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Mr John Pierce  
Chair - Australian Energy Market Commission  
PO Box A2449  
SYDNEY SOUTH NSW 1235

Dear Mr  Pierce

## **Review of the regulatory framework for stand-alone power systems**

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the AEMC's stand-alone power systems (SAPS) Priority One Draft Report, released on 18 December 2018.

The AER continues to support the use of SAPS where it is efficient to do so and where consumers maintain access to retail competition. We are strongly in favour of frameworks that allow competitive forces to minimise costs to consumers and to stimulate new energy markets.

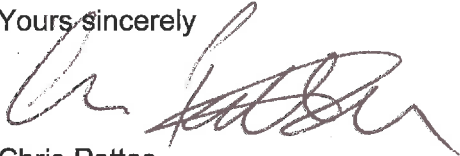
The draft report is a significant advance in the development of a framework to facilitate DNSP-led SAPS under the National Electricity Market (NEM) regulatory regime, although it needs further refinement and specificity to achieve its objectives. We support the AEMC's broad direction in the draft report and our submission (Attachment A) engages with key issues, building on both the draft report and our October 2018 submission. Our submission broadly covers the following:

1. Matters dealing with the transition to a DNSP-led SAPS and consumer protections. This includes supporting:
  - the AEMC's position on the grid connection precondition for a transition to a DNSP-led SAPS
  - a customer engagement approach rather than explicit informed consent, provided that existing customer protections and access to retail market offers are maintained
  - the RIT-D and minimum SAPS project evaluation requirements, especially as a way of ensuring that DNSPs test the provision of SAPS by the competitive market
2. SAPS service classification and delivery models, including commentary on the regulatory framework and the illustrative models covering the application of service classification and ring-fencing frameworks in the SAPS context and the scope of ring-fencing to address relevant issues; the AER's role in this framework; and our inclination toward the NEM consistency model as a starting point.

We note that third-party led SAPS will be considered further in a second Issues Paper and we intend to make a detailed submission in response.

We look forward to continuing to engage with the AEMC throughout the review process. To discuss any matters raised please contact Dale Johansen on (07) 3835 4679.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Chris Pattas', written over a faint, illegible printed name.

Chris Pattas  
General Manager, Networks (Distribution)  
Lodged electronically on: 5 February 2019

## **Attachment A**

The AER is supportive of the AEMC's broad direction at this stage of the review. However, a number of critical policy decisions remain undecided. We expect that once some of these issues are settled, especially around the regulatory design of SAPS delivery arrangements, subsequent policy issues will become more tractable.

### **1. Transition to a DNSP-led SAPS and consumer protections**

#### **Grid connection precondition**

The draft report describes the scenarios by which a newly connecting customer may, or may not, be offered a SAPS service in place of a network connection.

A new customer may approach a DNSP to seek a connection where there is no adjacent available network or SAPS. Under this scenario the customer may be required by the DNSP to make a substantial capital contribution reflecting the high cost of undertaking such a connection. Such capital contributions protect other customers from paying larger subsidies for high-cost-to-serve customers and this is a desirable outcome. The draft report notes the customer may in this case have an incentive to invest in a private SAPS (unrelated to the DNSP) rather than pay a large capital contribution to the DNSP. In fact we consider this may already be occurring.

We agree it is preferable for the connecting customer to continue to face incentives to consider acquiring a SAPS from the market in place of a traditional network connection. We share the AEMC's concerns that a regulatory 'solution' in this scenario would undermine existing price signals. The AEMC will further consider this issue in the next stage of the review.<sup>1</sup> We support this approach.

Another connection scenario is where a customer seeks a connection and there is a pre-existing SAPS nearby. The AEMC's position at this stage is to permit newly connecting customers to connect to the pre-existing SAPS as this allows a DNSP to fulfil its obligations more efficiently compared to a traditional network connection. We also support this proposed approach, but seek clarity on what connection costs this type of customer would incur. We also think there would be benefit in considering other scenarios, for example if a new customer incurs high costs to connect to an existing SAPS what would occur if a nearby new (or even established) customer wanted to connect?

#### **Customer consent to moving off-grid and customer protections**

The AEMC proposes that, where the customer experience under a SAPS is equivalent to that under an existing network connection, explicit informed consent from customers would not be required before transitioning them away from grid supply to a SAPS supply model.<sup>2</sup> Rather, DNSPs would be required to develop a 'SAPS customer engagement strategy' based on notifying and consulting affected parties in advance of a transition. The draft report notes that this is premised on customers continuing to benefit from price and reliability protections equivalent to network connected customers. This includes retaining a customer's existing access to competitive retail price offers (e.g. the 'NEM consistency model').

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<sup>1</sup> AEMC, SAPS draft report - Priority 1, December 2018, p. 67.

<sup>2</sup> 'Explicit informed consent' is a defined phrase under the National Energy Retail Law (NERL). In that context it relates to a retailer obligation. In this context we use the phrase in relation to a DNSP obligation but in other respects we intend it to have the same meaning as under the NERL.

We agree with the AEMC's proposed approach that where the customer is no worse off than if they were to remain network connected, explicit informed consent to be transitioned to a SAPS should not be required. The draft report describes the New Zealand model which incorporates a formal notice by the DNSP to affected parties of its intention to transition a customer to a SAPS. New Zealand DNSPs are also required to respond to questions and have regard to any comments or submissions received.

The above approach seems appropriate in reflecting the broader benefits which accrue to all grid connected customers from high-cost-to-serve customers being served more efficiently by SAPS. We also agree with the AEMC that should customer protections be weakened or access to retail market offers be limited by transitioning to a SAPS (e.g. as may be the case under the integrated service model) then explicit informed customer consent should be sought.

### **The economic test to determine whether SAPS is efficient or not**

The draft report indicates the Regulatory Investment Test for Distribution (RIT-D) would apply to SAPS proposals which meet the capital cost threshold (currently \$6 million). Further, that SAPS proposals below this threshold would be subject to a new set of minimum evaluation requirements, rather than an explicit test. These new requirements would be introduced to provide transparency and an opportunity for potential SAPS proponents to participate.

The AEMC's proposals are consistent with our own thinking on the need for an economic test and on the benefits of transparency. As set out in our October 2018 submission, we support the RIT-D's application for financially significant projects. In principle, we support the AEMC reviewing RIT-D provisions in the NER if there is reason to believe that amendments to the RIT-D framework are required to properly reflect SAPS scenarios. While we are yet to identify any specific limitation of the RIT-D framework that would undermine the effective use of SAPS, we are open to exploring whether such limitations exist.

As set out in our earlier submission, the RIT-D is focussed on NEM-specific benefits but facilitates recognition of non-market benefits via capital contributions from appropriate parties. Such non-market benefits may include bushfire risk mitigation or tourism promotion. The local Council may choose to contribute financially to the SAPS project to reflect those non-market benefits.

For projects below the threshold we consider a more limited set of obligations than the full RIT-D would be appropriate to match administrative burden to the potential benefits. We consider that an obligation to test the market for these services is essential to stimulate competition. We look forward to engaging with the AEMC on further development of minimum evaluation requirements (based on the example list in the draft report) for inclusion in a subsequent stage of the AEMC's review.

## **2. SAPS service classification and delivery models**

### **Contestability of service provision**

The draft report sets out two illustrative options for SAPS service delivery, noting that each incorporates advantages and disadvantages. Under each option the AEMC describes a means for SAPS provision to be contestable. This would be given effect primarily by the AER's application of the normal ring-fencing obligations which in turn are premised on service classification. Below, we discuss contestability under each option.

Under the 'NEM consistency model' the service elements of generation, network services and retail would remain separate. A DNSP would be permitted to provide network services

relevant to the SAPS such as for a community microgrid. However, non-distribution services such as generation and retail services would not be able to be provided by the DNSP. It would need to arrange for third parties or an affiliate to provide the generation services as a non-network solution. In the case of an individual power system SAPS, a third party would provide the full physical SAPS service as network assets would presumably not be required.

Under the 'integrated service delivery model' the various elements of a full SAPS service (generation, network services and retail) would be bundled and the AEMC proposes that the DNSP arrange for a third party or parties to provide the integrated service.

Under both models ring-fencing exemptions would be available to permit DNSPs to provide the full SAPS service (generation, network and retail) under certain circumstances, such as in remote locations where third party providers may be unavailable. This is consistent with the ring-fencing framework's current application where remote depots are exempted from some ring-fencing obligations and waiver applications are available more generally.<sup>3</sup> It is also consistent with the exemptions based framework we described in our October 2018 submission.

Contestability under both models relies on the treatment of generation, or the integrated service (depending on the model), as a non-network solution. As such the broad SAPS service would be defined as a distribution service and therefore be subject to classification as a standard control service, but discreet generation and retail activities related to SAPS would not be.<sup>4</sup> In this way the twin objectives of retaining the required existing cross subsidy (for DNSP network support payments to a generator) and establishing contestability may both be met.

While we support the AEMC's proposed use of existing frameworks, we note that application of the non-network support concept in a SAPS context may require clarification about the DNSP's ability to recover regulated revenue for services it does not provide itself, so the third party supplier(s) of the SAPS can be fully reimbursed by the DNSP.

The AEMC also indicates it does not intend, at this stage, to develop additional mechanisms for the AER to consider restrictions on DNSP provision of certain services nor ownership of certain assets in the context of SAPS.<sup>5</sup> We agree that relying on existing regulatory mechanisms is preferable. However this requires identifying and establishing a clear application of the service classification framework, supplemented by the ring-fencing framework, which drives appropriate outcomes for SAPS.

### **Our approach to ring-fencing**

We have an established and transparent process to assess ring-fencing waiver applications. We have assessed waiver applications for DNSPs to provide contestable services in remote areas where practical competition is limited due to a lack of available service providers.<sup>6</sup>

In determining whether DNSPs should be allowed to provide the non-distribution components of a SAPS (e.g. generation and retail services) we expect that a ring-fencing waiver assessment would involve testing the capacity of the market to provide these components. We would do so by undertaking public consultation on a ring-fencing waiver application. Our waiver assessment could also be informed by the DNSP's RIT-D or proposed minimum SAPS project evaluation requirements.

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<sup>3</sup> Specifically, offices or depots that have less than 25,000 connection points within a 100 km radius.

<sup>4</sup> AEMC, SAPS draft report - Priority 1, December 2018, p. 97.

<sup>5</sup> AEMC, SAPS draft report - Priority 1, December 2018, p. 92.

<sup>6</sup> See for example Essential Energy's 'provider of last resort' ring-fencing waiver: AER, Decision - DNSP applications for waivers from the Electricity Distribution Ring-fencing Guideline, December 2017, pp. 82-85.

We also note that 'contestability' from a regulatory framework perspective describes an unregulated activity, not the means by which the activity is procured. The draft report flags that DNSPs would use competitive tender processes to source third party provision of SAPS elements. Our Distribution Ring-fencing Guideline does not determine or prescribe the detailed procurement approach the DNSP should follow. This means ring-fencing requirements relate to obligations for the DNSP to separate its regulatory activities from contestable activities. It does not determine how a DNSP sources or procures its contestable services.

In this case, the regulatory framework's overarching incentive mechanisms become relevant and would drive the DNSP's procurement policies. We are not proposing additional obligations requiring particular policies at this stage of the AEMC's review, rather we simply note the limits of the ring-fencing framework.

#### **Further comments on the two illustrative service delivery models**

The NEM consistency model and integrated service model present different means of SAPS service delivery.

Under the NEM consistency model customers retain their current levels of access to retail offers and the existing customer-retailer relationship is maintained. These are significant advantages in favour of using the NEM consistency model as a basis for further consideration. We note there are complexities associated with the proposed financial arrangements underpinning the NEM consistency model. Those complexities require further consideration.

Under the integrated service model a regulated retail price would be required and the existing customer-retailer relationship would be lost, as would the customer's access to alternative retail offers. These are fundamental drawbacks to this model. As implied by the AEMC in the draft report, the customer's loss of their existing retailer and access to retail offers would mean customer explicit informed consent would be required. We discuss further the issues associated with retail price regulation below, in discussing the AER's potential role in a SAPS regulatory framework.

While we do not formally endorse either model at this stage of the AEMC review, and more work is required to flesh out the details of how these models could work in practice, we consider a framework based on the NEM consistency model is a good basis for further consideration of the detailed SAPS work that is now required. We consider the integrated service model is more problematic in a number of important respects. For example, while the NEM consistency model is more complex in terms of its financial flows, the transition from the existing regulatory framework appears less challenging than that for the integrated service model which would require more fundamental changes.

The final framework should support the principle that customers are no worse off through being transitioned to a SAPS (unless affected customers give their explicit informed consent to this) and that it should provide clarity to all energy market participants on the various SAPS roles and responsibilities.

#### **The AER's role**

The draft report does not propose additional responsibilities for the AER beyond our current functions, though those functions would extend to encompass SAPS solutions. Rather, the AEMC is focussed, in our view appropriately, on the incorporation of SAPS within the existing framework with minimal regulatory intervention to the extent possible.

The material exception to this relates to the integrated service delivery model where the AER (or a jurisdictional regulator) would potentially regulate retail tariffs for SAPS customers. We consider retail price regulation in a SAPS context would be complex, administratively burdensome and likely contentious. We have significant concerns about the need to set retail prices on an ex ante basis to give third party SAPS providers information necessary for them to bid for the right to provide SAPS activities. How such regulated prices would be determined, in the context of a potentially large number of geographically dispersed customers, is unclear.

### **3. Transition to third party led SAPS**

The draft report proposes that where a third party wishes to establish a SAPS to substitute for an existing network connection, the existing asset disposal mechanism would be applicable. A commercial arrangement would be struck between the relevant DNSP and the third party for the transfer of assets. The AER would have regulatory oversight, as we currently do in the context of asset disposals, as part of the distribution determination process undertaken every five years.

The third party would also need to compensate the DNSP for any stranded assets. That is, assets which were dedicated to supply of the customer(s) now proposed to be transitioned to a third party SAPS, but which do not themselves form part of the SAPS assets. Alternatively, assets may become stranded even if they would be useful to the third party SAPS provider but they and the DNSP are unable to reach an agreement on an asset transfer. In either case, the DNSP may need to levy a one off or ongoing fee on customers transitioning to a third party SAPS.

We are supportive of the AEMC's positions on third party led SAPS expressed in the draft report. We look forward to engaging further on these issues as part of Priority 2 of the AEMC's review.

