

25 August 2023



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Dear Ms Kaur

Ausgrid response re AER NSW Renewable Energy Zone (REZ) Supporting Guidelines

Ausgrid welcomes the opportunity to respond to the following draft guidelines and guidance notes published by the Australian Energy Regulator (**AER**), to support the regulation of network infrastructure projects under the *NSW Electricity Infrastructure Investment Act 2020 (EII Act)*:

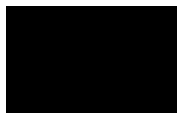
- Legal and functional separation guideline - EII Act (**LFS Guideline**);
- Cost allocation guideline - EII Act (**Cost Allocation Guideline**);
- Incentive schemes for non-contestable projects in NSW guidance note (**Incentive schemes guidance note**); and
- Confidentiality guideline - EII Act (**Confidentiality Guideline**).

We broadly support the draft guidelines. We recommend targeted amendments at **Attachment A**, including that the:

- LFS Guideline clarifies:
 - How it interacts with the AER's Ring-fencing Guidelines;
 - The scope of staff separation obligations for tenders;
 - That non discrimination obligations are intended to only apply to the Network Operator's *supply* of services; and
 - The definition of 'related electricity service provider';
- Cost Allocation Guideline replicates the NER Cost Allocation Guideline;
- Incentives schemes guidance note provides more certainty to Network Operators about which schemes apply *at the start* of the regulatory control period.

Ausgrid would welcome the opportunity to discuss our submission with you. Please contact Naomi Wynn, Regulatory Policy Manager at [REDACTED] or on [REDACTED].

Regards,



Fiona McAnally
A/ Head of Regulation

Attachment A: Ausgrid response re AER NSW REZ Supporting Guidelines

1. Legal and functional separation (LFS) Guideline

The draft LFS Guideline reflects a pragmatic approach to support REZ infrastructure development in NSW. Ausgrid would support the AER applying a similar approach in the Transmission and Distribution Ring-fencing Guidelines.

Below we provide five recommendations relating to the interpretation and application of the LFS Guideline. Similar to our discussions on Dual Function Assets for the Transmission Ring-fencing Guideline, we would like to discuss these issues with the AER, to ensure we have a clear understanding of the operational application of these Guidelines.

a. Amend the LFS Guideline and the National Electricity Rules (NER) Ring-fencing Guidelines to clarify the roles of Network Operators and Network Service Providers and how these Guidelines interact with one another

A Network Operator subject to the draft guidelines may also be a Network Service Provider under the NER. However, Network Operator activities under the EII Act are likely to be viewed as distinct from regulated activities under the relevant NER guidelines. As such, the draft LFS Guideline could be amended to make the interactions between the EII Act and the NER guidelines clearer - in particular in relation to the roles of the Network Operator under the EII Act and the Network Service Provider under the NER.

For example, our interpretation of the LFS Guideline is that EII Act regulated activities would be covered by the LFS Guideline (where the Network Operator is subject to under an EII Act revenue determination); whereas the NER Distribution and Transmission Ring-Fencing Guidelines applies to other regulated activities or services (where the Network Operator is subject to a NER revenue determination).

This implies that a Network Operator would be able to deliver existing services under the NER as well as EII Act services / activities, but different ring-fencing regimes would apply to these two separate activities. In effect, there would be overlapping ring-fencing requirements between EII Act regulated activities and NER-regulated activities. As we explain below in section 1.b. we anticipate that our network planners and network connections staff would work on REZ projects as it would be inefficient and impractical to duplicate roles for a tender project that we may not win. This could present challenges for staff such as our network planners and network connections teams to understand which ring-fencing requirements apply when they are working on REZ/REZ-adjacent projects, because for non-contestable REZ projects it would be the same teams working on these projects.

In this context, the AER should ensure that the combined operation of the LFS Guideline and the NER Ring-Fencing Guidelines does not unduly restrict the ability of a Network Operator to integrate REZ (EII Act regulated) and non-REZ (NER regulated) activities. Such integration is likely to be efficiency-enhancing and not in any way harmful to competition or consumers.

The design of the LFS Guideline appears to recognise this, however this is not reflected in the current NER Ring-fencing Guidelines. Ausgrid understands that the LFS Guideline is not intended to limit integration between a Network Operator and a NER-regulated distributed network service provider (**DNSP**) or Transmission Network Service Provider (**TNSP**). There is no requirement for legal separation of these activities, nor is there any requirement for separation of staff involved in NER-regulated activities.

However the NER Distribution Ring-fencing Guideline should be reviewed to ensure that the activities of the Network Operator and a NER-regulated DNSP can be efficiently and effectively integrated to result in the lowest cost for the collective service and activities for the benefit of

customers. We refer to our submission to the AER's Review of options to address gaps in transmission ring-fencing framework where we supply reasons for why an efficient approach to delivering the transition requires the most timely and cost-effective approach to delivering REZs and connections.¹

To date, the waiver mechanism in the Distribution Ring-fencing Guideline has been relied on to permit this and the drafting only allows DNSPs to submit tenders for REZs using waivers. However, we understand that waivers have not been issued for the subsequent REZs and suggest that more permanent solutions should also be considered. We recommend that the AER refine the definition of 'contestable electricity services' in the Distribution and Transmission Ring-fencing Guidelines so as to clearly exclude any EII Act regulated activities (we note that the equivalent LFS Guideline definition is more targeted).

b. Review the scope and intent of staff separation obligations

We recommend that the AER clarify the scope and intent of the restrictions in clauses 2.2(c) and (d) of the LFS Guideline. It is currently not clear who will be caught by the restriction on "staff involved in planning for network activities", or why the activities of these staff should be restricted. The AER should clarify, with examples, types of employees it considers to be relevant for the purposes of clauses 2.2(c)-(d).

Clause 2.2(d) of the LFS Guideline provides that staff cannot work on *both* a tender application and the REZ network planning for that project, and must be physically separated from those that do. The AER indicated at its 14 August 2023 public forum that this physical separation requirement is to be a *temporary* separation – that is, while the tender is being prepared. The AER should provide guidance on, and revise the LFS Guideline to clarify whether the physical separation is required only for the *tender application* stage and why. As noted above, we anticipate that our network planners and network connections staff would work on REZ projects as it would be inefficient and impractical to duplicate roles for a tender project that we may not win.

It should also be confirmed whether clauses 2.2(c) and (d) are intended to only apply where network activities are procured through a contestable process, and will have no application where there is non-contestable procurement, such as the Hunter-Central Coast REZ. Separation may be impractical and is likely to be unnecessary for non-contestable REZs. Where REZ network operations are to be non-contestable, imposing separation requirements would result in time consuming and costly resourcing burdens, resulting in potentially higher costs to customers and delays to the REZ rollout.

Ausgrid understands that clauses 2.2(c) and (d) are intended to only apply where network activities are procured through a contestable process, and will have no application where there is non-contestable procurement. We would suggest clarifying this in the explanatory materials.

¹ Ausgrid, Endeavour Energy and Essential Energy (2023). Submission Review of options to address gaps in transmission ring-fencing framework.
https://www.aer.gov.au/system/files/NSW%20DNSP%20submission%20re%20AER%20transmission%20ring%20fencing%20fmwk%20consultation-Signed_Redacted.pdf

c. Delineate that non-discrimination obligations are intended to only apply to *supply* of services by the Network Operator and not the acquisition of services by the Network Operator consortium

We recommend that the AER amend the LFS guideline to clarify that the non-discrimination obligations apply only to the *supply* of services by a Network Operator, rather than the *acquisition* of services by a Network Operator consortium.

A REZ Network Operator may be a consortium, particularly in contestable REZs, with each member of the consortium providing services which reflect their contributed skills and expertise. In this scenario, the Network Operator will likely be acquiring certain services (such as construction and/or operation and maintenance (**O&M**)) from the consortium members on an exclusive or preferred basis.

Ausgrid understands that the non-discrimination obligation is not intended to apply to this type of acquisition of services by the Network Operator from the consortium members. The prudence of a Network Operator's O&M and construction arrangements will be constrained by the competitive tender and/or AER revenue determination processes.

However these supply arrangements between a Network Operator and consortium members could be captured by the current drafting of the non-discrimination obligation in the LFS Guideline, which applies to things done by a Network Operator "in connection with the provision of regulated activities".

We suggest that the AER clarify clause 2.3 to be more clearly focused on only the supply of EII Act regulated services by the Network Operator, and to exclude to any acquisition of inputs to support the supply of those services.

d. Ensure a consistent definition of 'related electricity service provider' (RESP)

Our review of the LFS Guideline highlighted an inconsistency between the RESP definitions that are used in different parts of the LFS Guideline, and also between the LFS Guideline and the NER Ring-fencing Guidelines. The definitions should either be made consistent, or the reasons for any differences clearly explained.

i. Only use the terminology used within the LFS Guideline glossary

The LFS Guideline includes two different descriptions of a RESP at clause 2.3 and in the glossary. Ausgrid recommends that the AER remove the clause 2.3 description, or better align these definitions to reduce potential for confusion.

ii. Inconsistency with the NER Ring-fencing Guidelines

The RESP definition in the LFS Guideline is different to the NER Ring-fencing Guideline definitions in that the former includes all affiliates of a Network Operator (not just those that provide contestable electricity services). If an affiliate is not providing any contestable electricity services, it should not be treated as a RESP for the purposes of the LFS Guideline because there is no risk of cross subsidisation or discrimination in the contestable electricity market.

Ausgrid recommends revising the definition of a RESP in the LFS Guideline Glossary as follows, so that it aligns with the NER Ring-fencing Guidelines:

In relation to a Network Operator, includes:

(a) Any affiliated entity of the Network Operator, and

(b) The part of the Network Operator ~~that provides contestable electricity services,~~

that provides contestable electricity services, but excludes the part of the related entity that provides regulated electricity services.

This amendment ensures consistent drafting with the NER Ring-fencing Guidelines by applying the words ‘that provides contestable electricity services’ to both subclause (a) and (b) and not just subclause (b).

2. Cost Allocation Guideline

The draft EII Act Cost Allocation Guideline provides that Ausgrid, as a NSP with a pre-existing cost allocation methodology (**CAM**), will need to amend its existing CAM if it is involved in any EII Act regulated activities so that it meets the requirements of the EII Act Cost Allocation Guideline.

Given that some businesses will need to comply with both the NER and EII Act guidelines, and have a single compliant CAM, it is important that the EII Act guideline replicates the existing NER guideline.

We note that there are some differences between the EII Act Cost Allocation Guideline and the NER Guideline. For example the EII Act Cost Allocation Guideline includes a requirement that, where non-causal allocators are used, the aggregate of all shared costs subject to non-causal bases of allocation not be ‘material’. However, the rationale for this additional requirement is not clear.

Further, this requirement is inconsistent with the Cost Allocation Principles in the NER and is significantly different to how the NER Guideline operates. The NER Guideline allows for the use of non-causal allocators where a causal relationship cannot be established without undue cost and effort, without consideration of the materiality of the shared costs.²

As such, Network Service Providers with pre-existing CAMs approved under the NER Guideline that apply non-causal allocators to a material value of shared costs would be required to adjust their CAM to meet a requirement that is inconsistent with the NER to be involved in any EII Act regulated activities. This would potentially prevent a NSP from being appointed a Network Operator, if changes are required to be made to a NER-compliant CAM to meet the requirements of the EII Act Cost Allocation Guideline.

Ausgrid recommends revising the drafting of clause 2.1.4(3) to replicate the wording included in the NER Guideline to ensure a CAM already compliant with the NER would be compliant with the EII Act Guideline.

Our interpretation of the EII Act Cost Allocation Guideline suggests there is a further difference between the EII Act Cost Allocation Guideline and the NER Guideline in terms of the granularity with which costs are required to be allocated. Clauses 2.1.1. 2(a) and (b) of the EII Act Cost Allocation Guideline refers to the “activity or service type between or within which the cost item”

² NER clause 6.15.2(3)(ii), NER Cost Allocation Guidelines clause 2.2.4.

will be directly attributed / allocated. This appears to be inconsistent with the NER Guideline which only uses the term 'between'. It is not clear from the drafting whether the EII Act Cost Allocation Guideline is contemplating allocations both between activities / service types and within the activity / service type (i.e. to individual services within a service type or activity). There is also no rationale provided as to why more granular cost allocation may be required.

Ausgrid recommends clarifying the drafting to specify when (if at all) a Network Operator would be required to allocate costs *within* an activity or service type, as opposed to allocating costs to that aggregate activity / service type.

Another example of differences between the guidelines is clause 3.2 of the EII Act Cost Allocation Guideline, which requires a Network Operator to "provide, in its cost allocation methodology, a statement confirming that any marginal increases in direct costs as a result of including EII Act regulated activities, will match the marginal increases in shared costs." It is not clear how this will be measured. For example, the increase in direct costs could equal the increase in shared costs in absolute dollar terms, or in percentage increase in total direct cost terms. The rationale for this requirement is not clear.

Given that some businesses will be both a REZ Network Operator and a NER-regulated DNSP or TNSP, Ausgrid considers that the EII Act Cost Allocation Guideline should replicate the NER cost allocation guideline.

3. Incentive scheme guidance note

Incentive schemes are an important part of the framework for promoting efficient investment in, and efficient operation and use of, electricity services.

However incentive schemes can only promote efficiency where they are applied prospectively given that an incentive scheme can only affect the future behaviour of market participants.

The AER's draft guidance note states that it may not be appropriate in an initial non-contestable revenue determination under the EII Act to state with certainty whether an incentive scheme will apply to forecast expenditure. The AER considers that it should have discretion to apply an efficiency benefit sharing scheme (**EBSS**) at the end of the first (and potentially the second) regulatory control period.

Ausgrid understands that it may not be appropriate to apply incentive schemes in an initial regulatory period given the potential for uncertainty around the efficient 'steady state' level of expenditure. The decision to apply (or not) an incentive scheme should be made at the start of the period, so that once the decision has been made, the Network Operator should have certainty as to whether a scheme will or will not apply. This will ensure that the Network Operator develops processes to be able to do the scheme at the proper time and so the scheme can provide appropriate incentives for efficiency.

As such, we recommend that the AER clarify that certainty will be provided to Network Operators at the commencement of a regulatory control period regarding the application of incentive schemes to expenditure in that period.

4. Confidentiality Guideline

Ausgrid considers that the draft Confidentiality Guideline is fit-for-purpose.