

Ring-fencing for negotiated transmission services

Response to AER Consultation Paper on 'Options to address
gaps in transmission ring-fencing framework'

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Key messages

- » The Australian Energy Market Commission (AEMC) implemented a connections framework that promotes the long-term interests of consumers. It enables competition for the provision of connection services – which includes robust protections against Transmission Network Service Providers (TNSP) using their monopoly position to distort this competition – while also allowing customers to capture the efficiency benefits that are available through TNSP provision of contestable connection services.
- » If connecting parties choose the Primary TNSP to provide all connection services, the framework provides a smooth and time-efficient connection process disciplined by the threat of competition. Timely and efficient connection of renewable generation to the transmission network has never been more vital. It serves as the backbone for the energy transition, ensuring reliable and affordable supply for customers. Inefficient ring fencing arrangements would undermine this framework and lead to a connection process that is complex, time consuming, and costly.
- » The AER has proposed two solutions to a problem, but has provided no evidence that a problem exists. Instead, its views rely primarily on assertions from certain stakeholders. Given the potential costs that can be imposed through regulation, it is essential that the AER demonstrate that a material problem *actually* exists before potentially costly and destabilising changes to the framework are made. In proposing changes to the framework, the AER must also consider that additional segregation of negotiated transmission services may make it unviable for TNSPs to continue to supply these services. This outcome would severely reduce the depth of competition for transmission connection services, to the substantial detriment of customers.
- » The ENA urges the AER to use the powers that it already has to review TNSP compliance with the current arrangements and assess against the evidence whether there are shortcomings in those arrangements, before contemplating changes to the framework. Should any material issues be identified, any proposed rule changes will then be better targeted and supported by actual evidence. In particular, evidence is required to demonstrate how any proposed changes will benefit customers compared to the existing arrangements.
- » Reinforcing the need for the AER to undertake a review of compliance with the existing framework, the ENA is concerned that the current consultation process may lead the AER to consider there is a problem when one does not exist. Submissions from motivated stakeholders can often include claims that lack evidence. Further, the ENA has identified several issues with the AER's survey that mean that caution should be taken when interpreting the results.

Introduction

Energy Networks Australia (ENA) is pleased to make this submission to the AER on behalf of its transmission members in response to the Consultation Paper titled 'Options to address gaps in transmission ring-fencing framework'.

ENA 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.

This review comes at a time when the need for timely and efficient transmission and renewable generation investment has never been greater as Australia works through a once in a century energy

transformation on the pathway to net zero. Effective regulatory frameworks are critical to ensure the long-term interests of customers are protected through this transition.

The existing framework is in the long-term interests of consumers

In previous submissions to the AER the ENA has emphasised that the current transmission connections framework is intentionally designed to balance two objectives. That is, it safeguards competition while seeking to ensure that customers (connecting parties) can benefit from the experience of TNSPs to achieve the most efficient connection possible. It does this by allowing TNSPs to provide contestable connection services (with competitive constraints provided through the threat of competition), while including comprehensive measures to ensure that TNSPs cannot frustrate customers who prefer to choose an alternative provider. Importantly, the current framework allows the TNSPs to manage the minimal staff and other costs required in the presence of lumpy and typically infrequent connection projects by deploying specialist staff on other (i.e., regulated) activities when they are not required for connection activities. The regime of robust cost allocation methodologies ensures that these costs are allocated properly between regulated and non-regulated activities, ensuring that regulated customers are not exposed to inefficient costs and do not cross subsidise TNSPs' unregulated activities.

Customers benefit from TNSPs continuing to be incentivised to provide contestable connection services because:

- » The threat of competition ensures that TNSPs face an incentive to provide the most efficient connection service possible and gives customers access to alternative suppliers if this suits their needs
- » The regime provides the opportunity for TNSPs to compete with other providers by harnessing the economies of scale and scope that are available to them, and
- » It preserves the streamlined connection process that the AEMC put in place for the primary TNSP, which avoids the additional steps that would otherwise be necessary to ensure any third-party assets are designed in such a way as not to diminish the security and reliability of the shared network.

The AEMC, when implementing the new connections framework, anticipated that TNSPs would continue to have a prominent role in delivering contestable connection services. The objective of introducing contestability was to ensure that TNSPs are subject to competitive constraint, thus placing a discipline on the price and service offering from TNSPs, while also allowing parties the option to choose a third-party provider where they wish to do so. This framework reflects that in many instances it is in customer's long-term interests for connection services to be performed by the Primary TNSP. While many competitors are able to possess the economies of scale and scope efficiencies that are held by the Primary TNSPs, the technical imperative for TNSPs to approve the design of third-party providers means that TNSPs *must* spend additional time assessing any design prepared by others. As indicated above, this framework delivers a naturally streamlined process when connecting parties select the Primary TNSPs to provide all of the connection services, with the threat of competition disciplining the price and service offering.

In addition to the impact from the threat of competition, the AEMC has also emphasised that changes to reduce the information asymmetry between TNSPs and proponents¹, as well as the countervailing market power possessed by network users that connect to the transmission network, serve as an additional protection against the misuse of a TNSP's monopoly when it provides connection services. With respect to the countervailing market power held by network users, the AEMC stated:²

In particular, the Commission considers that market power possessed by a network service provider is, or is likely to be, mitigated by countervailing market power possessed by a network service user or prospective network service user, This countervailing market power arises because the network service users are themselves likely to be companies that have significant resources to negotiate effectively.

The role of the Independent Engineer and the introduction of the negotiating principles are also significant additions to the framework to reduce any information asymmetry between the TNSP and proponent.

As we move quickly towards net zero, there might be a propensity for connecting parties to prefer the Primary TNSP as the provider of contestable connection services given the timing benefits available. However, where other providers are able to find additional efficiencies connecting parties are able to draw on these third-parties to their benefit.

Additional regulatory hurdles would slow the renewable energy transition and increase consumer costs

The continued participation of TNSPs in the contestable connection services market is crucial to maintaining a competitive environment and enabling the timely and efficient connection of new generators in the NEM. Excessive regulation, including unnecessarily stringent ring-fencing measures, could make it uneconomic for TNSPs to provide contestable connection services. Should this occur, customers would be deprived of an important market participant, and competitive pressure in the market would be reduced.

The AEMC raised concerns about the impact of additional ring-fencing measures when evaluating the potential outcomes of extending the distribution ring-fencing arrangements to transmission. It identified that a more restrictive transmission ring-fencing framework would likely impede the ability and motivation of TNSPs to engage in the market and, consequently, diminish competition for contestable services. Specifically, the AEMC stated:³

The final rule more explicitly defines which services provided in relation to a connection are to be provided as negotiated transmission services on an exclusive basis by the TNSP, and which can be provided on a contestable basis. These changes will therefore have an

¹ AEMC, 'Rule Determination, National Electricity Amendment (Transmission Connection and Planning Arrangements) Rule 2017', 23 May 2017, p.39

² AEMC, 'Rule Determination, National Electricity Amendment (Connection to Dedicated Connection Assets, Rule 2021', 08 July 2021, p.35

³ AEMC, 'Rule Determination, National Electricity Amendment (Transmission Connection and Planning Arrangements) Rule 2017', 23 May 2017, p.167

implication for a TNSP's compliance with the ring-fencing guidelines. While this is not a concern under the existing ring-fencing guideline, the Commission acknowledges that a more restrictive approach to ring-fencing for TNSPs may affect the ability and incentives for TNSPs to participate in a market for the provision of contestable connection services, and would likely affect the degree of competition for contestable services under the framework set out in this final determination.

Clear evidence is needed before framework change is warranted

The AER should not ignore the potential for material indirect costs to be imposed by inappropriate regulation and ring-fencing arrangements. The potential for such costs means that for any framework change there must be evidence that a clear harm exists that is not being addressed in the current framework, and the benefits of addressing this harm are clearly outweighed by the costs of the measures used to remedy it.

The AER has suggested two solutions in its consultation paper without first establishing the existence of an underlying problem. The AER is yet to articulate any concrete gaps in this framework. It has, however, identified that it is not aware of the TNSP's current practices in certain areas and that it was unable to obtain public data on whether the framework is delivering benefits to connecting parties. The AER's support for new measures therefore primarily originates from stakeholder feedback during the transmission ring-fencing guideline review. The ENA notes that the majority of those stakeholders are competitors to TNSPs for the provision of contestable connection services, the implication being that they stand to directly benefit from additional regulation being imposed on TNSPs that would reduce their ability to compete for these services.⁴

The ENA considers that reliance on unsubstantiated claims made by motivated stakeholders does not meet the threshold of evidence required for a rule change request to be made in the interests of customers.⁵ Further, the AER's statements about the benefits of additional regulation for the cost and timeliness of network connections does not align with current evidence or the framework design. As indicated above, network connection will inevitably be faster when performed by the Primary TNSP given the requirement for TNSPs to approve third-party designs, while the threat of competition incentivises TNSPs to perform connections as efficiently as possible, including with respect to price.

⁴ Further, the ENA notes that the report by Incenta Economic Consulting referred to by the AER identified that the claims made in submissions to the AER about the need for ring-fencing for transmission network connection services lacked evidence and substance. See: Incenta, 'Competition issues for contestable transmission connection projects', December 2022.

⁵ Section 8(1)(c) of the National Electricity (South Australia) Regulations requires that a rule change request provide a statement of the nature and scope of the issue and an explanation of how the proposed rule would address the issue. The ENA considers claims by motivated stakeholders falls short of this requirement.

Use existing powers to assess the need for a rule change

The AER has extensive powers to obtain information and assess compliance with the rules. It is inconceivable that the AER would propose a rule change that includes seeking additional compliance powers without first using its current powers to identify if any changes to the regime are required.

The AER's Compliance and Enforcement policy highlights that its compliance work is intended to give consumers and energy market participants confidence that energy markets are working effectively and in their long term interests.⁶ The policy document notes that the AER has discretion in how it monitors compliance, stating:⁷

We have discretion in how we monitor compliance, when and how we investigate potential breaches, whether we take compliance action or enforcement action, and the appropriate nature of that action. We will choose the combination of compliance and enforcement tools that we consider will deliver the best outcome for consumers and the market.

Consistent with its legislated information gathering powers, the AER further identifies that it is able to undertake specific information requests and targeted reviews, and identifies that this can focus on areas of emerging concern, stating under the heading "Information requests and targeted reviews":⁸

We ask regulated businesses and/or AEMO for information about their compliance – both in respect of identified matters and as part of wider reviews of compliance practices and processes in an emerging area of concern.

The ENA urges the AER to use the measures already available to it to determine if there is evidence that TNSPs are not complying with existing arrangements before contemplating material changes to the framework. Should this process reveal potential compliance issues, including differences in interpretations of instruments, TNSPs encourage the AER to enter a dialogue with TNSPs to understand the nature of those issues. Following this, a fit-for-purpose course of action can be developed to rectify those specific issues. If the AER ultimately considers a rule change may be beneficial, having undergone a review of compliance with the current framework, this rule change can be better targeted and supported by actual evidence. This should include evidence how any proposed solution benefits customers compared to the current framework. As previously advocated by the ENA, any identified gaps in the framework should be addressed through the rules rather than in an AER guideline. This approach ensures that there is no conflict between the rules and AER guidelines.

⁶ AER, 'AER Compliance and enforcement policy', July 2021, p.1

⁷ AER, 'AER Compliance and enforcement policy', July 2021, p.5

⁸ AER, 'AER Compliance and enforcement policy', July 2021, p.6

The survey design has shortcomings

The ENA has identified several shortcomings with the AER's survey. These issues may distort or prejudice some responses such that the AER will need to interpret the results with caution. Some of the issues with the survey design include:

- » It does not ask respondents to reveal if they think a different framework is preferable. Even if stakeholders have some concerns with the existing model, they may significantly prefer it to one where TNSPs are restricted in their capacity to provide contestable connection services, or consider that these can be easily addressed through minor changes to the rules rather than through, for instance, functional separation.
- » The drafting of some questions is leading, and so may encourage participants to think there is a problem when one does not exist. Examples of this include phrasing such as 'frustrate', and 'TNSP use of its advantage'.
- » Certain questions will not deliver meaningful responses given the AER has not asked for evidence to support responses.
- » The design of the questionnaire includes many open-ended questions. This design can invite verbose responses that can be challenging to interpret and analyse. It also raises the risk that bias, implicit or otherwise, is applied in the interpretation of the responses.

No evidence of potential harms identified to date

The AER's consultation paper recites claims made by stakeholders of potential unchecked harms that exist in the current framework. As stated in the ENA's submission, and above, the AER has not yet engaged with the substance of these accusations or spoken directly to TNSPs to ascertain their validity. However, Incenta Economic Consulting, in response to the AER's Draft Transmission Ring Fencing Guideline, considered in detail the claims made by stakeholders and if there were any gaps in the regulatory framework created by the AEMC. Incenta analysed claims of gaps in the framework in the following areas:

- » Cost shifting to the regulated business
- » Charging a high price for an O&M service
- » Discrimination in relation to the Functional Specification
- » Use of confidential information for bids on contestable services, and
- » Conduct of the connection process is used to discriminate.

Incenta concluded that there were no material gaps in the framework and suggested that comments about the need for further regulation were likely based upon an incomplete understanding of the current regulatory requirements on TNSPs. It noted also that stakeholder claims about potential harms to competition were largely theoretical and not supported by evidence of inappropriate behaviour or

outcomes.⁹ The ENA is confident that if the AER undertook the same analysis as Incenta that it would reach the same conclusions.

One particular risk that was not specifically addressed by Incenta that was raised in the AER's consultation paper relates to information provided by distributors. The described risk is that because the TNSP is informed of distribution connections that involve upstream works at the terminal station that the TNSP can use that information to encourage the connecting party to connect to the transmission grid instead of the distribution network. However, ENA's TNSP members are not aware of any case where this has occurred in the NEM.

It is not obvious what advantage information about distribution connections would provide to TNSPs. In the first instance, we understand that the jurisdiction of concern is Victoria and, in this jurisdiction, AEMO manages the connection process and is the main point of contact for the connection applicant. Indeed, under the Victorian framework, where AEMO concludes an augmentation is required, AEMO determines if the project satisfies the criteria for contestability, selects the preferred solution, determines the technical specifications, and calls for tenders from interested parties. Importantly, it is AEMO that is responsible for preparing and managing the dissemination of the tender materials. The successful tenderer is then required to enter into a network agreement with AEMO, so that AEMO can provide the electricity network services required as part of its Victorian network functions.

In the Consultation Paper, the AER has correctly identified the features of the Victorian framework that make it competitive and limits the ability of the incumbent DTSO to discriminate in favour of itself or an affiliate.¹⁰ That competitive framework has resulted in at least eight different entities entering the Victorian market and delivering in Victoria.¹¹

With respect to the assertion that TNSPs, including DTSOs, have an incentive to disclose information obtained from a connection applicant to an affiliate, there are confidentiality obligations in Rule 8.6 of the NER. This rule imposes explicit and strict confidentiality obligations on all TNSPs in respect of the information they receive from a party seeking negotiated transmission services. TNSPs are committed to fulfilling their obligations under the NER, with no exception in relation to this obligation.

The division of the TNSP function and the contestability framework therefore means that DTSOs are already subject to functional separation. Imposing additional legal or operational separation obligations through ring-fencing guidelines is unnecessary and will impose significant additional costs and erode the benefits of contestability.

Further, if a distribution connection is so large that it requires upstream augmentation, it is likely that the connecting party has already enquired about connecting to the transmission network instead; noting the Primary TNSP would not be assured of performing all of the connection services. Ultimately, however, the connecting party is free to determine which network they wish to connect to and who performs contestable connection services based on what is best for them for the most cost effective and suitable connection option.

⁹ Incenta, 'Competition issues for contestable transmission connection projects', December 2022, p.6

¹⁰ AER, Consultation Paper 'Options to address gaps in transmission ring-fencing framework', pp. 21-22

¹¹ AusNet, Response to 'Options to address gaps in transmission ring-fencing framework' Consultation Paper