



**COAG**  
**Energy Council**  
Senior Committee  
of Officials

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

  
Dear Mr. Pierce

**Rule change request – contestable provision of services**

The COAG Energy Council agreed on 19 August 2016 to submit a rule change request to the Australian Energy Market Commission on the service classification framework and service classification definitions. These changes are requested in order to enable the contestable provision of services from emerging technologies.

This rule change request has been developed to address issues raised in the Australian Energy Market Commission's *Integration of Storage: Regulatory Implications* report provided to the Council in December 2015.

The rule change proposal is attached for your consideration.

Yours sincerely



**Mr Rob Heferen**  
Chair  
COAG Energy Council Senior Committee of Officials

September 16

Enc (1)

# Rule change request to promote the contestable provision of services from emerging technologies

Energy Market Transformation Project Team

19 August 2016

**COAG**  
Energy Council



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## **RULE CHANGE REQUEST TO PROMOTE THE CONTESTABLE PROVISION OF SERVICES FROM EMERGING TECHNOLOGIES**

### **1. Name and address of rule change proponent**

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### **2. Description of the proposed rule change**

This rule change request seeks to re-enforce the competition principle that services should only be regulated where competitive market forces cannot efficiently deliver those same services.

It seeks changes to the National Electricity Rules (NER or the rules) regarding new technologies that are becoming prevalent in the contestable market and capable of providing multiple services/revenue streams in *both* contestable and regulated natural monopoly markets.

For example, energy storage devices are capable of providing generation services into the wholesale electricity market, network support services that assist Distribution Network Service Providers (DNSPs) in providing network services, and in residential 'behind the meter' applications providing direct benefits to customers through increased self-generation and use, resulting in avoided electricity costs.

This rule change request seeks to promote the development of competitive markets for new technologies which are prevalent in the contestable market and capable of providing multiple revenue streams by:

- ensuring that, as a general rule, the service classification framework reflects the policy position that those technologies should be contestable services under the regulatory framework, unless it can be established that the competitive market is unlikely to efficiently and effectively deliver the service. It is anticipated this would only occur in a few exceptional circumstances;
- amending relevant service classification definitions and processes to enhance regulatory predictability with regard to:
  - the likely classification of new technology based services, including treatment where the technology is capable of providing multiple services across the market;
  - addressing regulatory lag. For example, facilitating timely re-classification of services or classification of new services in order not to hinder the development of effective competition in relation to emerging technologies.

It is important to note, the changes are not intended to exclude DNSPs [and Transmission Network Service Providers (TNSPs)] from choosing to participate in contestable markets through an appropriately ring-fenced entity. The Energy Council's (Energy Council) view is that consumers will benefit most from a



market that fosters participation by all parties, subject to appropriate protections against misuse or potential misuse (for example, the threat of misuse is sufficient to deter entry) of market power.

The changes are also not intended to exclude regulated DNSPs from using new technologies to improve the quality of the regulated service and potentially reduce the cost of the regulated service for customers.

The rule change request therefore seeks to:

- a) promote effective contestable markets for new technologies where possible;
- b) improve regulatory certainty by enhancing the service classification process.

Energy Council requests that the Australian Energy Market Commission (AEMC) make necessary changes to the relevant provisions of the NER to achieve these goals. In the following pages, Energy Council highlights a range of issues within the rules which may require changes, and proposes broad solutions noting the complexity of issues to be considered.

The potential solutions proposed in this rule change request involve:

- A. **Amendments to service classification:** changes to clarify the boundaries of services that can be provided by a DNSP in their regulated capacity and to provide enhanced regulatory certainty around the likely treatment where technologies may provide multiple services i.e. in the regulated and contestable markets.
- B. **Amendments to the process for service classification:** service classification is currently conducted for each DNSP through the Framework and Approach (F&A) process. This has resulted in a business by business process that lacks transparency as to the Australian Energy Regulator's (AER) likely approach to service classification. There are also issues regarding inflexibility in service classification processes i.e. both with respect to the AER's discretion and timing for re-classification of services.

Energy Council recognises that the proposed changes outlined in this request may require consequential changes in other areas of the rules and encourages the AEMC to consider the flow-on implications.

Further, the solutions proposed in this rule change request focus on DNSPs. However, the AEMC is also requested to consider the equivalent parts of the regulatory framework for TNSPs in chapter 6A of the NER. Energy Council considers that most of the issues are equally relevant to TNSPs, although notes that there are some differences between the rules for DNSPs and TNSPs, particularly in the service classification arrangements.

Energy Council considers these proposed changes will help to support an effective transition to a more diversified and dynamic electricity market where consumers are being presented with more choices for their electricity supply. They are also consistent with Energy Council's desire to support enhanced competition and innovation in the electricity sector by re-enforcing the competition principle that services should only be regulated where competitive market forces cannot efficiently deliver those same services.



The proposed changes will address issues identified in the AEMC's storage report.<sup>1</sup> These include the potential blurring of the boundaries between 'traditional' regulated network services and emerging 'non-traditional' services and an associated lack of regulatory certainty and confidence in the framework around the treatment of new types of technologies that are capable of providing multiple revenue streams.

The proposed changes go beyond the storage report recommendations in recognition that other technologies may raise similar challenges for the regulatory framework. As such the proposal seeks changes to ensure that the service classification and related provisions are technology neutral and sufficiently flexible to provide greater resilience and responsiveness to accommodate changing market conditions and technologies in the future.

In addition to responding to the storage report, proposed changes also seek to introduce improvements to the service classification process to enhance regulatory certainty and transparency and to drive a stronger focus on recognising the opportunity to move services from the regulated sector to contestable markets, where competition is developing.

### **3. Subject matter is within AEMC's powers**

Energy Council submits that this rule change request falls within the subject matter on which the AEMC may make rules.

Firstly, Section 34 of the National Electricity Law (NEL) empowers the AEMC to make rules to regulate the activities of persons (including Registered participants) involved in the operation of the national electricity system. The rule change request relates to clarifying the regulatory treatment for revenue and pricing purposes of the activities of DNSPs.

Schedule 1 of the NEL further elaborates on the specific subject matter for the rules including transmission and distribution system revenue and pricing rules (see clauses 15 to 24 and 25 to 26H) and the 'Specification and classification of electricity network services as direct control network services or negotiated network services' (clause 34A).

### **4. Background to the rule change request**

#### ***A. Changes in market conditions***

The Australian Energy Market Agreement, which underpins Energy Council's work, recognises that effective operation of an open and competitive national energy market will contribute to improved economic and environmental performance and deliver benefits to households, small business and industry. This recognises that liberalised competitive energy markets with low barriers to entry provide strong incentives for innovation, cost reduction and service delivery.

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<sup>1</sup> Integration of Storage: Regulatory Implications, 3 December 2015



It is widely acknowledged that new technologies and business models emerging in the electricity market have the potential to greatly expand the choices that consumers have to meet and manage their energy needs. It is also acknowledged that various market participants and potential new market entrants are likely to derive value from these new opportunities.

New technology based services could be provided by a regulated network business and have the potential to contribute to a more efficient regulated service. However, in many instances these services could also be provided by an unregulated entity with a business model that allows it to coordinate and monetise benefits for different parties in the electricity market.

Another issue is that new technologies are emerging that have the capability to provide multiple services/revenue streams across the electricity sector. For example, a storage device has potential to be used to dispatch energy into the competitive wholesale market; to provide network support as an input to the regulated network service; or in the contestable retail sector ‘behind the meter’ to offset the customers’ retail load.

Energy Council notes that the main thrust of the Hilmer reforms in the 1990’s was to separate out the ‘natural monopoly’ elements of the electricity market from competitive elements and to implement a vertically disaggregated market structure. However, the ability of new technologies to provide multiple services introduces complexities with respect to separation between regulated and competitive services, while maximising the benefits to consumers of new technology developments.

### ***B. Electricity Network Economic Regulation: Scenario Analysis***

Advice to Energy Council in July 2015 on the outcome of stress testing the economic framework<sup>2</sup> recognised that changes underway in the electricity sector mean there is a growing need to consider electricity policy from a whole of system perspective, recognising that delivering the National Electricity Objective (NEO) through regulation may not always be compatible with enabling greater consumer choice. It noted that policy, therefore, needs to make sure that consumer empowerment and system efficiency policy objectives are aligned.

More specifically, Energy Council’s stress test identified a number of potential barriers to development of competition in unregulated alternative service markets. In particular, the stress test questioned the timeliness of reclassification of services as contestable services in terms of the capacity to keep pace with market developments. The result was a recommendation to review whether the service classification framework is fit for purpose such that it will not hinder competition in alternative service markets and associated benefits to customers.<sup>3</sup>

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<sup>2</sup> Policy Advice to Energy Council, June 2015, Electricity Network Economic Regulation: Scenario Analysis.

<sup>3</sup> In the service classification process AER may consider the possibility of increased competition in traditional monopoly services or potential for competition in new types of services, and may decide not to regulate such services. Recognising competition takes time to emerge, the process provides for a transition path.

### **C. AEMC's Storage Report**

On 3 December 2015, the AEMC delivered a final report titled *Integration of Storage: Regulatory Implications* (the storage report). The report was part of its new technology work program and focused on whether the existing regulatory frameworks are sufficiently flexible to support the integration of new storage technologies – noting potential benefits for consumers and market participants alike.

The AEMC's storage report found that the ability to provide multiple services/revenue streams means storage has the potential to interact with the entire electricity sector, for example dispatching energy into the wholesale market, at the network level providing network support services or 'behind the meter' at the residential level offsetting the customers' retail load.

The report found that at a high level the NEL and NER approach to regulating DNSPs based on the service provided, rather than the asset, is consistent with a technology neutral approach and the framework is broadly capable of accommodating new-technology based services that are entering the market, including the potential for storage devices/investments to provide services in both the regulated and competitive market segments.

However, the AEMC process found that at a practical level, storage technologies (and other new technologies such as energy management systems) are having the effect of blurring the lines between the traditional regulated network service and new non-traditional services and that this is resulting in a lack of confidence in the existing framework, particularly with respect to:

1. the regulatory treatment of storage (and other new technologies that are becoming prevalent in the contestable market and capable of providing multiple services/revenue streams) – the report found regulatory uncertainty regarding the likely classification of services has implications for investment decisions in new innovative services by regulated DNSPs, competitive market players and new entrants
2. supporting competitive neutrality and confidence in new innovative markets that could benefit consumers – stakeholders considered that in a more dynamic and complex market, where new technologies can provide services across the sector and potentially provide multiple services/revenue streams, existing mechanisms used to separate regulated and competitive activities of DNSPs (for example, ring-fencing guidelines) may be insufficient to allay concerns about potential misuse of market power by DNSPs.

The AEMC's report noted that DNSPs are already showing interest in using storage capability on the network, including for network support (as an alternative to investment in poles and wires) and to assist with quality and reliability of supply.

The report also noted that there are already a number of players entering Australia's storage market and that this suggests that competitive market forces are developing such that any regulation of new technologies and services should be minimised to instances where there is clear evidence of market failure.



The AEMC report recognised the need to ensure DNSP investment in storage services does not undermine competitive market developments, while ensuring at the same time that DNSPs are not prevented from employing these and other innovative technologies that could improve the quality and/or lower the cost of the core regulated service.

Additionally, the report noted that the NEM regulatory framework is designed to /should encourage efficient market-based outcomes and as such should not act as a barrier to whatever technology delivers the most cost effective service for customers.

Noting these issues, the AEMC storage report found that:

1. Storage services ‘behind the meter’ should as a general rule be treated as contestable and therefore be ‘unclassified’ by the regulatory framework and DNSPs should only be allowed to own storage ‘behind the meter’ through an effectively ring-fenced affiliate that ensures separation of contestable market activities from the provision of the regulated service.
2. Storage ‘behind the meter’ by a DNSP for network support should generally be sourced from the contestable market i.e. contracted from a third party or ring-fenced business.
3. Recognising the potential for storage technologies to contribute to an improved regulated service, there should not be a blanket prohibition on DNSPs investing in storage technology ‘on their network’ (as part of the regulated service) nor any absolute requirements for competitive procurement of services on the network as the existing incentives in the framework should lead DNSPs to select the most efficient procurement option.
4. Where a technology investment by a DNSP is capable of providing a mixture of services (i.e. regulated and contestable services), the regulatory framework should not create a barrier to customers/the market benefiting to the largest extent possible from the range of services/revenue streams. However, the AEMC noted such issues could largely be managed through current cost allocation, shared asset guidelines and ring-fencing requirements, which AEMC considered generally robust noting the latter are under review by the AER.

In order to implement the above findings, the AEMC specifically proposed:

- consideration of changes to service classification definitions
- clarifying the boundaries of services that can be provided by a regulated DNSP
- consideration of the potential need for cross-ownership restrictions in the NER<sup>4</sup>.

The AEMC noted this work should be conducted in tandem with the AER’s review of the ring-fencing guidelines in 2016.

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<sup>4</sup> Pg. 14, AEMC Integration of Storage: Regulatory Implications, Final Report, Dec 2015

## 5. Statement of issues

Energy Council seeks to support the development of competitive electricity markets with low barriers to entry which foster innovation, customer choice and support the delivery of efficient, low cost services to consumers. Regulatory frameworks and market designs need to enable adoption of new technologies and provide opportunities for increased competition where this leads to better outcomes for consumers.

Rapidly changing markets mean that traditional network services now have competitive alternatives which could provide more cost effective options to support network management and address network constraints, while providing additional benefits to consumers and the market. Recent developments with storage technologies, including reduction in costs and the development of innovative service models, demonstrate how quickly new competitive markets can emerge.

Regulatory frameworks need to enable the development of new contestable markets in a timely fashion and not provide unfair advantage to incumbents. The adoption of new technologies and services often require the development of innovative business models to monetise different revenue streams. For contestable markets to emerge, service providers need investment confidence that they can compete on a level playing field, and are not disadvantaged, or unnecessarily constrained from exploiting multiple revenue streams where the technology has this capability.

Energy Council supports the premise put by the AEMC that storage and similar new technologies that are becoming prevalent in the market and capable of providing multiple services/revenue streams should as a general rule be treated as contestable services in the regulatory framework.

However, Energy Council also agrees with the AEMC finding that there should not be a blanket prohibition on DNSPs investment in storage or other new technologies emerging in the contestable market.

Energy Council recognises there may be circumstances where competition takes time to develop, and that investment by networks in new technologies 'on the network' will support a more efficient investment and higher quality regulated network services.

Further, Energy Council considers there are likely to be some instances potentially in geographically isolated segments of the network where such investments 'behind the meter' by a DNSP might reasonably be part of the regulated service; that is in cases where it can be established that the competitive market cannot deliver the service within a reasonable period of time and regulated service provision is the only means by which customers could access the service and receive benefits. It is however expected that these circumstances would be the exception to the general rule.

Energy Council disagrees with the AEMC's proposal to consider imposing cross ownership restrictions on DNSPs under the national framework. This is because cross ownership restrictions are largely imposed



by/or have links with state-based provisions or licence conditions<sup>5</sup> for network businesses. It is Energy Council's view therefore that any cross-ownership restrictions should more appropriately be considered by jurisdictions outside of the NER. Electricity network businesses are also considering options to reform their business models in response to changes in consumer preferences and technology options. Energy Council believes it is not appropriate to cut off options for network businesses to develop new businesses and new revenue streams.

This rule change request seeks to ensure that the above policy positions are implemented through changes to the service classification framework. The proposal is made on the basis that current service classification definitions and associated provisions lack sufficient clarity such that the absence of regulatory certainty with respect to the treatment of new technologies could have detrimental impacts for investment in new technologies in both the regulated and contestable market segments.

In addition to the issues identified by the AEMC, Energy Council has identified some issues with the service classification process that would benefit from changes to the relevant rules. These include:

- Concerns regarding the current business by business approach to service classification as required by the F&A process and a lack of clear guidelines, transparency and certainty around the AER approach.
- Concerns that the current rules limit the AER's discretion with respect to potential opportunities to re-classify services as contestable and are contrary to the policy aim of promoting development of effective competition over and above regulation of services.
- Concerns that the regulatory cycle may be too slow to respond with respect to potential for re-classification of services or regulatory recognition of new services and could potentially limit the emergence of new competitive markets.

Energy Council is conscious that allowing DNSP's to own new technology solutions as part of the regulated service could have potential detrimental impacts on the development of competitive markets. Energy Council also notes that the regulatory and market frameworks should support the most efficient provision of electricity services and optimisation of investments i.e. asset utilisation is maximised and there are not significant barriers to parties realising multiple services/revenue streams.

With respect to asset utilisation /optimisation, Energy Council broadly agrees with the AEMC finding that current cost allocation, shared asset and (soon to be revised) ring-fencing arrangements should be capable of enabling and managing the exploitation of multiple services/revenue streams. However, Energy Council believes there is a need to consider whether changes to the service classification definitions and related provisions could provide up-front certainty/transparency as to the likely regulatory treatment of investments that will provide multiple services i.e. in both the regulated and contestable markets.

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<sup>5</sup> In some cases state-based ownership restrictions are reflected in state-specific ring-fencing guidelines grandfathered into the national regime, but these are to be replaced with a single national guideline.



With respect to the potential impacts on development of the competitive market and the issue of the DNSPs procurement approach, Energy Council agrees with the AEMC's finding that where a DNSP wants to invest in storage (and other technologies) 'behind the meter' to provide support for the regulated service, such services should be sourced from the competitive market i.e. from a third party or ring-fenced affiliate. Energy Council notes the AER's view<sup>6</sup> that it cannot currently impose a particular approach with respect to a DNSPs investment in distributed energy resources to manage a shared network issue, but that ring-fencing guidelines and the incentive mechanisms in the regulatory framework should work together to ensure that DNSPs choose the most efficient option.

With respect to DNSP investment in new technologies 'on the network' as part of the regulated service, Energy Council notes the AEMC's finding that this should be subject to the AER's usual service classification and that DNSPs should have sufficient incentives under the current framework to undertake the most efficient investment option.

## **6. Proposed solutions**

### ***A. Service classification definitions and related provisions***

#### Boundaries of services that can be provided by a DNSP

The AEMC's storage report found that a contributor to current uncertainty about the regulatory treatment of storage technologies (and potentially other new technologies) is the absence of a clear-cut delineation between the regulated and non-regulated parts of the energy market.

The following issues were identified as key contributors to the lack of clarity around the boundaries of the DNSP's regulated service:

1. Distribution services are currently very broadly defined as services provided by means of, or in connection with, a distribution system. The AEMC noted that the words 'in connection with' appear to imply the service does not itself need to utilise assets that fall within the scope of the distribution system<sup>7</sup> and that it potentially allows for services provided 'behind the meter' to be defined as a distribution service.
2. The lack of consistency between the AER's interpretation that services provided from storage 'behind the meter' would fall within the definition of a distribution service and the AEMC's preliminary finding that such services should be unregulated<sup>8</sup>.

To address this issue, the AEMC proposed consideration of changes to more clearly define the DNSP's regulated network service based on the physical or spatial limitations of the distribution system itself. A

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<sup>6</sup> Pg. 24, AER Electricity Ring-fencing Guideline – Preliminary Positions, April 2016

<sup>7</sup> Pg. 13, AEMC Integration of Storage: Regulatory Implications, Final Report, Dec 2015

<sup>8</sup> Pg. 58, AEMC Integration of Storage: Regulatory Implications, Final Report, Dec 2015



key driver for this proposal appeared to be the AEMC's view that storage 'behind the meter' should always be a contestable service, i.e. provided by a third party or by a ring-fenced affiliate of the DNSP.

Energy Council considers a spatial approach has some logic because it links to one of the key reasons the network service is a natural monopoly i.e. the asset is not economic to duplicate. However, a spatial delineation may be overly simplistic in the context of current market developments where services are capable of being provided remotely and a focus on the physical asset (i.e. the distribution system) may be inconsistent with the service-based approach to regulation that is favoured by industry and Energy Council.

Energy Council notes the key challenge of accommodating new technologies into the service classification framework is that the investment may be capable of providing multiple services/revenue streams in both the regulated and contestable market; and the need at the same time to ensure the regulatory framework continues to provide strong separation of regulated and competitive services.

#### Service classification definitions

While the AEMC's storage report found the current service classification definitions are capable of accommodating new technologies, such as storage, it also highlighted that the ability for new technologies to be classified as providing or being capable of providing a distribution service (and therefore be one that may be subject to economic regulation) is at odds with the policy intent that storage and other new technologies that are becoming prevalent in the contestable market and capable of providing multiple services/value streams should as a general rule be contestable. The AEMC therefore recommended consideration of clarifications to the service classification definitions.

It is important to understand the role of service classification. Service classification determines whether economic regulation will apply to the DNSP's various services and the form of any price controls that will apply.

The starting point for service classification is to determine whether the service falls within the definition of a 'distribution service'. Under the NER, a distribution service is a service provided by means of, or in connection with, a distribution system.

In classifying distribution services, the AER must have regard to the 'form of regulation' factors in the NEL<sup>9</sup>. These factors provide guidance to the AER in deciding whether a service has the characteristics of a service that should be regulated, such as barriers to entry, the relative market power of networks and customers, the availability of substitute services, and the information available to networks and customers in coming to agreements.

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<sup>9</sup> Section 2F



Because these factors are in the NEL, the AEMC is not able to amend them. However, the form of regulation factors are an important part of the service classification process, because they are the basis of the AER's decisions on whether a service should be regulated. The AEMC should advise Energy Council on whether the form of regulation factors remain appropriate in the context of changes in the electricity market and its deliberations on the issues in this rule change.

Once the AER makes a decision on the distribution services that should be regulated, the NER allows the distribution service to be classified as either a 'direct control service' or a 'negotiated distribution service'<sup>10</sup> - the former being a service for which prices will be determined under a form of control set by the regulator, the latter only involving negotiation of pricing in accordance with requirements in the NER and arbitration in the event of a dispute. The NER then provides for sub-classification of 'direct control services', as either a 'standard control service' (SCS) or as an 'alternative control service' (ACS) which affects the form of price control that the AER can impose.

While the NEL definition of a *distribution service* has a functional characteristic (it refers to a distribution service provided by ...a distribution system) the service classification definitions mentioned above do not refer to the characteristics of the service; instead they refer to either the manner in which the DNSP can recover the costs associated with providing that service; or having that classification because they are not classified as another type of service. Energy Council considers this approach is potentially contributing to a lack of clarity in the definitions and what services are actually captured, as well as their practical application.

A case in point is that the NER defines SCS as a direct control service that is subject to a control mechanism based on a DNSP's total revenue requirement; and defines an ACS as a distribution service that is a direct control service but not a standard control service.

Currently the AER classifies an SCS as the services of a monopoly provider that are central to provision of the shared network and relied on by most customers. However, the important distinction between SCS and ACS services is that the DNSP must recover the cost of providing SCS services by averaging them across all customers (i.e. smeared 'postage stamp' pricing applies), while ACS services are customer specific and charged on a per customer basis to those that directly benefit from the services. The implications for development of competition of classifying services is that the smeared pricing of SCS services in effect rules out third parties from competing to provide those same services, while the per customer prices for ACS services opens up the possibility for other parties to compete to provide the service.

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<sup>10</sup> The NER also allows the AER to not classify the services i.e. an unregulated service.



Given the issues raised above, and acknowledging that the service classification definitions operate in concert with Rules 6.2.1 and 6.2.2, Energy Council requests that the AEMC considers changes to the service classification definitions and related provisions in the NER necessary to:

- A. implement the policy intent that new technologies that are becoming prevalent in the contestable market and capable of providing multiple services/revenue streams should as a general rule be classified as contestable services i.e. unclassified under the regulatory framework
- B. reflect Energy Council's position that there should not be a blanket prohibition on services provided by these new technologies being classified as regulated where this can be reasonably justified (e.g. where the technology will entirely be used for network support or where competition does not exist)
- C. ensure the SCS definition (and/or associated rules) more clearly reflect the intent that the relevant services (or allowable inputs to SCS services) must have natural monopoly characteristics
- D. reflect the growing number and complexity of services in the electricity market, including if possible the capability of new technology investments to provide multiple services i.e. in both the regulated and contestable markets with a view to enhancing certainty for market participants and new investors
- E. provide more clarity and certainty around how the AER interprets and applies the service classification definitions and associated rules (see sections below).

#### Rules favouring the status quo

Rules 6.2.1 and 6.2.2 of the NER are the key rules guiding the AER's decisions on classification of services. Energy Council proposes changes to the wording of Rules 6.2.1(d) and 6.2.2(c)(3) and (d) to remove prescription around the AER's consideration of services that have previously been regulated which Energy Council believes favour the status quo.

The wording in these rules provides the AER with limited discretion over reclassification of services and the rules are framed contrary to the policy aim of promoting development of effective competition over and above the economic regulation of services.

Energy Council also notes the limitations on the AER's discretion reflect the context for their development and are no longer warranted. That is, the rules were developed as part of a process to transfer economic regulation from jurisdictional regulators to a new national regulator.

Further, in a less dynamic market a more static or conservative approach to classification of services may have been appropriate. However, in a changing marketplace changes to the rules to allow the AER more discretion on re-classification of services would allow a more proactive approach to moving services out of economic regulation, and would also likely stimulate greater debate in the market on potential for contestability of services.

## ***B. Service classification processes***

### Service classification guidelines

Under the current NER the AER considers service classification on a case by case basis as part of its decision on the F&A which establishes various parameters at the outset of each individual network businesses' determination. Hence, the AER's most recent F&A decisions reflect the AER's latest policy on its practical application of the service classification framework, including the definitions. This arrangement has resulted in a business by business approach to service classification and a lack of transparency and certainty around the AER approach.

The F&A process aims to provide an evidence base for the AER's decisions by including a process of calling for stakeholder submissions. However, Energy Council notes the F&A process is network specific and understands that it can often attract limited engagement from stakeholders. This is likely because the F&A process is conducted very early in the determination process when stakeholders are ill-prepared to participate and/or there may be limited understanding amongst some stakeholders that this process underpins what services will and will not be regulated.

Energy Council proposes that the NER be amended to require the AER to develop and maintain a Service Classification Guideline setting out the AER's standard approach to applying the service classification framework. Energy Council considers such a change would enhance transparency, consistency and regulatory certainty for stakeholders.

Energy Council also proposes that the development of, and any amendment to, the new Service Classification Guideline should be subject to the Distribution Consultation Procedure already provided for in the NER so that there is broad consultation on the Guideline. The AER should be required to consult with other interested parties as part of this process, in addition to the usual parties that it must consult under the Distribution Consultation Procedure (as is currently the case for consultation on the ring-fencing guidelines). A single<sup>11</sup>, dedicated process that is subject to proper consultation would be more effective in engaging stakeholders than the current arrangement of individual processes for each determination process. It would promote a more robust dialogue on service classification issues and ultimately enhance transparency and promote consistency in regulatory treatment.

It is noted that service classification would still be considered as part of each specific F&A process, with the focus of deliberations being the relevant application of the guideline to that network business. With a view to enhancing regulatory certainty and consistency of approach, it is proposed the guideline would be binding unless the AER considers an alternative approach is clearly more appropriate.

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<sup>11</sup> It is recognised that some jurisdiction specific considerations/variations may be needed due to differing policy positions on contestability of services.

### Regulatory lag in the timing of service classification

Energy Council's 2015 stress test of the economic framework identified 'the timing of regulatory recognition' as a potential barrier to development of competition in alternative service markets. It was considered that a regulatory lag in the opportunity to re-classify services could negatively impact the development of effective competition.

Similarly, Energy Council is concerned about a potential gap in that any new services introduced 'within-period' are unregulated and there is potentially a window of opportunity for the DNSP to use its monopoly advantages to restrict development of competition for those services. Noting the AER's new ring-fencing guideline has potential to address the default treatment of new services, Energy Council encourages the AEMC to monitor the issue as it evolves in the ring-fencing review.

Given the pace of change in new technologies, the current process may not be sufficiently flexible. Currently, service classifications are determined as part of the F&A process approximately two years before the regulatory control period commences and are then locked-in for the regulatory period, which generally has a minimum period of five years. This means that towards the end of a regulatory period, service classifications may have been determined up to seven years ago and may no longer reflect current market conditions and the emergence or potential for competition in the service.

Energy Council therefore proposes that the NER be amended to specify under what circumstances within-period classification decisions may be appropriate and the process involved, including the parties that could initiate a within-period process to consider re-classification<sup>12</sup>. A within-period re-classification may be appropriate, for example, for both new services and for existing services where market conditions indicate a change of classification would provide benefits. A need for re-classification could also be triggered as a consequence of changes to the Service Classification Guidelines, the process for which would reasonably consider opportunities for early/mid-period implementation of relevant changes.

Energy Council recognises that there are significant potential complexities and flow on implications of changing service classifications within a regulatory period, for example changes to allowed revenues and prices would be preferable through a mechanism that is established at the time of the determination, which would allow for within-period adjustment without a full re-opening of the determination. It is Energy Council's view however that there is considerable potential benefit for consumers from removing or reducing the regulatory lag of classification decisions.

Energy Council notes the AEMC may wish to consider addressing a within-period mechanism in the proposed Service Classification Guideline.

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<sup>12</sup> It is noted that a regulatory lag in opportunities to re-classify regulated services benefits the DNSP and the DNSP would have little incentive to initiate a process that might result in benefits to the competitive market.

### ***C. Consequential and related changes***

Energy Council recognises that the proposed changes outlined in this request may require consequential changes in other areas of the rules and encourages the AEMC to consider the flow-on implications.

As noted in section 2 above, the AEMC is requested to also consider the equivalent parts of the regulatory framework for TNSPs in chapter 6A of the NEL. Energy Council considers that most of the issues and proposed solutions outlined above are equally relevant to TNSPs. However, there are some differences between the rules for DNSPs and TNSPs, in particular the service classification and ring-fencing arrangements, which will mean there will need to be differences in how the proposed solutions are implemented for TNSPs.

### **7. Contribution to the National Electricity Objective**

Under section 7 of the NEL, the NEO states:

“The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to

- (a) price, quality, safety, reliability and security of supply of electricity
- (b) the reliability, safety and security of the national electricity system.”

The relevant aspects of the NEO for the purposes of this rule change request are the efficient investment in and use of energy services for the long term interests of consumers with respect to price, quality and reliability of supply.

The changes proposed by Energy Council will contribute to the achievement of lower cost, higher quality and more reliable supply outcomes through supporting greater contestability in the delivery of those services where competition exists.

The rule changes will contribute to enhanced regulatory certainty for investors and lower barriers to entry for third parties to offer contestable services. This will support increased consumer choice in electricity services which will drive innovation and lower cost outcomes for consumers.

It aims to avoid investment in underutilised assets, by supporting arrangements where the revenue streams which flow from technologies, such as storage, can be fully monetised and captured by the market and consumers.

### **8. Explanation of Expected Benefits and Costs**

The changes outlined above are intended to create a level playing field for competitive services that substitute for some of a customer’s need for distribution network services. The changes should also allow distribution network businesses to access these services either from competitive providers where these are available, or directly where there are no competitive alternatives. Energy Council expects that this will



improve the efficiency of investments in network services, by providing benefits to parties along the electricity supply chain.

In cases where competition takes time to develop, or where customers are for some reason unable to exercise choice, the changes will ensure regulated networks are not prohibited from investing in new technologies that could improve the standard of the regulated service for these customers.

### ***End-use customers***

Electricity end-use customers would:

- be presented with an increased range of innovative energy supply options
- be able to choose the options that best reflect their preferences.

Improving opportunities for consumer choice in the electricity market will improve signals about how customers value electricity services and the investments needed to deliver these services.

### ***Providers of competitive services***

For customers to access these benefits, companies developing competitive services need to be viable, which requires access to markets. The changes outlined above would support development of a viable competitive services market by creating:

- a level playing field for access to end-use customer markets
- access to markets to provide services to regulated businesses.

### ***Electricity retailers***

Electricity retailers may also choose to enter markets to provide competitive services to customers. These retailers would benefit from the proposed changes in the same way as other competitive service providers.

### ***DNSPs***

Distribution network service providers are expected to benefit from:

- new options to procure services and improve the efficiency of providing distribution network services to customers
- greater certainty about the situations where direct investments by DNSPs in new services will be allowed, and revenue will be recovered
- opportunities to reform business models and enter competitive markets through ring-fenced businesses.



### ***Costs generally***

There are also potential **costs** from these reforms for a range of parties.

- The implementation costs of the revised rules are expected to be low. The AER and DNSPs will be required to apply the new rules in the regulatory determination process. However, understanding and applying changes to the regulatory framework is part of this process, and additional costs related to these changes will be low.
- The greatest risk to end-use customers occurs if providers of competitive services are not able to develop viable business models and regulated parties are excluded from providing these services. In this situation, potential benefits available to customers will not be realised.

### ***AER***

The proposed rule change will provide the AER with greater ability to define the boundary between regulated and unregulated services for TNSPs and DNSPs, and support the better allocation of the costs and benefits based on the revenue streams of different investments.

In implementing the rule change, the AER would be required to:

- Develop a new Service Classification Guideline in consultation with stakeholders, and apply that guideline to its process for service classification in particular network determinations.
- Develop a process to consider within-period classifications according to requirements outlined in the rules.
- Consider any impacts on the design and application of ring fencing guidelines.

### ***AEMO***

The proposed rule will not affect the Australian Energy Market Operator's declared network functions.