



10 February 2017

Mr John Pierce
Australian Energy Market Commission
PO Box A2499
Sydney South NSW 1235

Lodged Online

RE: NATIONAL ELECTRICITY AMEDNMENT: CONTESTABILITY OF ENERGY SERVICES

Origin Energy (Origin) appreciates the opportunity to provide input to the Australian Energy Market Commission's (AEMC) assessment of rule change requests submitted by the COAG Energy Council and the Australian Energy Council to promote the contestable provision of energy services (ref ERC0206 and ERC0218).

At the time the National Electricity Rules were initially developed, they did not fully anticipate the considerable uptake of distributed energy resources (DER) across the National Electricity Market or the ability of these assets to provide both regulated and contestable services. As a result, we agree with the Rule change proponents that changes are necessary to better define how services that can provide both regulated and contestable services should be classified.

We are strongly of the view that the promotion of efficiency, and notably dynamic efficiency, is best achieved when services are procured and supplied through a competitive market. We do not believe that allowing a distribution network service provider to directly participate in the behind the meter contestable market for DER is consistent with the National Electricity Objective and the original intent of the Hilmer Report which advocated for the separation of monopoly and competitive activities.

For these reasons, we consider that a number of definitions underpinning the classification framework need to be better defined to make clear where the distribution system ends and what the differences between a distribution service and an input to a distribution service are. Achieving this clarity will preserve the integrity of the emerging DER market while also ensuring that a distribution network service provider is compensated for the most efficient solution to fulfilling its regulatory obligations, be it through traditional investment, DER or other solutions.

Origin's responses to specific questions proposed in the AEMC's consultation paper are provided as an attachment. We would welcome the opportunity to discuss our views further with the AEMC. If you have any questions regarding this submission please contact Sean Greenup in the first instance on (07) 3867 0620.

Yours sincerely

A handwritten signature in blue ink that reads "K. Robertson".

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Consultation Question

- a) *Is there a problem with the current process for distribution service classification? For example:*
- i. *does the current determination by determination approach reduce clarity over likely service classification decisions?*
 - ii. *does the timing of the framework and approach process (in advance of each distribution determination) inhibit stakeholder engagement on service classification decisions?*
- b) *Would a distribution service classification guideline increase clarity regarding distribution service classification?*
- c) *To what extent does service classification being locked in over the regulatory control period create a lag in appropriate reclassification of services?*
- d) *What other changes to the economic regulatory framework may be required to allow clear and properly informed decisions on reclassification of services within a regulatory control period?*
- e) *What would be the costs and benefits of allowing reclassification of services within a regulatory control period?*

The most significant problem with the classification of services process is how the various definitions are interpreted and applied.

We consider that a guideline as proposed by the COAG Energy Council could establish a consistent and transparent approach, especially across regulatory periods. However, any guideline will be limited in its effectiveness if it entrenches the existing ambiguities around definitions.

In terms of the timing of the classification process, we agree with the Rule change proponents that the gap between the Framework and Approach process and the lodgement of the regulatory proposals is longer than preferable; in many instances there is a gap of six months.

We recognise that a distribution network service provider (DNSP) needs to understand in advance how the different services it provides are going to be regulated to enable it to prepare its regulatory revenue proposal accordingly. Notwithstanding, we consider that this gap should be compressed and that a guideline would provide certainty to support a shorter window.

In terms of changes to a classification within a regulatory period, as a general principle we strongly support regulatory certainty. Any provision to allow a reclassification within period would need to be underpinned by consistent, clear and unambiguous triggers and materiality thresholds. On this basis we would expect that a reclassification would be an exceptional event and not open to manipulation.

Consultation Question

- a) *Does the definition of distribution services provide clear guidance regarding which services are distribution services and which are not?*
- b) *What type of changes could be made to clarify the term?*
- c) *What would be the pros and cons of changing the definition of distribution services?*

We consider that the current definition of a distribution service is not sufficiently clear, notably around those services that can provide both network support and other contestable services. We consider that this could be resolved with a definitive and more binding definition of a distribution system and the

term 'in connection with'. This in turn could make clear the difference between a service and an input to a service and whether that input is capex or opex.

The Rules define a distribution service as a service provided by means of, or in connection with, a distribution system, with a distribution system being a distribution network, together with the connection assets associated with the distribution network.

The distribution system is therefore made up of two components; the network assets and the connection assets. The network assets are the apparatus, equipment, plant and buildings used to convey, and control the conveyance of, electricity to customers. The connection assets are the agreed point of supply established between a DNSP and the customer.

As part of its regulatory proposal, a DNSP must propose capital expenditure to meet the expected demand, quality, reliability or security of supply of distribution services. Typically, these services include planning, designing, constructing and maintaining the distribution system. Capital expenditure is either system or non-system. System capital is expenditure on the actual distribution system itself. Non-system expenditure is not part of the distribution system but necessary to support the delivery of direct control services, and specifically standard control services.

However, the term 'in connection with a distribution system' implies that a service does not itself need to utilise assets that fall within a distribution system and related connection assets, but can be provided by any assets or other means provided that the service is being provided 'in connection with' a distribution system.

The AER has recently defined a standard control service as 'services that are central to electricity supply and therefore relied on by most (if not all) customers such as building and maintaining the shared distribution network.'¹ Furthermore, the AER has also adopted the view that when a distribution network (or any other third party) installs an electrical asset within a customer's premises it considers that this will result in the customers' wiring becoming an embedded network, which the AER suggests is also a special type of distribution system.²

The manner that the AER has interpreted this definition to date means that a DNSP can directly invest in DER behind the meter for network purposes. The consequence is that a DNSP is therefore operating in a competitive market with the shield of a regulated return.

We do not accept that each and every residential premises should be considered as an embedded network as suggested by the AER. Embedded networks have distinct characteristics, namely they have multiple occupants that do not have a direct connection to the distribution system, and for this reason are subject to various operating conditions, such as the AER's Exempt Selling Framework.

We believe a definition of 'in connection with' suggests that the activity is in conjunction but not necessarily as part of. We believe that behind the meter is not part of the distribution system as it is beyond the agreed point of supply. In other words, the installation of DER cannot be considered system capital expenditure because it is not part of the distribution system.

In addition, we note the AER Ring-fencing Guidelines, and certain jurisdictional network licensing regimes specify that a DNSP must not carry on a related business within that legal entity, where related business is deemed as producing, purchasing or selling electricity. We consider that DER with its ability to generate electricity for direct retail sale to customers meets the criteria for being a service that should be provided by a related party.

¹ AER, Framework and Approach for Energex and Ergon Energy 2015–2020, p. 10.

² AEMC, Integration of Storage: Regulatory Implications, Draft Report, October 2015, p. 37.

Nevertheless, while we argue that DER is not system capex and as a contestable service should only be provided through a related party, we are not suggesting that DER could not be an input into the provision of direct control services. Our position is if DER is the most efficient solution to a network problem it must be procured from the relevant competitive market and the costs of its procurement recovered through a DNSP's revenue allowance as opex.

We support the proposal from the AEC to lower the threshold for a RiT-D as this would provide the AER with the granularity and transparency to allow it to make an assessment regarding the appropriateness of DER as an efficient non-network solution.

Consultation Question

- a) *Do the form of regulation factors provide clear guidance to the AER in determining whether distribution services should be classified as direct control services, negotiated services or be left unclassified?*
- b) *Should the requirement to not change service classification unless a new classification is clearly more appropriate be removed?*

As stated above, we consider that the most critical step in the classification of services is correctly making the initial assessment of whether a service is a distribution service or not.

Once this has been made, the AER is to have regard to the form of regulation factors set out in the National Electricity Law in deciding how to classify a distribution service between a direct control service and a negotiated service.

Among other things, the form of regulation factors requires that the AER have regard to the presence and extent of barriers to entry by alternative providers and any interdependencies between an electricity network service provided by a DNSP and any other service provided by a DNSP in any other market.

We believe there is too much discretion around how the extent of barriers to entry and interdependencies could be assessed. We believe these require greater clarity to enable stakeholders to understand the parameters with which the AER will make its assessment. We support the position of the COAG Energy Council for a classification guideline to set out how the AER is to apply the factors in practice. We would anticipate this guideline could operate in much the same way as other existing guidelines apply.

With respect to the requirement to not change service classification unless a new classification is clearly more appropriate, we believe consistency across regulatory periods provides the market with certainty. However, where the market for the service has unambiguously altered, the classification should reflect its contestability and market characteristics at the time of classification.

We also note that if there has been no previous classification, the classification should be consistent with the previously applicable regulatory approach. We consider that this is unclear. We believe that each regulatory period that distribution services should be classified according to their potential contestability at that time.

Consultation Question

- a) *Are the NER clear regarding classifying direct control services as standard or alternative control services?*
- b) *Do the NER provide effective guidance to the AER in classifying direct control services into standard and alternative control services?*
- c) *Should the requirement to not change service classification unless a new classification is clearly more appropriate be removed?*

Correct classification between standard and alternative control services will lead to greater price transparency and the better allocation of services to a user pays approach. Furthermore, correct classification will facilitate contestability.

The AER must, in classifying a service have regard to, among other things: the potential for development of competition in the relevant market; possible effects on administrative costs; and the extent the costs of providing the relevant service are directly attributable to the person to whom the service is provided.

We believe that there needs to be greater certainty regarding how the AER will have regard to these requirements. As stated above, where elements of interpretation apply, we support the adoption of a Guideline to make clear what the AER's approach will be and how it apply these in practice.

In the event that the AEMC considers that clarifying the definition of a distribution system and the term 'in connection with' would not prevent a DNSP from directly operating in the contestable behind the meter market, then we strongly support the application of an alternative service classification as proposed by the AEC to address the definitional issues.

As stated above, we are strongly of the view that the promotion of efficiency, and notably dynamic efficiency, is best achieved when services are procured and supplied through a competitive market. We do not believe that allowing a DNSP to directly participate in the behind the meter contestable market for DER is consistent with the NEO and the original intent of the Hilmer Report which advocated for the separation of monopoly and competitive activities.

Consultation Question

- a) *Is there a problem with DNSPs having service delivery discretion in relation to demand response, network support and other inputs derived from assets located 'behind the meter'?*
If so:
 - i. *What is the problem?*
 - ii. *How material is it?*
 - iii. *Provide examples of the problem?*
- a) *Is the problem unique to demand response, network support and other inputs provided by means of assets 'behind the meter'?*

We agree with the position that a DNSP should only be allowed to recover the efficient costs of providing network services and that they should be incentivised to do so.

Specifying each specific project and program a DNSP should undertake during a determination period would require the regulator applying an engineering judgment about what the most appropriate solution is potentially years in advance without due recognition of the market conditions at that point in

time. The alternative would be for the regulator to make an annual judgement. Both scenarios are both impractical and inefficient.

For these reasons, a DNSP needs discretion to apply its judgement to achieve the most efficient investment solution at the relevant point in time. The role of the regulatory framework should be to establish a framework that incentivises a DNSP to pursue the most efficient solution and to punish the business for inefficient investments.

The current regulatory framework consists of multiple mechanisms that interact with one another and are collectively critical to providing incentives and signals post a revenue determination. It is imperative that all mechanisms operate in tandem and as intended to ensure the completeness of the regulatory framework. In this regard, we believe an assessment of the effectiveness of these schemes is warranted to ensure they are not producing unintended consequences, especially for contestable services such as DER.

Furthermore, we note that the AER's Ring-fencing Guideline requires a DNSP to deal with competitors of its related businesses on substantially the 'same terms'. However, we also note that a DNSP is only required to demonstrate the adequacy of its procedures upon reasonable notice.

Where a related business operates in direct competition with other providers it is imperative that each party competes on equal terms. A compliance framework with only enforcement powers and no mandated penalties will not act as a credible threat. While we recognise that this issue is outside of the AEMC's current scope, the potential for a DNSP to discriminate between parties and investment options needs to be recognised.

With respect to ensuring that when a DNSP adopts a DER solution that it is the most efficient option, we believe that this can only be achieved through a transparent and robust cost allocation method and a more granular RiT-D. In this regard, we support the proposal put forward by the AEC to impose a lower RiT-D threshold to provide this necessary transparency.

Consultation Question

- b) Is an objective for service classification in the NER necessary? For example, COAG Energy Council considers the NER should be more explicit in providing that only services which exhibit natural monopoly characteristics should be economically regulated.*
- c) Should the steps of service classification be informed by the same considerations? For example, should all service classification steps be based on market characteristics, rather than on the form of regulation that applies to the service?*
- d) Within this framework, should new classification(s) be added? d) The proponents of the rule change requests consider that service classification is no longer only determining which services are economically regulated and which are not. It is increasingly having significant effects on the application of the distribution ring-fencing, cost allocation and shared asset guidelines. Should the AER expressly be required to have regard to the interaction of service classification with these other forms of regulation?*
- e) Are the NER clear as to what can and cannot be classified? If not, what changes would be required?*

In a well-functioning market, supply choices and the corresponding investment decisions are driven by price signals. When markets are integrated or dependent on a monopoly intermediary, the regulatory framework must ensure this does not compromise upstream and downstream market-driven environments. Therefore the relationship between the monopoly DNSP and its related businesses can greatly impact competitive outcomes.

For this reason we strongly support the views put forward by the AEC that where a service is dependent on assets as a conduit to the market that the AER must expressly consider the interaction of its service classification with other regulatory instruments that safeguard the integrity of competitive markets.

Consultation Question

- a) *Does the regulatory framework provide balanced incentives for DNSPs to use the most efficient mix of:*
- i. *network or non-network options?*
 - ii. *capital and operating expenditure?*
 - iii. *a range of technologies?*
 - iv. *assets that are positioned behind or in front of the meter?*
 - v. *providing the services "in-house" or procuring the services from other parties?*
 - vi. *procuring the services from third parties or related entities?*

The Rules requires that the AER must accept the forecast of required expenditure of a DNSP that is included in a building block proposal if the AER is satisfied that the total of the forecast expenditure reasonably reflects the efficient costs of achieving the expenditure objectives.

In deciding whether or not it is satisfied, the AER must have regard to, among other matters: the substitution possibilities between operating and capital expenditure; whether the capital expenditure forecast is consistent with any incentive scheme or schemes that apply to a DNSP; and the extent a DNSP has considered, and made provision for, efficient and prudent non-network options.

However, we believe that there is an incentive for a DNSP to prefer capital expenditure. The reason being that operating costs are expensed and recovered within the regulatory year that they are incurred. They are effectively a pass-through, notwithstanding a DNSP can achieve some efficiency rewards from outperforming their benchmark allowance.

Capital expenditure on the other hands attracts both a return on debt and a return on equity. Shareholders achieve a return on their investment based on the return on equity component. Therefore, the incentive for shareholders is to maximise the capital investment. We believe this produces a perverse incentive towards capital solutions.

A DNSP should be incentivised to source DER and other technologies from the contestable market. This incentive should be sufficient to encourage a DNSP to acquire these services but not exceed the savings that would otherwise accrue from deferred or avoided capital spend. Identifying the value that would achieve this balance is dependent on the robustness of a DNSP's reporting information and the AER's cost allocation guidelines. We believe these instruments are not sufficiently mature to provide rigorous or correct incentives. The cost allocation guidelines require rigorous review given they have not been assessed following the AER's revised ring-fencing guidelines and in many instances have not been updated for near a decade.

Consultation Question

- a) *Is there a problem with the current planning framework in relation to network support and demand management? If so:*
- i. *What is the problem (e.g. the detail or timeliness of relevant information; DNSPs being both the decision-maker of investment decisions and the asset owner)?*
 - ii. *How material is it?*
- b) *Provide examples?*

We consider that the key issue associated with the current planning framework is ensuring that a DNSP demonstrates how it has considered non-network in their planning considerations. In this regard we see two obstacles: 1) ensuring that a DNSP does not confer a competitive advantage in favour of its related businesses that provide contestable energy-related services; or 2) that there is not a bias towards network solutions.

In terms of the former, it is essential that a DNSP provides exactly the same level of information, connection standards, turnaround times etc to all parties at the same time to ensure a level playing field. Providing this information to the market would act as a mechanism to stimulate competitive outcomes for behind the meter network support services. It would enable a range of service providers to offer different solutions while building a greater understanding of emerging network issues; this in turn can facilitate greater competition going forward. Failure to ensure all relevant information is provided on equal terms will create a bias towards a DNSP's related business and limit the effectiveness of the market.

For this reason, the planning framework should signal to the market in a transparent and accessible format where DER may be a practicable solution in specific geographic locations and over what time period. Not only would this meet the obligation of equal access to information, but it would act as a mechanism to stimulate competitive outcomes for behind the meter network support services.

Consultation Question

- a) *Does the combination of the cost allocation principles in the NER, the AER's cost allocation guideline and the DNSPs' CAM provide for efficient cost allocation in relation to assets that can provide both direct control services and network support or demand response?*

The current cost allocation guidelines were approved in 2008, and in the case of the Victorian DNSPs their cost allocation guidelines are still based on the Essential Services Commission cost allocation guidelines developed in 2003.

One of the principal reasons for establishing a national ring-fencing guideline was that the jurisdictional guidelines were no longer fit for purpose. This reasoning must also extend to key supporting guidelines such as cost allocation. On the basis that existing guidelines have remained in place since 2008, it is essential that they are reviewed as a matter of priority to ensure they are fit for purpose and support the integrity of the revised national ring-fencing guideline. Any review must be through a consultation process consistent with the Rules.

Furthermore, in reviewing the allocation of costs, the AER should devote greater attention to how a DNSP determines forward looking prices and ex post cost allocations and the relationship between these two inter-related cost/revenue items, rather than the existing approach where costs for these services are simply allocated on an ex poste basis.

We also support the views of stakeholders at the AEMC's public forum that advocated transparent transfer prices. We consider the internal charging for support services needs to be more rigorous and

transparent than the current ex post allocation and there is merit in considering options such as a forward looking transfer price.

Consultation Question

a) *Does the shared asset guideline provide efficient incentives for DNSPs to invest in assets that can provide both direct control services and other services? If not:*

- i. *i. What is the source of the issue?*
- ii. *ii. What is the extent of the issue?*

b) *iii. Provide examples?*

The Shared Asset Guideline sets out the arrangements when regulated assets are used to generate unregulated revenues. A key feature of the shared asset principle is to ensure that a DNSP does not recover the costs of network assets twice; once from regulated revenues and again from unregulated revenues.

Origin understands that when a DNSP establishes an asset it determines the proportion of the asset use for regulated purposes and the portion for unregulated using a DNSP's cost allocation method. A shared asset arises when the use of the regulated asset changes after its initial cost allocation.

The AER will make a cost reduction if the unregulated use of the shared assets is expected to be greater than one per cent of a DNSP's total smoothed annual revenue for that regulatory year. For larger networks such as Energex and Ausgrid this trigger amount is of the order of \$17M per annum, with the cost reduction being 10 per cent of shared asset unregulated revenues.

A DNSP should be incentivised to maximise the use of their regulated assets. However, when the relationship is with a related party, competitors are relying on the effectiveness of cost allocation to ensure that the financial incentive provided to a DNSP does not cross-subsidise the charge for the use of the shared asset. We believe that where a related business operating in energy-related services uses a shared asset (e.g. a truck), the rate paid for the use of that shared asset must be forward looking and commensurate with a market rate.

Not only must the AER's Shared Asset Guideline and cost allocation be assessed to determine that it does not result in biases towards related parties, but compliance must be rigorously and transparently assessed annually to ensure these schemes deliver their intended outcomes.