisions should be sufficiently flexible to adequately capture an array of extreme events, and ensure that distributors are appropriately compensated for their required responses.

4. **Treatment of regulatory inflation and type of debt allowance provided.** The regulatory treatment of inflation and the issue of the type of debt allowance provided in the regime (real or nominal) have the potential to lead to important differences in risk allocation over time between current and future customers and network equity holders.

This issue is currently subject to an Australian Energy Regulator review, and it is important that risk allocation issues arising from this are clearly and consistently understood by all parties.

Enhanced consumer engagement

The regulatory framework should be sufficiently flexible to ensure that consumers' preferences drive regulatory outcomes. The joint Energy Networks Australia, Energy Consumers Australia and Australian Energy Regulator New Reg project was launched in June 2017 to explore ways to improve sector engagement and identify opportunities for regulatory innovation.

The New Reg project has identified potential reforms to the regulatory framework to ensure it is sufficiently flexible to accommodate the delivery of outcomes that consumers want. We have separately provided to the Commission further information around this project, including through public materials provided to a joint workshop held on 25 June 2020.

In addition, the Energy Security Board's *Health of the National Electricity Market* report released in February 2020 questioned whether the constraints that ring fencing places on distribution businesses lead to sub-optimal outcomes in a transitioning

system.³ Energy Networks Australia supports sufficiently flexible ring fencing arrangements to ensure that distribution businesses are able to provide innovative solutions that reflect customers' and community preferences.

We look forward to continuing to collaborate on the 2020 ENERF review, and if you would like to discuss the contents of this submission, please contact Lucy Moon, Head of Regulation, at lmoon@energynetworks.com.au.

Yours sincerely,

A handwritten signature in blue ink that reads "ADillon".

Andrew Dillon
Chief Executive Officer

³ Energy Security Board, Health of the National Electricity Market, 24 February 2020.