Explanatory Statement

Transmission Efficiency Test and revenue determination guideline for NSW non-contestable network infrastructure projects

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AUSTRALIAN ENERGY REGULATOR

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1 About this document

1.1 Introduction

This Explanatory Statement accompanies the Australian Energy Regulator's (AER) final Transmission Efficiency Test and revenue determination guideline for NSW non-contestable network infrastructure projects (Guideline).

The AER exists to ensure energy consumers are better off, now and in the future. We are the economic regulator for electricity and gas networks in every state and territory in Australia except Western Australia. We regulate electricity networks under the National Electricity Law and National Electricity Rules (NER) and natural gas pipelines under the National Gas Law and the National Gas Rules.

We are also a Regulator under the NSW *Electricity Infrastructure Investment Act (2020)* (EII Act) and *Electricity Infrastructure Investment Regulation (2021)* (EII Regulation). A key function is to apply a Transmission Efficiency Test and make revenue determinations for Network Operators authorised by the Consumer Trustee or authorised (or directed) by the NSW Energy Minister to carry out network infrastructure projects (under Part 5 of the EII Act). This function is the subject of the Guideline.

Section 38(5) of the EII Act requires the Regulator to publish guidelines on its website about the Transmission Efficiency Test to be used to calculate the prudent, efficient and reasonable capital costs of network infrastructure projects. Clause 47 of the EII Regulation also requires the AER to publish on its website guidelines about the exercise of its functions more broadly under Part 5 of the EII Act, which includes making (and remaking) revenue determinations. We have combined these two aspects into a Guideline relating to non-contestable network infrastructure projects (this Guideline) and a separate guideline relating to contestable network infrastructure projects.[1]

We published a draft guideline in November 2022 and held an online public forum to allow stakeholders the opportunity to ask questions about the draft Guideline before submissions were due. We received submissions from Transgrid and Energy Networks Australia (ENA) on the draft Guideline.

A summary of the submissions received on the draft Guideline, and our response, is in section 2 of this Explanatory Statement.

1.2 Role of the Guideline

A Network Operator may be selected to carry out a network infrastructure project in one of two ways:

1. Under a non-contestable process, a Network Operator is selected directly by the Infrastructure Planner.
2. Under a contestable process, a Network Operator is selected through a competitive assessment process conducted by the Infrastructure Planner.

[1] See: AER, *Revenue determination guideline for NSW contestable network projects*, August 2022.

A contestable process may also be used to select a person who will assist a Network Operator in carrying out a network infrastructure project.

The regulatory process varies significantly between the non-contestable and contestable paths. However, both processes provide consumer protections by seeking to limit the costs for carrying out network infrastructure projects to an efficient level. The non-contestable process is subject to a more typical regulatory assessment by the AER, which substantially replicates Chapter 6A of the NER that applies to the regulation of Transmission Network Service Providers. The contestable process relies on the Infrastructure Planner conducting a competitive assessment process to reveal prudent, efficient and reasonable costs.

To satisfy the EII Regulation, our Guideline sets out our regulatory role under the non-contestable process, including:

- which of our NER guidelines, incentive schemes and models apply to non-contestable projects, or where we will develop specific EII guidelines, incentive schemes and models, (section 3.1.3 of the Guideline).
- the information and consultation requirements on a Network Operator in submitting a revenue proposal to us (sections 3.3.1 and 3.3.2 of the Guideline).
- our approach to assessing a Network Operator’s revenue proposal and making a revenue determination (that is, a propose/respond model), with a focus on where this approach deviates from our application of NER Chapter 6A, (chapter 5 of the Guideline).
- how we will apply our Transmission Efficiency Test to each network infrastructure project, (section 5.2 of the Guideline).
- our approach to depreciation, (section 5.3 of the Guideline).

1.3 Development of EII specific guidelines

The final Guideline references EII Regulation 42 which requires us to:

(a) issue guidelines for network operators about the following -

(i) the legal separation of the entity through which a network operator conducts regulated activities from any other entity through which it conducts business,

(ii) the establishment and maintenance of consolidated and separate accounts for regulated activities and other activities conducted by the network operator,

(iii) the limitations on the flow of information from or within the network operator if there is the potential for a competitive advantage or disadvantage to arise, and

(b) set standards about the legal and functional separation of the regulated activities of a network operator from other activities of the network operator, and

(c) monitor compliance by network operators with the standards.

We will also develop:

- an EII Confidentiality guideline.

- a Service Target Performance Incentive Scheme (STPIS), which will apply to non-contestable determinations from the second regulatory control period.[2]

We anticipate finalising guidelines required under Regulation 42 in the second half of 2023. We will consult with stakeholders on the development of these guidelines.

We will commence developing our EII STPIS at a later date, noting that this scheme will not apply to non-contestable determinations until the second regulatory control period. We will also consult with stakeholders on the development of this scheme.

1.4 Overlap between the EII framework and the NER

At the time of publishing this Guideline we were aware that the EII framework does not differentiate services under the EII framework from prescribed transmission or prescribed distribution services under the NER. This potentially means that Network Operators are subject to two regulatory regimes (the NER and the EII framework).

We expect the issue to be resolved before the end of this year. Should resolution of this issue require an amendment to this Guideline, we will make it in accordance with the amendment process described in the Guideline.

[2] EII Regulation, s. 47B (2).

2 AER response to submissions and key changes from the draft Guideline

The AER's consideration of issues raised by stakeholders in submissions to the draft Guideline are set out in the table below. We have also consulted with the NSW Office of Energy and Climate Change (OECC) and the Energy Corporation of NSW (EnergyCo) in developing this Guideline.

Issue	Submission	Comment	AER response
Early engagement by Network Operator with stakeholders and the AER	Transgrid	Transgrid supported early engagement by a Network Operator with stakeholders and the AER. However, Transgrid noted that there are some scenarios that may present challenges to early engagement, including where the network project covered by the non-contestable revenue proposal cannot be consulted on while an associated contestable procurement process is underway. Transgrid submitted that the AER consider acknowledging these scenarios as exceptions to the early engagement expectation in the Guideline.	We consider that our Guideline provides a Network Operator with sufficient discretion to determine how it should engage with stakeholders, particularly for the initial revenue proposal, drawing on the principles set out in the AER's Better Resets Handbook.[3] We have considered whether we should state a range of exceptions where a Network Operator is not required to use its best endeavours to undertake pre-lodgement stakeholder engagement for an initial revenue proposal on a project. Our decision is to not list any exceptions for specific scenarios, but rather request that discussion of potential exceptions commence as early as possible with us. Based on its circumstances, the Network Operator should use best endeavours to conduct early engagement. To elaborate, there are still a range of ways a Network Operator could engage including for example, increasing its stakeholder's awareness of how the EII regulatory framework operates, the interaction of a non-contestable network project with related contestable network projects (subject to commercially sensitive information), the scope of the non-contestable project and where Transgrid considers there are

[3] AER, *Better Resets Handbook - Towards consumer centric network proposals*, 9 December 2021.

Issue	Submission	Comment	AER response
			particular uncertainties. We understand that Transgrid has proceeded to engage with its own customer panel on this basis. Impact on final Guideline: For the reasons outlined, we have amended the final Guideline to be clear that the Network Operator should use best endeavours to undertake pre-lodgement engagement (section 3.5.1 of the Guideline). Where limitations to engagement are expected (at any stage of the process) the Network Operator should raise the issues it has identified with us early.
Timeframe for submitting a revised revenue proposal	Transgrid ENA	Transgrid and the ENA are concerned about the timeframe provided to a Network Operator to prepare its revised revenue proposal. They consider a Network Operator requires the timeframe stated under the NER to prepare its revised revenue proposal. The NER timeframe is 'not more than 45 business days'. Transgrid submitted that this is the minimum timeframe it considers achievable given internal governance as well as changes to forecast costs and other elements that may be required based on updated information.	EII Regulation 50(1)(b) states that we must make a revenue determination within 126 business days of receiving a Network Operator's revenue proposal. It is not practicable to conduct a reset process under the EII framework if a Network Operator is provided with 45 business days to prepare its revised revenue proposal. To do so would provide the Network Operator with close to one third of the 126 business days to prepare and submit its revised revenue proposal. However, we have made some changes to the indicative timing in Table 1 of the Guideline by providing 28 business days for the Network Operator to submit its revised proposal (increased from 20 business days). To provide this additional time we will now have 24 business days to make and publish our final determination (down from 28 business days) and consultation periods for stakeholders have been reduced by 4 business days in total. We do not consider that reducing the time to hear from stakeholders any further would be in the best interests of NSW electricity consumers.

Issue	Submission	Comment	AER response
			We appreciate that the limited timeframe impacts on internal review and clearance processes. However, the AER and Network Operators must be flexible in managing internal governance processes. We also note that the revenue proposal will have a much more limited scope compared with revenue proposals submitted under the NER framework and we reiterate that timing in the Guideline is indicative only. **Impact on final Guideline**: Table 1 of the Guideline amended to provide 28 business days for the Network Operator to submit its revised revenue proposal (increased from 20 business days).
Apply a fit-for-purpose approach for incentive schemes	Transgrid ENA	Transgrid and ENA submitted that the AER should exempt projects carried out under the NSW regulatory framework from the efficiency benefit sharing scheme (EBSS) and the capital expenditure sharing scheme (CESS). Transgrid considered that there will be little or no opportunity to reprioritise expenditure given the determination will relate to a single project. Alternatively, if the AER incentive schemes were to be applied under the NSW regulatory framework, then Transgrid submitted that the CESS and EBSS only apply from the second regulatory control period. ENA submitted that the Service Target Performance Incentive Scheme (STPIS) is better suited to transmission network projects progressed under the NER where the planning and connections are managed by the incumbent transmission network service provider. ENA therefore seeks clarity on the application of the	The EII Act requires us, in making our determinations, to take into account the principle that incentives should be given to network operators to promote economic efficiency. EII Regulation 47A(3)(b) also requires that as far as reasonably practicable, we make guidelines consistent with the NER Chapter 6A. The premise of both NER Chapter 6A and EII Chapter 6A is a propose/respond model. The above points place an onus on the Network Operator to demonstrate why, for a particular network infrastructure project the EBSS or CESS should or should not apply or be modified in some way. The AER has discretion whether and how we might apply these incentive schemes depending on the circumstances. We are open to considering modifications to the application of our schemes and would do so on a case-by-case basis. EII Regulation 47B(2) requires us to develop a STIPS guideline to be applied by us in remaking a non-contestable revenue determination.

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		transmission incentive framework at a project determination level.	We will develop a STPIS as outlined in section 1.3 and will consider the issue raised by ENA when developing that scheme. **Impact on final Guideline**: For the reasons outlined, we have amended the Guideline to state that depending on the circumstances and the reasoning, we may be willing to consider modifications to the application of our incentive schemes (section 3.3 of the Guideline).
Forecasting risks in global socio-economic climate	Transgrid	Transgrid submitted that accurately forecasting costs for a large infrastructure project five years ahead is challenging, particularly in the current economic climate. It indicated that it would welcome engagement with the AER on this issue of forecasting risk prior to the finalisation of the guidelines. Transgrid stated that the AER's draft guideline sets out that a revenue proposal may include mechanisms to adjust the revenue proposed to be paid. Transgrid seeks clarification on how the AER will treat mechanisms to adjust revenue proposed to be paid given they may reduce forecasting risks.	We acknowledge the current economic environment and the impact that it is having on supply chains and the cost of inputs. While we generally consider network operators remain best placed to manage forecasting risk, we would welcome discussions with network operators regarding any specific cases where it can be demonstrated that there is a forecasting risk that cannot be managed by the network operator using current practices. A network operator may include in its revenue proposal mechanism/s to adjust any amount provided for in a determination. However, Regulation 51 of the EII Regulations provides the AER with discretion as to whether or not to include an adjustment mechanism in its determination. We note that the EII non-contestable framework is largely consistent with the NER Chapter 6A framework and therefore includes several adjustment mechanisms including pass through events and nominated pass through events. In assessing any proposed adjustment mechanisms, we are likely to have regard to the nominated pass-through event considerations referenced in the EII Chapter 6A Rules. The ability of a network operator to propose adjustment mechanisms under the EII framework should not be interpreted as a retreat from incentive-based regulation. Incentive regulation is fundamental to promoting efficiency in both

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			Chapter 6A of the NER and the EII Act.[4] For example, we note that we continue to expect expenditure forecasts proposed by a network operator and any adjustment mechanisms to be respectively unbiased estimates and symmetrical in their application. **Impact on final Guideline**: We have amended section 5.5 of the Guideline to set out how we intend to assess mechanisms proposed to adjust amounts included in our revenue determination.
Inclusion of risk costs in NSW EII framework	Transgrid	Transgrid supported the inclusion of provisions for risk costs in the NSW EII regulatory framework. In relation to this issue, Transgrid referenced Regulation 50A(e) of the EII Regulations. Regulation 50A lists the separate components (building blocks) of a revenue determination. Regulation 50A(e) relates to other risks for which the Network Operator is not already compensated for under the return on capital component. The regulation mirrors rule 6A.5.4(7) of the NER. Transgrid submitted that the nature and scope of risk costs is likely to evolve during the process and therefore a flexible approach should be taken to them.	In further discussions with Transgrid, it noted that the issue would benefit from the AER stating what costs are specifically included as 'risk costs' in the component (building block). In past decisions we have not identified any risks which are not already captured in regulatory allowances. However, should a network operator identify and quantify risks that it considers are not captured in current allowances we would consider the merits of the case made by the network operator. **Impact on final Guideline**: We have not identified a need to amend the final Guideline in response to this issue.
Financeability	Transgrid ENA	Transgrid and ENA noted that the draft Guideline states that: *"This Regulation permits us to adjust depreciation if we consider that there is merit in doing it on a whole of business basis assessing, amongst other things, key financial metrics."*	EII Regulation 47D requires us, as the Regulator, to consider financeability in the context of our assessments around depreciation. We do not consider that our comment that we may consider depreciation on a whole of business basis pre-empts the national

[4] EII Act, 37(1)(b).

Issue	Submission	Comment	AER response
		Transgrid and ENA stated that the AER should not pre-empt an approach under the NSW framework while the national arrangements are being settled. Transgrid considered this to be particularly important given the NSW framework relies heavily on Chapter 6A of the national regulatory framework. ENA suggested that, should the AER proceed with the proposed drafting, it should: • Provide further clarity in its final guideline on how its proposed approach aligns with the objects of the EII Act and what additional information may be required in relation to demonstrating alternative depreciation schedules. • Engage further on the breadth of the financeability assessment that is undertaken to determine the appropriate depreciation profile.	arrangements. Rather, it clarifies that we have the flexibility to take this approach if we considerate it appropriate to do so. As is required, our proposed approach to assessing financeability and any adjustment to depreciation will be legally consistent with the objectives of the EII Act. The Commonwealth Department of Climate Change, Energy, the Environment and Water has recently lodged a rule change proposal with the AEMC, *Rule Change Proposal - Treatment of financeability for Transmission Network Service Providers*. The rule change proposes the AER should outline how depreciation is expected to be applied to different types of asset classes for actionable ISP projects. We anticipate taking the same approach on depreciation adjustments for financeability reasons to EII projects as we do for actional ISP projects, and we expect our depreciation guideline should provide greater transparency around the breadth of our proposed approach and where we are likely to adjust depreciation for EII projects. We expect to engage with stakeholders during the development of the depreciation guideline (assuming a financeability rule change is made). **Impact on final Guideline**: For the reasons outlined, we have not in substance amended the final Guideline. However, in section 5.3 of the Guideline, we have added the word 'regulated' in front of 'business basis' to clarify that is what we meant.
Timing for development of confidentiality	ENA	ENA sought clarity on the timing of the development of the guideline required under EII Regulation 42 (which deals with	This issue is addressed in section 1.3 of this Explanatory Statement. **Impact on final Guideline**: Amended to include indicative timing for developing supporting guidelines and that we will undertake

Issue	Submission	Comment	AER response
and ring-fencing and STPIS.		ring-fencing arrangements), the EII confidentiality guideline and the EII STPIS.	stakeholder consultation in developing them (section 3.3 of the Guideline).
Section 5.7 of the draft Guideline – Transferring REZ network infrastructure to the NER	N/A	Since releasing our draft Guideline, regulations have been made to allow for network infrastructure assets to be transferred to a determination made under the NER at a future point in time.	**Impact on final Guideline**: Amended section 5.7 of the Guideline to reference the new EII Regulation permitting the transfer of REZ network infrastructure to the NER framework.
Pre-period costs	N/A	During pre-lodgement engagement with Transgrid for the non-contestable element of the Waratah Super Battery Project, Transgrid indicated that it will incur costs for the project prior to the commencement of the regulatory period and that these costs will need to be recognised in its first revenue determination.	**Impact on final Guideline**: Amended to note that if a Network Operator incurs costs related to the carrying out of a network infrastructure project prior to the first regulatory period commencing, how we intend to assess such costs (section 5.2.5 of the Guideline).

Glossary

Term	Definition
AER	Australian Energy Regulator.
EII Act, the Act	*Electricity Infrastructure Investment Act 2020 (NSW).*
EII Regulation	*Electricity Infrastructure Investment Regulation (NSW) 2021* made under the EII Act.
NER	National Electricity Rules.
Network Operator	Has the meaning given to that term in the EII Act.
OECC	Office of Energy and Climate Change.
Project, network infrastructure project	A REZ Network Infrastructure Project or Priority Transmission Infrastructure Project as defined in the EII Act.
Regulator	A person or body appointed as a regulator under section 64 of the EII Act. The AER has been appointed as a Regulator for the purposes of Part 5 of the EII Act.
Transmission Efficiency Test	The test to be applied to calculate the prudent, efficient and reasonable capital costs for development and construction of a network infrastructure project under section 38(4) of the EII Act.