

Our Ref: **D19/35135**
Your ref: **EMO0037**
Contact Officer: **Olivia Boyd**
Contact Phone: **02 6243 1248**

GPO Box 520
Melbourne VIC 3001
Telephone: (03) 9290 1444
Facsimile: (03) 9290 1457
www.aer.gov.au

8 August 2019

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

Dear Mr Pierce

Review of the regulatory frameworks for stand-alone power systems - Priority 2

Thank you for the opportunity to comment on the Australian Energy Market Commission's (AEMC) *Review of the regulatory frameworks for stand-alone power systems – priority 2* Draft Report. We support the development of a nationally consistent framework to enable customers to make choices about their electricity supply, in a way that maintains core customer protections and does not disadvantage customers that remain on the grid. We also recognise the benefits of regulation of smaller third party-led SAPS (SAPS) at a jurisdictional level, as outlined by the AEMC.

We consider that the regulatory framework outlined in the Draft Report for 'category 1' SAPS would likely be disproportionate, unless category 1 SAPS are subject to a relatively high threshold. A revenue determination under Chapter 6 of the National Electricity Rules is a complex and demanding process involving high fixed costs. We consider that such a process would only be viable where the overall cost of a Chapter 6 revenue determination was relatively small on a per customer basis. Unless the SAPS NSP was similar in size to the smallest DNSPs that are currently regulated by the AER, we consider that the cost of a revenue determination may outweigh the benefits to SAPS customers. Moreover, regulated network tariffs may not be sufficient to ensure effective retail competition in a SAPS, particularly if the cost of supply in a SAPS is substantially higher than off-grid customers.

In appendix A to this submission, we provide further comment on various aspects of the AEMC's draft report.

Yours sincerely,



Sarah Proudfoot
General Manager, Consumers and Markets

Attachment A

Economic regulation of category 1 SAPS network service providers

We understand the importance of regulated networks as a foundation for vertical disaggregation and retail competition in the AEMC's proposed model for larger category 1 SAPS. However, Chapter 6 NER revenue determinations impose a level of regulatory complexity and organisational effort that only relatively sophisticated and well-resourced entities are able to effectively participate in. The determination process requires a level of expert support and guidance that would be unlikely to be commensurate with the resources available to a small community based SAPS systems. This leads to an expectation of high fixed costs to engage support for processes that operate over approximately three years. To be viable, small SAPS systems would need the cost of a Chapter 6 revenue determination on a per customer basis to be small, relative to the normal network costs.

Taking these factors into account, we consider it unlikely that systems with fewer than 50,000 customers would be viable. In practice, given the natural tendency for scale economy to be a significant factor in commercial decisions, the practical minimum size of a business regulated under Chapter 6 may be higher.

For example, the smallest DNSPs that are regulated by the AER, Power and Water Corporation and EvoEnergy, have customer numbers of 85,710 and 191,482 respectively, and RAB values of \$967 million and \$933 million respectively.¹ We consider that a Chapter 6 revenue determination would likely be disproportionate for an NSP that is smaller than the smallest DNSPs that currently exist in the NEM.

There are several metrics that could be used to determine the appropriate threshold above which a Chapter 6 revenue determination would be fit-for-purpose for a SAPS network operator. These metrics could be incorporated into the coverage test recommended by the AEMC in the Draft Report. For example, the AEMC could consider the cost of undertaking a Chapter 6 revenue determination for on-grid DNSPs currently. It would be possible to benchmark the cost of a revenue determination by expressing it as a percentage of a DNSP's total revenue over a five year determination period, total opex and capex allowances over a five-year determination period, RAB size, number of customer connection points, or any other relevant measure.

Were Chapter 6 revenue determinations to be required for SAPS NSPs with several thousand customers or less, we consider that this could effectively prohibit category 1 SAPS from being established. Alternatively, it may lead to the market for category 1 SAPS being limited to affiliates of the DNSP, who may be able to leverage the economies of scale and experience of DNSP staff to engage with the complex regulatory framework that governs DNSP revenues and pricing.

Were several category 1 SAPS to be established, there would also be significant additional administrative cost to the AER in undertaking Chapter 6 revenue determinations and annual pricing approvals. In particular, we note that the cost to the AER of undertaking a revenue determination for a DNSP under Chapter 6 of the NER is not proportionate to the size of the DNSP. The level of analysis and engagement that the AER must undertake under the requirements of the NER is similar for all DNSPs. The size of the DNSP does not necessarily

¹ AER, *State of the Energy Market 2018*, p. 135.

determine the level of resourcing and effort involved in making a regulatory determination or conducting annual pricing approvals.

An alternative to a high threshold (in terms of customer numbers) for a category 1 SAPS could be another form of light-handed regulation to establish a separate network tariff. This could be based on a top-down benchmarking approach, rather than a bottom-up building block approach. There may be several ways to do this, for example, it may be possible to determine a network tariff with reference to broader retailer standing offer prices.

Retail arrangements for category 1 SAPS

We note three potential retail issues associated with category 1 SAPS customers under the model that the AEMC has proposed. First, where limited numbers of customers are transitioned to one or more SAPS, we consider retailers are unlikely to react by offering SAPS-specific retail tariffs. That is, retailers are unlikely to innovate by establishing SAPS-specific retail tariffs unless large proportions of their customer base are directly affected.

Second, we note the cost of supply in a third party led SAPS, even one large enough to be considered a category 1 SAPS, may be higher than in the broader interconnected network. Both the cost of generation (possibly including storage) and of network services may be spread across a relatively small number of customers, potentially leading to higher per unit costs. This could impact a retailer's willingness to offer SAPS customers retail tariffs at the same level as customers which remain part of the interconnected network. There may even be risk that retailers choose not to engage at all with customers served by SAPS if they consider the transaction costs associated with determining appropriate retail tariffs for limited numbers of potential customers are prohibitive. While the above issues may not impact the AEMC's approach to the category 1 model of supply, they may impact customer willingness to transition to a third party led SAPS.

Third, we understand that existing NEM Retailer of Last Resort (RoLR) arrangements will apply to category 1 SAPS. However, in our view, a RoLR event for a category 1 SAPS would likely be very different to a RoLR event in the interconnected network. Typically, when a RoLR event occurs, the AER would issue a RoLR notice to appoint a RoLR to each connection point and direct AEMO to transfer the failed retailer(s) customers to the RoLR(s). Were a category 1 SAPS to be largely supplied by only one or two retailers, a RoLR event may involve appointing a RoLR to supply most or all of the customers in a category 1 SAPS. Rather than just appointing additional customers to the RoLR, the RoLR may find itself to be the primary retailer for an entire SAPS. This would be a very different business model to normal RoLR situations in the interconnected network and could be financially problematic for the RoLR, particularly if the SAPS customers have a higher cost to serve compared to the RoLR's existing customer base.

Administration of the category 1 SAPS 'coverage test'

In the AEMC's Draft Report, the categorisation of a SAPS into either category 1 or 2 will be determined by a coverage test that will establish whether retail competition would be feasible. We suggest that this coverage test should be administered by jurisdictional regulators. We consider that jurisdictional regulators will be responsible for licencing of category 2 and 3 SAPS, and will be in the best position to apply a holistic view of third-party led SAPS to such an assessment. However, we consider that jurisdictions should consult with the AER in conducting these assessments. For example, the AER should advise on whether a DNSP

revenue determination under Chapter 6 of the NER (or any other mechanism for setting network tariffs) would be fit-for-purpose for a given SAPS, as part of the coverage test process.

Operator of Last Resort schemes

We support the AEMC's recommendation that jurisdictionally appointed operator of last resort (OoLR) schemes, to be activated in the event that a SAPS provider of generation and network functions fails, should be provided competitively. While DNSPs may be well positioned to provide this service, a poorly designed OoLR scheme could result in DNSPs passing costs on to customers of the regulated business. For example, were a SAPS provider to accrue large debts and go bankrupt, the DNSP may take on significant financial risk in taking on the OoLR role. Some of the options to mitigate the risk of costly SAPS failures raised in the AEMC's Draft Report, such as DNSPs providing input into the design of a SAPS upfront, should also be carefully considered to ensure any costs are not allocated to customers of the regulated network business.

It should be noted that appointment of a DNSP as an OoLR may conflict with the AER's ring-fencing and cost allocation guidelines. For example, provision of OoLR services for the generation component of a SAPS would not fit the definition of a 'distribution service' in the NER, and would therefore need to be legally separated from the DNSP.

We see risks associated with proposals in some submissions to the AEMC's Consultation Paper, under which a third party led SAPS could transition to become a 'Priority 1' or 'DNSP-led' SAPS as part of an OoLR event. The AEMC's framework for DNSP-led SAPS is designed to promote efficient operation of the existing network. By contrast we see a risk that a DNSP may face increased costs from operating a failed SAPS, particularly if a third party has not built or operated the SAPS to an appropriate standard in the past. Incorporating failed third party led SAPS into the DNSP's regulated network would seem contrary to the aims of the Priority 1 SAPS arrangements outlined in the AEMC's recent Final Report.

Regulation of SAPS in Queensland

The AER currently regulates off-grid microgrids in Queensland via individual retail exemptions, as the Queensland NERL does not exclude off-grid areas. Unless the Queensland government enacts changes to the NERL, the AER will continue to regulate off-grid SAPS. Should the Queensland government choose to adopt the AEMC's recommendations in full or in part and establish a licencing regime for third party led SAPS, consideration would need to be given to any the interaction with regulation of off-grid areas by the AER through individual exemptions. For example, the Queensland government may need to consider changes to the Queensland NERL to avoid third party SAPS being subject to both the AER retail exemption framework and any future licencing regime with similar features.

Jurisdictional regulation of category 2 and 3 SAPS

We note that the AEMC has highlighted a number of benefits of jurisdictional regulation for smaller SAPS. We also see merits in this approach: It would allow jurisdictional regulators to set licence terms that are more suitable to local conditions and needs, and avoid the need for a single SAPS provider to be subject to two layers of regulation (e.g. jurisdictional regulation for safety, reliability standards, and dispute resolution, and national regulation for other aspects). While noting our position in our submission to the consultation paper – that NER

and NERR provisions can likely be adapted for SAPS – we also see merit in jurisdictional regulation of smaller SAPS for the reasons the AEMC has outlined.

Like the AEMC, we are concerned that differing regulatory regimes between standard supply, embedded networks, and third-party SAPS may provide opportunities for ‘regulatory arbitrage’, whereby third parties make decisions on behalf of customers due to regulatory incentives, rather than the best interests of the customer. We recommend that the AEMC work with jurisdictional regulators in the implementation of a regulatory regime for categories 2 and 3 SAPS to ensure that the consumer protections recommended in the report are implemented at the jurisdictional level. Strong consumer protections for third party led SAPS customers, along the lines recommended in the AEMC’s draft report, will reduce opportunities for regulatory arbitrage between different forms of supply.