

Contestability of energy services

Response to AEMC Consultation Paper

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Overview

Energy Networks Australia welcomes the opportunity to provide a submission to the Australian Energy Market Commission's (AEMC) Consultation Paper on the draft rule changes proposed by COAG Energy Council and the Australian Energy Council relating to contestability of energy services published on 15 December (the Consultation Paper).

Energy Networks Australia is the national industry body representing businesses operating Australia's electricity transmission and distribution and gas distribution networks. Member businesses provide energy to virtually every household and business in Australia.

Energy Networks Australia has developed a set of principles to inform and frame its approach to contestability and service classification issues raised by the two rule change proposals (see below).

Box 1 - Contestability and classification principles

Principle 1 - Primacy of efficient delivery of network services to customers

Customers should pay no more than necessary for the delivery of regulated network services. i.e. monopoly network customers should not be required to pay a 'premium' to support inefficient delivery models to support a goal of facilitating competition.

Principle 2 - Avoid unfair cost shifting between customers of the shared network

Rules that are based on customer choice, but which fail to address unintended impacts of some customer's choices on other customers have the potential to lead to harmful and unfair outcomes.

Principle 3 - Reliance on flexible incentives to drive efficient expenditure solutions

Commercial incentives to drive efficient outcomes will outperform and deliver more flexible outcomes that benefit customers than inflexible, pre-designed regulatory 'fixes' or narrow prohibitions on service inputs.

Principle 4 - Regulatory frameworks need to provide transparency and confidence in investment decisions

Only where networks, customers and third parties can confidently make clear investment proposals and decisions will efficient solutions be chosen, and regulatory risks and investment costs borne by customers be minimised

Principle 5 - Regulatory interventions in network service delivery should be the minimum necessary to address clearly established problems ("the necessity principle")

This principle matches the Hilmer Committee's competition principles relating to government interventions in infrastructure service markets.

Applying these principles, Energy Networks Australia recommends that with respect to the two rule change proposals the AEMC:

Rule change process and incentive frameworks

- » Ensure all stakeholders have a clear and common understanding of the operation of the current incentive-based regulatory regime, prior to consideration of any introduction of restrictions on service delivery discretion, or development of any alternative 'more preferable' rules;
- » Require an extremely high standard of empirical evidentiary material from the rule change proponents in supporting any proposals that would undermine the incentive-based nature of the existing regulatory regime;
- » Undertake a review of the potential implementation costs of significantly lowering the Regulatory Investment Test threshold for network support and demand management projects. Energy Networks Australia is open to assisting the Commission in this regard;
- » Fully consider the commercial drivers of rule change participants, and the likely competitive impacts of any restrictions on insourcing or self-supply options;

Classification of services

- » Ensure any revised classification rules place a primary focus on market conditions, emerging competition and the likely costs and benefits of regulation; and
- » Take into account the role of stability in classification decisions through a regulatory control period in promoting efficiently financed and timely ongoing investment in services, thereby promoting the long-term interests of customers.

Further background to these issues and proposals are set out in the remainder of this submission.

Approach to assessing rule change requests

Energy Networks Australia generally supports the proposed approach to assessing the rule change requests outlined in the Consultation Paper.

The AEMC has identified more than six overlapping processes relevant to the consideration of the rule change, including other rule change and framework review processes that may produce specific outcomes that affect the same issues identified by the rule change proponents.

Clear problem identification and evidence from proponents

Given the role of a stable, predictable regulatory framework in helping to minimise the financing costs borne by customers for long-lived network infrastructure investments, the early stages of a rule change process should place a premium on:

- » efficiently establishing if there is a clear problem identified and evidenced by the rule change proponents; and
- » assessing whether the rule change proposed is required and fit for purpose.

In some cases, it may be possible to develop a modified alternative to the rule change would better address the identified and evidenced problem.

It is important for the accountability and predictability of the rules regime that while the rule change mechanism is open to market participants, rule change processes do not unintentionally evolve into a process of the AEMC itself being placed in the position of being expected to:

- » evidence and establish an identified problem with the existing rules framework – a matter which is the responsibility of the proponent to discharge; and
- » develop a full suite of potential alternative solutions prior to a clear problem being soundly evidenced.

This would create an environment where rule changes routinely become an investigation on behalf of the rule change proponent of a claimed problem, rather than an independent assessment of a case for change, and the development of solutions that are fundamentally different in kind from those put forward by the proponent. This process would blur the distinction between commissioned and properly wide ranging ‘thematic’ reviews of emerging issues, and individual rule changes. It also would lower the predictability and accountability of the regime and rule change process.

Based on the AEMC’s correct assessment that aspects of the rule change proposals appear to be based on misconceptions or a lack of understanding of the current operation of regulatory framework, Energy Networks Australia considers that the AEMC and AER may wish to consider jointly additional non-regulatory approaches to assisting stakeholders’ understanding of the operation of existing incentive-based regulatory frameworks.

Potential market and commercial drivers of rule change

As part of its rule change assessment the AEMC should consider that market participants seeking to avoid the network use of behind the meter storage may have a direct commercial interest in:

- » limiting alternative delivery models by which individual customers could efficiently be offered storage solutions; and
- » limiting the procurement models by which one of their potential customer segments (NSPs) could choose to self-supply.

It is evident that some market participants will see the storage services market as an opportunity to increase margins, maximise customer retention and minimise risk of competitive churn in retail markets.

A number of customer advocates and regulators continue to recognise that segments of Australian retail markets are not subject to strong price discipline or competitive pressure.¹

The Chairman of the ESC Victoria recently observed:

"Around us, we see markets with characteristics that force us to question the effective state of competition. Price structures are at odds with what we might expect in a highly competitive market....Retailers have developed contract arrangements that effectively 'hide' their actual prices. Customers have a very low awareness of the market, how they are engaging with it or what it really means for them."

A recently released Energy Consumers Australia survey has further indicated that nearly half of all households in NSW and Queensland have never switched supplier (47 per cent and 52 per cent respectively) while even in Victoria, which is regarded as among the most competitive markets globally, 36 per cent of households have never changed their supplier.²

¹ St Vincents de Paul Society, [The NEM: A hazy retail maze](#), December 2016

² Canberra Times "Open energy markets failing households" 5 February 2017

Incentive frameworks

Need for focus on customer outcome

Energy Networks Australia considers the Consultation Paper and workshop usefully clarifies that the key policy issue raised by the rule change proposals is the role of service provider discretion in delivery of regulated network services, under an incentive-based regulatory framework.

The primary principle in addressing that policy issue must be the efficient delivery of network services to customers. As already recognised in the existing framework including the National Electricity Objective, legislative pricing and revenue principles and the *National Electricity Rules*, network customers should pay no more than efficient or necessary cost for the delivery of regulated network services. Networks have a mandatory obligation to deliver services, and must have the capacity to use the delivery model best adapted to a diverse range of network and market circumstances to meet the common needs of customers of the shared network.

Applying the above principle, monopoly network customers should not, for example, be required to pay a 'premium' to support inefficient network service delivery models to support a goal of fostering or facilitating competition. Where a goal of promoting future competition and efficient delivery of regulated network services conflict, primacy should be given to outcomes that lower cost for customers of the shared network. This is consistent with the existing revenue and pricing principles of the National Electricity Law, and Chapter 6 of the *National Electricity Rules*.

An assessment of the long-term interest of consumers creates potential to consider benefits beyond the network service and its efficiency. However, if policy decisions are taken to incur any higher costs to current consumers through restricting network service delivery options, it would be important to provide clear evidence that demonstrated that the future benefits clearly outweigh the currently realised costs. This is a key empirical task for the Commission should this policy option be further pursued.

As the Chair of the Victorian Essential Services Commissions has pointed out, it is critical to distinguish between the ends (of efficiency) and the means of achieving this, which may be competition in some cases, and incentives in others:

Nowhere other than in that policy paradigm is competition anything other than a means to an end. The end is always efficiency: the efficient allocation and use of society's resources such that suppliers' production decisions align with the preferences exercised by consumers, now and into the future – without deadweight losses or economic rents. Efficiency is, and must be, the outcome we seek. But competition is not synonymous with efficiency. Competition is a means. Efficiency is the end. Testing for signs of competition is not axiomatically equivalent to testing for efficiency. Testing for, and finding signs of competition and declaring "mission accomplished" is equivalent to declaring

a cake will be delectable just because we observe the required ingredients laid out on the kitchen counter.

This may mean that regulators need to act not only to prevent anticompetitive conduct, they may also need to focus on preventing non-competitive outcomes as they emerge. But in doing so, regulators should not be lulled into replacing one non-competitive outcome with another.³

Accordingly, the regulatory framework should provide networks with the scope to deliver services in an efficient way to customers by owning and operating whichever technologies minimise the efficient long-term cost to serve. This recognises that networks are obliged to deliver network services to customers, not operate sets of poles and wires.

Efficient models of network service delivery

A blanket effective ‘requirement to outsource’ (through either structural separation or a technology-based ownership ban) would represent a very significant distortionary intervention in the operations of the network. Such a measure would tell a network ‘how’ to operate, not which outputs are valued. In regulatory design terms, this would be a trip backwards through time towards previous cost of service and input-based regulation.

Given the diversity of operating and market conditions across Australia, there are many different possible scenarios for the delivery of these assets and services and it would be risky for the regulatory framework to make pre-emptive calls on best delivery mechanisms. Rather, reliance on incentives can deliver solutions that capture multiple value streams, without inflexible service or asset-based prohibitions.

The most efficient model for network service delivery will be the approach that allows:

- a) the most efficient solution possible to manage the service requirement – whether that is poles and wires, storage or any other non-network solution; and
- b) for it to be procured as efficiently as possible to meet the service requirement – whether that is insourced or outsourced.

To ensure the most efficient solution can be chosen, a genuine non-network alternative to a conventional solution must be able to come forward. For instance, a non-network solution on customer premises needs to be:

- i) able to be deployed in the right locations; and
- ii) equivalently firm to meet the service requirement in the right place at right time with equivalent certainty to poles and wires.

³ [*If the retail energy market is competitive then is Lara Bingle a Russian cosmonaut?*](#) Speech by ESC Chairperson Dr Ron Ben-David, June 2015

In the absence of that, networks will build the next most efficient option, which may be either grid-connected storage, distributed energy resources, or poles and wires. If the network owns the storage and has unequivocal rights to maintain and control the resource, then it appears clear this could represent an equivalently firm service.

However, it is yet to be tested whether business models and contractual frameworks are available and offered in the market that provide equivalently firm service solutions, with the outsourced service provider agreeing to accept appropriate damages premised on the value of lost load or liability to the network in non-delivery.

To ensure it can be procured as efficiently as possible, where a storage or distribution energy resource, or non-network solution is most efficient, it is important to allow a competition between both insourcing or various outsourcing delivery options.

In some cases, an outsourced solution could be more economically efficient if the economies achievable by the supplier (aggregator, individual customers, retailers with Virtual Power Stations), outweigh any additional costs of outsourced service delivery, such as pricing strategy (in an inefficient market), interface costs, cost of capital, and supplier margins.

Conversely, an insourced solution could be more efficient if the costs of outsourcing outweigh the benefits. It is simply not possible based on the rule change request, and the state and nature of emerging technologies and markets to conclude that generally outsourced solutions will be delivered at a less cost than insourcing and in a timely way that responds to the network service provider's requirements. For example, in any procurement situation, costs to customers could be higher than they might otherwise be where the framework allows networks to co-fund some percentage of the asset to guarantee network support.

Existing incentive mechanisms, as well as legal and regulatory constraints incentivise networks to utilise the most efficient mode of service delivery. For example networks:

- » must demonstrate that proposed capital and operating expenditure programs are efficient;
- » have expenditure profiles that are subject to benchmarking to provide further assurance that proposed expenditure reflect efficient costs;
- » are incentivised by multiple schemes such as the capital expenditure efficiency sharing scheme and the efficiency benefit sharing scheme to deliver least cost solutions;
- » are obligated to undertake regulatory investment test processes across a range of new investments (noting that rule proposals exist to broaden this range to replacement projects);
- » remain subject to a recently expanded range of ring-fencing and cost allocation obligations which further support incentives for efficient and non-discriminatory service delivery options.

Box 2 - Case study - storage to address network constraint

Due to a network businesses service requirement, it is possible that the most economic solution to a particular network constraint is for an NSP is to deploy a storage program to avoid or defer network augmentation. It is possible that to secure the customer participation in the non-network program, the relevant individual customer would be offered access to the use of the battery (outside network support requirements) below the stand-alone cost at which a participant in the contestable energy market could offer that same service.

This is an economic efficiency, not a detrimental outcome to the storage market. This is because it expands demand for storage devices, compared to the amount that is otherwise required by a constrained set of participants. The individual customer hosting the storage asset also receives an economic benefit - and all network customers receive a benefit through the most economical solution being adopted.

Such cost-sharing outcomes between all customers are not foreign to the role of network service providers, which deal with them on a regular basis. For instance connection frameworks require assumptions of the efficient solution and the contribution of an individual customer and the future network service benefits of the asset. In these circumstances, the very fact that an individual customer *could*, or *would* be prepared to, otherwise bear the full cost of the new asset without a contribution from other beneficiaries on the network does not mean that this is the efficient, fair solution, or more *pro-competitive* outcome

As noted above, recent reforms have sought to ensure networks are exposed to strong regulatory incentives to minimise the cost of service delivery, including being indifferent to capital versus operating cost outcomes, and insourcing vs outsourcing. If there are residual issues, these should be addressed in the regulatory framework, not compromising service delivery discretion to limit the circumstances and manner in which networks can employ flexible service solutions.

Energy Networks Australia through its partnership with the CSIRO on the Network Transformation Roadmap supports further evaluation of the regulatory framework and reforms to put these issues beyond doubt as markets become more dynamic. The solutions supported, however, remain consistent with the overall incentive framework (e.g. the trialling and use of 'totex' regulation, and a focus on output-based incentives).

Classification of services

Objectives

The service classification process should have a clear objective, which should support and take into account the National Electricity Objective.

This is consistent with the design and structure of other elements of the Rules, which have objectives guiding other significant processes (such as incentive schemes and mechanisms, and rate of return estimation processes).

Guidance on classification decisions

Energy Networks Australia supports examining the classification process to ensure it is fit for purpose in light of significant market and technological changes since the design and implementation of current arrangements.

The ENA-CSIRO Electricity Network Transformation Roadmap has identified that ensuring robust ‘competition’ tests and assessment processes will have an increasing role to play in delivering efficient outcomes for consumers. Such tests should be aimed at refining the scope of economic regulation to those areas where the presence of enduring monopoly power and an assessment of the costs and benefits of regulation suggest regulatory intervention benefits the long-term interests of consumers.

Clarifying the purpose and scope of classification

Energy Networks Australia supports the work of the AEMC in the Consultation Paper and workshops to date to clarify the purpose and scope of the classification process.

The focus of the classification process should be appropriately classifying services delivered to customers, not inputs to services to customers. This recognises the fact that asset-based definitions of network services would be unworkable given the capacity of a range of existing network assets to provide multiple services with different classifications. It also underpins the incentive-based nature of the framework, by ensuring that economic regulation does not constrain the network in delivering the service using the most efficient mix of assets and other inputs.

Form of regulation factors

The form of regulation factors play an important ‘gatekeeper’ function in economic regulation, and their scope, application and content raise broader regulatory design issues than their functioning in the contestability rule changes. As an example, they play a similar conceptual role to the declaration criteria in Part IIIA of the *Competition and Consumer Act*, and the coverage criteria in the gas access regime.

The AEMC should consider these interlinkages and in particular the objectives of Part IIIA s.44AA, to “provide a framework and guiding principles to encourage a consistent

approach to access regulation in each industry". That is, a key purpose of the Part IIIA framework is to promote consistent principle-based approaches to industry access regimes approach to the coverage, scope and pricing principles that should apply.

With this perspective, the form of regulation factors appear in contrast to the declaration and coverage criteria, to be:

- » complex and multi-layered, adding uncertainty to their interpretation;
- » based on distinct economic concepts to the declaration criteria, without it being clear whether such difference is intended to bring about different outcomes or assessment approaches;
- » rarely practically used as the basis for in-depth market or competitive analyses by the AER, which generally appears to adopt high-level qualitative based assessments;
- » unbalanced and inconsistent with the declaration criteria in lacking a requirement for the decision-maker to be affirmatively satisfied of a range of factors before regulation of a service can be introduced;
- » missing a wider 'public interest' test allowing consideration of wider impacts (such as indirect investment impacts, and broader public welfare considerations).

Service classification decisions should be primarily driven by market-based considerations of the state of competition in the market, barriers to entry, countervailing market power, availability of information and substitutes. That is, classification decisions under the Rules should not be driven by the *current* content of subsidiary guidelines and other instruments (which can and do change more frequently, and with fewer procedural consultation safeguards than the rule change process).

This would invert the intended governance framework of the NEL, NER and subsidiary guidelines and instruments. Rather, the AER's obligation is to ensure that its ring-fencing guideline, cost allocation obligations, and shared asset approaches are workable and responsive to the policy determinations made by the AEMC on the different types of classifications and when each should be applied.

Role for classification stability in promoting customer outcomes

In developing any reforms to existing classification regimes it should be recognised that overall stability in classification approaches protects and promotes the long-term interests of consumers.

Classification decisions need to take into account actual and emerging market conditions. A classification regime, however, that featured an unstable and regularly changing a set regulated and unregulated services or within period reclassification would be contrary to the National Electricity Objective, because it would be likely to result in:

- » significant complexity for end-customers;
- » higher coordination and compliance costs for market participants, which may

ultimately be borne by customers;

- » distorted or delayed investment incentives for services that may be considered at higher risk of within period re-classification;
- » significant additional regulatory complexity and costs;
- » potential instability of network charges arising from resulting required adjustments to regulatory asset bases, cost allocations and approved network tariffs for a range of services.

It is not yet clear that technology and market changes have accelerated to a point of making within period adjustments to classifications feasible of in the long-term interests of customers. In this regard, Energy Networks Australia considers that an interim step of the AER being required to develop a clear classification guideline, and conduct regular reviews of this guideline represents a preferable initial reform step.

Network investment decisions are based on classification decisions – therefore, movement of services between regulated services and other types of services must be managed carefully and consistent with the basis of the original investment (i.e. not result in potential for uncompensated *ex post* stranding that will drive increased financing costs, or poor service and reliability outcomes for customers).

Consistency with previous classifications approach

Energy Networks agrees that during the classification process the mere fact a service has previously been classified in one way should not be determinative of the future classification of a service.

This clause of the *National Electricity Rules* sought to recognise that divergent approaches had previously been taken across jurisdictions, and that there should be some weight attributed to the goal of providing a degree of regulatory certainty and market continuity around previous classifications.

The fact, however, that the transition to AER regulation from previous jurisdictional regimes has largely occurred does not warrant the Rules attaching no weight to the goal of regulatory certainty and continuity between periods of classification outcomes. Network businesses therefore continue to support previous classification being a factor to consider, but the rule provision being adjusted or clarified by the AEMC in a manner that makes clear it should not be a determinative factor.