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John Pierce
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PO Box A2449
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Dear Mr Pierce

Submission on contestability of energy services

Thank you for providing the opportunity to comment on these two related rule changes by the COAG Energy Council (COAG EC) and the Australian Energy Council (AEC). The AER recognises the significant issues raised by the two rule change proposals, noting for example, that the proposed changes, if all adopted, could significantly change the role of regulated network service providers in the provision of energy services in Australia.

As you know, the AER has recently finalised the Electricity Distribution Ring-fencing Guideline (the Guideline) and is in the process of implementing the Guideline and setting out more detailed compliance arrangements. In the course of preparing the Guideline, it became apparent that interactions between regulated and contestable business activities are becoming more complex. I believe we are seeing natural monopoly services of energy networks narrow in scope compared with the recent past. It is also apparent that network businesses are interested in and increasingly active in identifying commercial opportunities offered by non-regulated services, such as distributed energy resources. This is evidenced by, amongst other things, the number of battery trials we are seeing network businesses undertake.

Against this background, we have set out a number of observations and suggestions in response to your questions and issues raised in your consultation paper. We can see clear benefit in clarifying and updating some of the terms and processes relevant to the classification of services, as proposed by the COAG EC rule change. However, in regards to the more fundamental changes proposed in the AEC rule change, such as mandating the competitive provision of distributed energy resource (DER) services to network businesses, this is a more significant step away from the current regulatory regime. These issues deserve fuller scrutiny and it may be desirable, if the more straightforward changes to classification proposed by the COAG EC were seen as more urgent ahead of the next reset cycle, for the AEMC to progress this work in two separate stages or time-frames.

Attachment A provides some further explanation of how service classification, ring-fencing and cost allocation work together. This also responds to a number of issues raised in the AEMC's consultation paper.

We would welcome the opportunity to discuss these matters further, when convenient. If you have any queries regarding this letter, please contact Chris Pattas, General Manager, Network Pricing, Policy and Compliance on 03 9290 1470.

Yours sincerely

A handwritten signature in blue ink, appearing to be 'PC', is written above the printed name.

Paula Conboy
Chair

Submission on contestability of energy services

Introduction

Our comments are provided in two sections. The first section is concerned with the AEMC's questions 1 to 5, which focus on the approach to classifying services and associated processes. The second section is focussed on questions 6 to 8 (incentives) and then 9 and 10 (cost allocation), which appear more related to the AEC rule change.

In broad terms we are generally comfortable with most COAG EC proposals in relation to classification, with the exception of the proposal to re-open classification decisions mid-term. We consider this would create significant disruption to the regulatory process though yield relatively modest benefits in relation to facilitating the provision of new services.

We are of the view that many of the issues raised in the COAG Energy Council rule change proposal are useful refinements to the NER and can be implemented reasonably quickly, such as before the next NSW electricity regulatory proposals are submitted to us in 2018. However, the issues raised in the AEC proposal raise more complex issues. On this basis, we consider the two rule change proposals should be advanced separately and that further consultation is required in respect of the AEC proposal.

Section 1 — Questions 1 to 5

Question 1

Is there a problem with the current process for distribution service classification?

We consider existing provisions of the National Electricity Rules (NER) regarding service classification could be streamlined to achieve greater consistency across jurisdictions. This is particularly relevant now, in light of establishing our new Electricity Distribution Ring-fencing Guideline with national application. Service classification determines, in part, the ring-fencing treatment of services. While some jurisdictional variation in service classification will appropriately reflect jurisdictional specific circumstances, we consider service classification consistency is an important element in also achieving consistent ring-fencing outcomes. This will promote regulatory transparency, understandability and development of competitive markets by minimising uncertainty for new entrants.

Further to the point raised above, cl. 6.2.2(d) of the NER requires that classification of direct control services should not change unless a different classification is clearly more appropriate. We have typically interpreted this provision as meaning that an existing direct control service classification should not be changed other than because of a change in circumstances relevant to that service and that jurisdiction, such as a change in jurisdictional policy. This has resulted in the maintenance of direct control service classifications originally determined by jurisdictional economic regulators prior to us assuming this responsibility. While the current approach has promoted regulatory consistency over time within jurisdictions, it has resulted in the retention of unnecessary differences in classification across jurisdictions.

We also note that there appears to be some tension between cl. 6.2.2(d) and cl. 6.2.2(c) which sets out a number of other factors the AER must have regard to in classifying direct control services as either standard control or alternative control. These other

factors include, appropriately in our view, the potential for development of competition in the relevant market. This has meant that in practice the AER has had to weigh up the different factors and over time, as markets for services have developed, it has resulted in placing less weight on previous treatments (clause 6.2.2(d)). Nevertheless, the removal of this clause will facilitate more appropriate and timely classification of services in responding to new service developments.

We consider cl. 6.2.2(d) of the NER may be removed.

Would a classification guideline increase the clarity regarding service classification decisions?

We support the development of a classification guideline. We have independently formed the view that a service classification guideline would improve clarity and regulatory predictability for both the operators of regulated networks and potential new entrants to contestable markets associated with network activities. Accordingly we have already commenced some internal preparatory work. We think a guideline will assist stakeholders to appreciate the importance of service classification and better understand how decisions on service classification are made. Improved transparency is particularly relevant now, with the introduction of our new Electricity Distribution Ring-fencing Guideline.

We also consider that the process of developing a classification guideline may help stakeholders engage with our service classification process. We understand that some stakeholders may not be aware of, or find it difficult to engage with, the service classification process for a specific network business which begins with the Framework and Approach stage of a distribution determination. By engaging with stakeholders in developing a service classification guideline, we consider stakeholder views may be better reflected in service classification outcomes.

To what extent does classification being locked in over the regulatory control period create a lag in appropriate reclassification of services?

We appreciate that classification takes place before the previous regulatory control period ends, raising concerns about the durability of service classification over the length of a regulatory control period. For example, is the market for energy services evolving so quickly that changes to classification within the regulatory control period ("within period") could be required. However, we consider these concerns are somewhat overstated.

While classification is initially considered at the time of the Framework and Approach, our classification approach is not finalised until our final determination, which is generally only a few months before the beginning of the regulatory control period. We undertake service classification decisions with a view to prospective developments in policy, markets and technology over the upcoming regulatory control period. We do not consider that our service classification decisions have, or are likely to, inhibit development of competitive markets for energy services or otherwise delay uptake of efficiency enhancing technologies by network businesses.

Within period classification changes would be complex and costly to administer. Such changes would affect price or revenue caps, operation of incentive schemes and other aspects of a Determination such as the basis on which cost allocations have been made. A Determination would be effectively reopened, raising questions about consultation and transparency. Associated resourcing implications for both regulated businesses, stakeholders and the AER would be considerable.

We consider the benefits from in-period classification change do not outweigh the associated costs and complexity which would be very high. Ultimately, those additional costs would be financed by electricity customers.

Question 2

Does the definition of distribution services provide clear guidance regarding which services are distribution services and which are not?

The NER definition of distribution services is particularly relevant now, in light of the Electricity Distribution Ring-fencing Guideline which provides that only distribution services may be provided by a ring-fenced distribution network business. Under the new national ring-fencing approach, non-distribution services must be provided by a separate legal entity—a range of obligations attach to this delineation. Previously, the delineation of distribution services from non-distribution services had no particular regulatory relevance, other than for cost allocation. For example, regulatory treatment of an unregulated distribution service was, in the past, no different to the treatment of a service determined to be a non-distribution service.

The NER currently defines distribution services as “a service provided by means of or in conjunction with a distribution system”. We consider this gives rise to uncertainty in two ways. First, it may be arguable that a specific service is, or is not, consistent with the definition. The phrase “in conjunction with” may be interpreted very broadly. Potentially almost any service provided with resources otherwise used to provide distribution services may also be considered to be a distribution service. We consider that in an evolving market and technological environment this does not promote regulatory certainty or efficient market outcomes.

Second, the emphasis in the definition of a distribution service should be on the notion of “service”. We consider a service is concerned with providing something to a consumer. The term “distribution service” should reflect that something is being provided to or performed for a customer. We think this will help mitigate confusion that sometime arises, as noted in the AEMC’s rule change consultation paper, about the difference between services and inputs.

What types of changes could be made?

In our view distribution services need not be defined separately. Rather, distribution services may be considered in more general terms so that their physical characteristics are not specified, with emphasis instead on provision of a service by a distributor to a consumer. The definition of a distribution service could instead be determined through the service classification process. Alternatively, less importance may be placed on the definition of distribution services and the focus instead placed directly on the services we classify as direct control services and negotiated services. That is, avoid the step of identifying what is a distribution service before the classification of services.

If either of the above approaches was adopted, our process to determine service classifications would begin by considering all services provided by a network business and considering which of those should be regulated having regard to the form of regulation factors.

Aside from the definition of a distribution service, other NER and NEL definitions that could be re-considered include *network service*, *transmission service* and *shared*

distribution service to make these clearer and made consistent with any changes made under these rule changes.

What are pros and cons of changing the definition of distribution services?

As noted in the previous question, the current definition is static and does not adequately reflect the significant changes that are underway and our regulatory task in future. A definition of distribution service that can adapt over time is preferred.

Question 3

Do the form of regulation factors provide clear guidance to the AER in determining whether distribution services should be classified as direct control, negotiated or left unclassified?

The form of regulation factors¹ are concerned with identifying whether service provision may be subject to market failure justifying economic regulation under the NER. We explain in our Framework and Approach papers and distribution determinations how we apply the form of regulation factors to determine service classifications. In future, we consider this could be set out in a new classification guideline.

While the form of regulation factors are appropriately targeted at barriers to entry and the presence, or potential presence, of alternative service providers for specific services, we consider they could be simplified. There are currently seven separate factors which incorporate, to different degrees, terminology familiar to economic regulatory practice, but which may not be as clear to non-experts. For example: “externalities”, “substitute”, “market power” and “countervailing market power”.

We consider the current form of regulation factors may be streamlined to focus more directly on whether a service is likely to be provided on a contestable basis in the foreseeable future, or similar such wording. Moreover, we consider the terminology used in the form of regulation factors may be made more accessible for stakeholders.

With respect to negotiated services, we consider the form of regulation factors provide little direction as to whether a service should be classified as a negotiated service. We further consider the negotiated service classification itself requires re-consideration with a view to potentially removing this category from the range of service classification options or better specifying its purpose. Where regulatory intervention is justified the direct control service categories of standard control and alternative control services are available. Where regulatory intervention is not required we classify services as unregulated, meaning that we do not regulate their price or terms and conditions. It is unclear exactly what utility a negotiated service classification currently provides. Existing examples of services classified as negotiated services, such as in South Australia, are legacy approaches inherited from jurisdictional economic regulators.

It is also possible this category could be used as an intermediate step for services which are transitioning between alternative control and unregulated categories. It has not really been used in this way, and nor can we think of any examples of this. In either case, however, it is likely it will be used sparingly if at all.

Question 4

¹ National Electricity Law, s. 2F—Form of regulation factors.

Are the NER clear regarding classifying direct control services as standard or alternative control services?

We have found the NER sufficiently clear to distinguish between services that should be classified standard control compared to alternative control. However, in practice there are two distinct categories of alternative control services which are not currently reflected transparently in the NER. First, some services may be described as monopoly services for which a specific customer is identifiable. The cost of providing these services may therefore be recovered from relevant customers through separate charges, as provided for under the alternative control classification.²

Second, some services may become contestable such that a standard control classification would prevent a market developing because the service is provided as part of the bundled standard control service.³ Such services should also be classified as alternative control.

Separately identifying alternative control services in the above two categories would be useful because the market characteristics of the services are very different. One service is a monopoly service that may be unlikely to become contestable in any foreseeable period, but is provided to an identifiable customer. The other service is contestable, or potentially contestable.

Splitting the two alternative control services in this way would improve the operation of the ring-fencing guideline. At present, the NER establish that alternative control services are not treated differently to standard control services by the Electricity Distribution Ring-fencing Guideline. However, arguably, potentially contestable services should be ring-fenced because the service is being offered (or may be offered) in a contestable, or potentially contestable, market.

Question 5

Is an objective for service classification in the NER necessary?

A service classification objective may have some merit, particularly in providing further guidance to the AER in developing a service classification guideline, as was the case for the rate of return provisions. However, our experience with such provisions suggests that these 'sub-objectives' to the NEO can also be problematic and lead to further disputation. Overall, we would prefer to rely on the NEO as an overarching objective. As we note above, the clarification and simplification of classification factors is likely to provide sufficient guidance to the AER in both developing its guideline and classifying services in its framework and approach and determinations.

Should steps of service classification be informed by the same considerations?

As noted above, clarifying the service classification factors would be desirable and would lead to more consistent and better service classification decisions.

Within this framework, should new classifications be added?

We think the current classifications should be reconsidered given earlier questions we have raised about different types of alternative control services and the relevance of negotiated services.

² NER, cl. 6.2.2(c)(1).

³ NER, cl. 6.2.2(c)(5).

The proponents of the rule change requests consider service classification is no longer only determining which services are economically regulated and which are not. It is increasingly having significant effect on the application of the distribution ring-fencing, cost allocation and shared asset guideline. Should the AER expressly be required to have regard to the interaction of services classification with these other forms of regulation?

Service classification and ring fencing are inherently linked. As classification is concerned with deciding which services are regulated, classification necessarily defines the ring-fencing treatment of services. The Electricity Distribution Ring-fencing Guideline is designed around this close connection. Ring-fencing is concerned with preventing network businesses from taking advantage of their knowledge and insight in contestable commercial opportunities associated with their regulated activities.

Are the NER clear as to what can and cannot be classified? If not, what changes would be required?

An improved definition of services may help address the issues raised by the AEMC consultation paper about the distinction between services and inputs

Section 2

Issues raised by the AEC rule change

There seem to be two substantive issues underpinning the AEC rule change. First, should distribution network businesses be entirely prevented from competing to provide energy-related services, such as distributed energy resources (DER), in contestable markets. This issue is currently addressed through the Electricity Distribution Ring-fencing Guideline which provides for functional, legal and accounting separation (but not structural separation) of network businesses from the contestable provision of DER service to other parties. Underlying this question is whether the new national ring-fencing approach is sufficient.

Second, should network businesses be prevented from providing network support to themselves. The AEC proposes that network businesses be required to procure DER inputs from the market. That is, that network businesses be prevented from themselves investing in DER inputs to support their provision of network services to customers.

While we note the importance of effective ring-fencing for establishment of competitive markets in DER services, with associated long-term benefits for customers, what is it that makes DER unique such that a network business should not be able to provide these inputs to itself, even if it can do so more efficiently. There are other inputs, such as vegetation management, network construction and IT services, that network businesses undertake in the provision of services to customers (as opposed to a service provided to a customer) but which could be provided by third parties. The AEMC should examine this issue more closely.

The AEMC, in its further work on this rule change, could consider some further issues in order to fully address whether further regulatory interventions should be undertaken:

- Given the intended operation of the Electricity Distribution Ring-fencing Guideline, what remaining gap or deficiency would be addressed through the proposed stronger provisions and would these further requirements be justified in terms of the National Electricity Objective (NEO).
- The relative efficiency effects of preventing network businesses from providing certain network inputs to themselves as compared to the potentially broader benefits of such a restriction on the market for DER as a whole.
- The potential for alternative regulatory interventions to achieve similar pro-market outcomes, such as a requirement for network businesses to publish details of opportunities for network support DER—facilitating effective cost-benefit comparison of self-investment in DER versus purchasing these services from third parties.

Limits of ring-fencing

The Electricity Distribution Ring-fencing Guideline aims to achieve separation between a network business' involvement in contestable markets from its provision of regulated services. The potential for ring-fencing to provide an appropriate level of separation between regulated and competitive markets has yet to be tested. Full implementation of the new ring-fencing arrangements is not expected to be achieved until the beginning of 2018.

Of course, the Electricity Distribution Ring-fencing Guideline can only go so far—it requires legal and functional separation of contestable from regulated activities. It does not (and cannot) impose an obligation on a network business to procure a service that

can otherwise be provided by a ring fenced affiliate or third party. Apart from the fact that the new ring-fencing framework has not yet been tested, the AEMC would need to consider the costs and benefits of moving to a stronger structural separation approach and how such an approach could be accommodated in the NER or the NEL.

Appendix A — links between service classification, ring fencing and cost allocation

We consider there is value in setting out how service classification, ring-fencing and cost allocation work together. We are aware of network businesses interested in acquiring DER assets and using them for both network support (standard control) and to (indirectly) provide energy sales. Consider the following hypothetical.

A network business buys an asset to provide both regulated and contestable services. At the time of acquisition, the NSP must identify how the asset is to be used and attribute the cost in accordance with its AER approved Cost Allocation Method (CAM). [A CAM sets out the NSPs approach to cost allocation. The CAM cannot be varied without AER approval.]

Assume a distribution business purchases 20 line maintenance trucks. The trucks can be added to the Regulated Asset Base (RAB) in accordance with the CAM. The attribution might be (say 80% RAB to 20% non-RAB) based on historic use. The attribution is based on an allocator (such as kilometres or hours of use) for provision of regulated versus non-regulated services. Once the allocation is made, the trucks in the RAB should not be used for non-regulated service provision. These allocations are now somewhat fixed. The distribution business cannot use the trucks for more than 20% of the time (or distance) for contestable work. If it does, the distribution business is in breach of the NER because assets in the RAB cannot be used for non-regulated purposes.

Of course, the network business could seek to use trucks that are in the RAB to earn unregulated revenue subject to the Shared Asset Guideline (SAG). This is permissible under the NER if the use of the trucks does not materially prejudice the use of the truck for standard control purposes. In addition, the network business would have to return 10% of the unregulated revenues earned by the trucks to standard control customers (once a materiality threshold has been reached). However, if the use of the RAB asset was prejudiced, it would not be possible to share the asset under the SAG. In those circumstances the asset's cost allocation would need to change through a disposal/transfer of value.

Many of these RAB adjustments are minor and may not be reported. Where there is significant divergence between intended cost allocation and actual allocation, accounting for these allocation issues is important. The Electricity Distribution Ring-fencing Guideline improves the separation of regulated and contestable business activities by imposing the cost allocation principles where assets are shared between regulated and unregulated activities. That is, the ring-fencing framework lifts cost allocation up from dealing only with distribution services (provided by a regulated network business) to deal also with the separation of a regulated network business from its affiliates providing non-distribution services.

Limits of cost allocation

The AEC's principle issue is concerned with the provision of a range of distributed energy resources by network service providers, including but not limited to, battery storage. The AEC is concerned that distribution network businesses should not be allowed to invest directly in certain types of assets. In particular, where a distributor wishes to utilise DER, the rule change would require it procure these services from a ring fencing affiliate or from a third party.

A DER is an asset that can be used to provide different services. For example, batteries are a type of DER and can be used to alleviate network congestions (network support), which is a service a network business can use to avoid or delay capital expenditure on network augmentation. Second, batteries can also be used as a means to trade energy, buying and selling to profit from the volatility of wholesale electricity markets. Third, batteries can be used to store energy produced by a customer's solar PV cells for use at a later time in order to avoid reliance on energy imported through the electricity network and thereby reduce peak demand and the need for network augmentation.

These examples show how a single type of asset can be used for very different purposes. Multiple use assets are not unusual. For example, a service truck can be used to provide regulated network services as well as other contestable services. Unlike the truck example, battery assets are able to provide different services simultaneously. For example, a battery might be used to alleviate load congestion and sell energy at the same time.

How the costs of a battery would be allocated to these different uses is unclear. It is possible to avoid cross-subsidies if the cost of a battery is properly allocated to each service the battery is used to provide. However, the correct approach to allocating the cost of a battery that can be used for two or more purposes simultaneously is not straightforward. We have yet to see how network businesses would allocate such assets across different service classifications.

A further cost allocation issue concerns the adjustment that may be required if the initial allocation of costs of a battery proves to be incorrect, which is a possibility given the newness of these assets and lack of historical pattern of use to draw on.

For these reasons, we acknowledge the concerns raised by the AEC in its rule change proposal indicating the limitations of cost allocation approaches in relation to multi-purpose assets. However, this in itself does not mean these concerns would be sufficient to move to a different operating model as proposed by the AEC. The AEMC would need to consider the pros and cons in this regard and keeping in mind the existing framework is yet to be tested.