

9 February 2017



Mr John Pierce
Chairman
Australian Energy Market Commission
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Chief Executive Officer

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Dear Mr Pierce

RE: AEMC Consultation Paper – National Electricity Amendment (Contestability of energy services) Rule 2016 and National Electricity Amendment (Contestability of energy services – demand response and network support) Rule 2016

Ausgrid is pleased to provide comments in relation to the AEMC's consultation paper on the rule change requests submitted by the COAG Energy Council and the Australian Energy Council (AEC) (the proponents) in relation to the contestability of energy services.

We have identified a number of key issues arising from the rule change requests and the AEMC's consultation paper, which are discussed in the attachment. The attachment also responds to each of the questions posed by the AEMC. We look forward to the opportunity to provide further input as the issues are defined in more detail, and specific options are developed.

In summary, Ausgrid considers that the scope of issues on which the consultation paper seeks comment is very broad with little in the way of specific proposals or options. In addition, the proponents have not provided adequate reasons for their concerns, nor substantiated their claims with supporting evidence. The current regulatory arrangements provide efficient incentives to DNSPs in the situation where they invest in an asset which can provide both regulated and unregulated services (such as battery storage) – whether or not the asset is located 'behind the meter' (BTM) on a customer's premises.

The AER's ring-fencing guideline addresses many of the concerns put forward by the proponents in relation to the behaviour of DNSPs in potentially contestable markets. DNSPs must comply with this guideline as soon as practicable and no later than 1 January 2018.

It is premature to propose further changes before the guideline has been fully implemented and its impact has been assessed.

A core feature of incentive-based regulation is to give DNSPs incentives to seek out the most efficient way to deliver network services while meeting demand and reliability standards. It is in Ausgrid's interests that a competitive market in battery storage develops and that customers have greater demand response capability, in order to provide more cost-effective alternatives for the delivery of network services.

It is important that the National Electricity Rules (NER or Rules) continue to support flexibility for DNSPs to determine the type and scope of arrangements they can consider in order to deliver network services most efficiently. We do not support restrictions on asset ownership, or prescriptive procurement requirements for DNSPs. Removing the existing flexibility would undermine the current regulatory framework, add additional costs for customers, and would not enhance the long term interests of customers.

We also note that some regulated assets installed BTM are used solely for regulated purposes (eg, load control), and it would be inappropriate to use BTM as an arbitrary delineation point between regulated and contestable services. The AEMC needs to be wary of proposing changes which have unintended consequences, prevent efficient investment by DNSPs, or increase the burden of regulatory compliance where existing regulations are sufficiently robust.

Ausgrid does not currently own any embedded generation or energy storage assets located behind customer meters, while there are about 500-1000 battery systems and more than 100,000 embedded generators installed directly by customers. Ausgrid's view is that DNSP investment in distributed energy resources (DER) should be viewed as additional to, not a substitute for, customer investment in DER.

Ausgrid does not support moves to allow the reclassification of services within a regulatory control period. The current process provides an appropriate balance between stability and flexibility in the regulatory framework. Changing service classifications within a regulatory period would increase uncertainty for DNSPs and customers, damage investment incentives, and cause complex flow-on effects in terms of adjustments to a range of variables such as the regulated asset base, allowed revenue and prices.

As mentioned above, we are concerned that the scope of issues on which the consultation paper seeks comment is very broad with little in the way of specific proposals or options. We understand that this may reflect the early stage of the consultation process. Nonetheless, it is important for the proponents of any changes first to demonstrate that problems exist (or are likely in the future) and that they are not resolved by existing or proposed regulation. At that point specific proposed changes can be tested by opening them for comment by interested parties.

We support the AEMC's intention to undertake ongoing consultation as part of the rule change process. We also stress the importance of releasing an options paper as part of the consultation process, to enable interested parties to respond in detail to specific proposals and their potential impact before preparation of any draft rule change.

There is also significant uncertainty about the interaction between these rule changes and Ausgrid's upcoming regulatory determination. Ausgrid is concerned that the proposed timetable for the AEMC rule change process will not leave sufficient time for Ausgrid to consider the implications as part of the upcoming regulatory determination process, particularly given the fundamental nature of some of the proposed changes.

We seek reassurance that the AEMC will only introduce changes for implementation in the next regulatory determination if there is sufficient time for DNSPs to implement and transition to such changes, and to consider the implications of any changes for the wider revenue determination.

If you have any queries or wish to discuss this matter in further detail please contact Joe Pizzinga, Chief Financial Officer on (02) 9269 2121 or via email jpizzinga@ausgrid.com.au.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Richard Gross', with a stylized, flowing script.

RICHARD GROSS

Chief Executive Officer

Attachment – Ausgrid’s Submission on Contestability of Energy Services

1 Introduction

Ausgrid has identified a number of key issues arising from the rule change requests and the AEMC’s consultation paper, which are discussed in section 2 below:

1. The process for consultation and development of recommendations;
2. Articulating and demonstrating the problem to be addressed;
3. Is service classification the right vehicle to address concerns?
4. Consistency with the incentive-based regulatory framework;
5. Flexibility of the regulatory framework to adapt as technology changes;
6. Flow-on effects of any changes to the regulatory framework; and
7. Consistency with other regulatory reviews and regulatory changes.

Section 3 responds to the individual consultation questions raised by the AEMC.

2 Key Issues

1 Process for consultation, development and implementation of options and recommendations

Ausgrid appreciates the opportunities provided by the AEMC to consult regarding possible rule changes. The AEMC’s consultation paper is a useful document because it sets out the background to the issues and their place within the regulatory framework for DNSPs.

However, we are concerned that the scope of issues on which the consultation paper seeks comment is very broad, while there is little in the way of specific proposals or options. We understand that this reflects the early stage of the consultation process. Nonetheless, in framing our submission our initial response is relatively broad. As the specific issues and options the AEMC is considering are clarified, we look forward to the opportunity to provide a more detailed, focused submission on those specific issues. Our understanding is that this opportunity will be made available over the coming months as the AEMC progresses its thinking on the various issues involved.

Furthermore, we believe it is important to test any proposed changes by opening them for comment to interested parties. We therefore encourage the AEMC to release an options paper as part of its consultation process, to enable interested parties to respond to specific proposals and their potential impact in detail. In addition, stakeholders should have the opportunity to comment on the detail of any options prior to the draft determination stage – this provides the best chance to avoid unintended consequences and to craft a rule change that promotes the National Electricity Objective (NEO).

The AEMC’s indicative project timeline suggests that a draft determination (or options paper) will be published in September 2017. Depending on the nature of the final changes, the AEMC may seek to implement some or all of the changes (particularly those relating to service classification) from the start of Ausgrid’s next regulatory period.

We are concerned this timeline will not leave sufficient time for Ausgrid to consider the implications as part of the regulatory determination process. The AER is expected to publish its final Framework and Approach Paper by July 2017. Ausgrid will submit its revenue proposal in January 2018, with the AER making its draft determination in August 2018.

Ausgrid is concerned about the potential for uncertainty regarding the interaction between these rule changes and the regulatory determination. We seek reassurance that the AEMC will only introduce

changes for implementation in the next regulatory determination if there is sufficient time for DNSPs to implement and transition to such changes, and to consider the implications of any changes for the wider revenue determination.

2 Articulating and demonstrating the problem to be addressed

Ausgrid's view is that the proponents have not demonstrated clearly any inadequacies in the current regulatory framework that justify changes to the NER. Furthermore, the proponents have not recognised the damaging impact of their proposals on the regulatory framework, and the potential additional costs to consumers.

The general concern driving the proposed rule changes is that the current regulatory framework is not 'fit for purpose' in light of rapidly changing technology in the energy sector. In particular, new technologies may allow greater competition in network services, or may create markets in new non-regulated services. The proponents are concerned that aspects of the current regulatory framework will not ensure that competitive markets thrive, and that customers will not benefit from dynamic efficiencies which result in a greater range of services at the lowest cost.

Within this broad area of concern are a number of more specific issues. In order to assess the adequacy of the current framework and any potential deficiencies, it is important to dissect each individual concern and analyse whether there is any basis to revise the NER for the long term interests of customers. Both proponents have drawn attention to the potential situation where a DNSP installs an asset behind the meter (BTM) and then it (or a ring-fenced entity) on-sells competitive services enabled by that asset.

While there seems to be general unease about the role and behaviour of DNSPs, there is little evidence that these concerns are borne out in practice in the current market. In fact, if the incentive framework was inadequate many of the behaviours suggested by concerned parties (such as DNSP dominance of contestable markets) would already be occurring – yet no evidence of this has been provided by the proponents. The markets for hot water storage and home battery storage are cases in point – the hot water storage is well established and the home battery market is still emerging, but DNSPs have virtually no involvement in either market.

We also note that the COAG Energy Council's rule change seeks to "promote the development of competitive markets for new technologies that are capable of providing services in both contestable and regulated markets".¹ The focus of the AEMC's deliberations must be assessing whether the rule change proposals promote the NEO and the long term interests of electricity customers, not solely focus on the impact on competition in contestable services. Promoting competition in contestable services is only one of many implications for customers that are consistent with this objective, and the AEMC needs to make an assessment having regard to the multiple impacts across the market.

Ausgrid is concerned that the proponents have not fully evaluated the substantial damaging impacts on the economic regulatory framework and the extra costs for regulated customers that would result from the rule changes proposed.

3 Is service classification the right vehicle to effect change?

As noted by the AEMC, changes to the approach to service classification are not the appropriate means to address the proponents' concerns. Ausgrid agrees with the AEMC's clarification that economic regulation is based on services, not assets.

Service classification is important to electricity customers because it determines the need for, and scope of, regulation which applies to different network services. Therefore, service classification under the NER significantly affects how the efficient costs of providing the services are determined and charged to customers.

¹ AEMC, Consultation Paper, National Electricity Amendment (Contestability of energy services) Rule 2016, 15 December 2016, p1.

The rule changes seek to effect change by requiring DNSPs to procure some inputs from contestable markets rather than investing in the assets to provide such inputs (such as battery storage devices). However, as noted by the AEMC “this is unlikely to be possible” via changes to the framework for distribution service classification, “because these are not services that can be classified within distribution service classification”.²

Instead, it is necessary to examine the *services* provided by assets such as batteries to assess which, if any, should be subject to economic regulation. Similarly, the *location* of the asset (which side of the meter it is located) is not the key factor determining whether it is associated with a service that is either regulated or not regulated.

4 Consistency with the incentive-based regulatory framework

Ausgrid does not believe the rule changes proposed are consistent with the incentive-based framework for network regulation. This applies both to the proposal to require DNSPs to procure some inputs to their network services, and the proposal to allow reclassification of services within a regulatory period. Furthermore, Ausgrid believes that allowing DNSPs to own assets such as batteries BTM does not impede customer choice in contestable markets.

The regulatory framework for DNSPs is based on the principle that DNSPs are constrained by a revenue control which allows them to recover a given amount of revenue while providing network services to an agreed standard. Where a DNSP can provide these services at a lower cost, they are able to share the benefit of the reduced costs with customers over an agreed period. This gives DNSPs an incentive to provide network services in the most cost effective way.

The existing regulatory framework reflects a demonstrated balance between regulatory certainty and discretion, and between prescriptiveness and flexibility. Any changes to this balance need to be carefully considered in terms of the likely impact on incentives and the long term interests of customers.

A key tenet of the current regulatory framework is a defined regulatory control period (currently 5 years), within which the main regulatory controls are held constant. If the regulatory controls are subject to ongoing review and there is a risk of service reclassification within the regulatory period, the incentives for efficiency will be eroded and the incentives for investment will be compromised.

For this reason Ausgrid does not support reclassifying services within the regulatory period. This would increase uncertainty and the risk of stranded assets, because DNSPs may make investments on the basis of existing service classifications but then find the service is reclassified and they are unable to recover the costs associated with those investments via regulated revenue. As a result the required rate of return would increase to reflect increased risks.

The consultation paper discusses whether DNSPs should be required to procure some inputs from contestable markets including network support, demand management and inputs provided by assets located BTM. The Energy Council proposes that DNSPs should not be barred from owning assets that are BTM, but that they must be held and operated within a ring-fenced entity, to ensure competitive neutrality in the DNSP’s purchasing activities. The AEC goes further to suggest that the DNSP should not be able to own these assets.

Increasing the prescriptiveness of regulation by requiring DNSPs to procure some inputs is likely to increase costs to customers because it reduces the ability for DNSPs to adopt new technologies or innovative service delivery.

DNSPs have successfully owned and operated load control devices BTM for over 50 years without any concerns being raised about whether this is appropriate. Ausgrid currently has almost half a million customers on load control via the use of hot water storage. There is substantial customer

² AEMC, Consultation Paper, National Electricity Amendment (Contestability of energy services) Rule 2016, 15 December 2016, p12.

value in the load control provided by the DNSP via a cheaper tariff. Additionally, having the capability to dispatch significant controlled load during off peak periods greatly contributes to the reliability of the network. The loss of controlled load would have significant consequence for network reliability and performance.

To ensure that DNSPs have the flexibility to use the most cost effective approach to providing regulated services, Ausgrid does not support any blanket limitation on the type of assets they can own (either directly or in a ring-fenced entity). Such a prohibition could also lead to extra costs for customers due to the additional transaction costs and risks associated with the procurement approach. Also it is not clear how such a prohibition would work with other regulatory arrangements, such as the demand management incentive scheme.

The AEC's assertion that competition in new technologies will be thwarted if networks invest in such technologies is mistaken. Their proposal for extensive regulation fails to recognise the following points:

- DNSPs will only consider installing batteries BTM when they address a network limitation. This will limit both the location and timing of a DNSP's investment so that it is likely to be a small proportion of the overall potential market for batteries, given the potential value they offer customers, who will respond to price signals that reflect value over the full supply chain.
- If a DNSP invests in an emerging technology and wants to earn a regulated revenue stream on the asset, the AER will assess whether this investment is efficient. Part of this assessment is whether there will be sufficient DER provided through the competitive market to address the network limitation, without any regulated investment. We expect that the AER will make these assessments taking a forward looking view of the potential growth in residential battery storage, with AEMO battery forecasts providing an independent point of reference.
- Not all regulated assets installed BTM have additional functionality which could be used to sell different services to customers in the competitive market. The primary example of this load control devices that are currently installed. Ausgrid notes that many of the smaller metering providers/retailers do not have the capability to deploy load control using an advanced meter, and have therefore requested that load control continue to be provided via the DNSP's equipment. If the AEMC constrained the inability of DNSPs to continue to offer this service, it would be likely to result in a loss of competition among metering providers.
- Where an asset is used primarily to provide a regulated service, the DNSP will be constrained in its ability to compete with competitive service providers in relation to contestable services, because they need to ensure the regulated asset will be available when it is required for network services. This will limit the nature of the related services that a DNSP could offer in the competitive market. It means that the essence of the service offered by a DNSP will differ from those services available from competitive providers.

For example, if a DNSP installs battery storage to manage peak demand, the DNSP will need to ensure that it has the first option to utilise the stored electricity. Therefore other load management services available for offer will be constrained by the primary use of the asset, which is to manage network constraints.

For these reasons, allowing NSPs to offer such services does not impede customer choice in contestable markets.

5 How well does the regulatory framework adapt to technological change?

The existing regulatory framework has a number of features which encourage dynamic efficiency in the electricity sector, and the adoption of new technologies, while providing a stable regulatory environment which is in the long term interests of consumers.

First, DNSPs have discretion in terms of the manner in which they provide network services, so are able to investigate and adopt new technologies as they become cost-effective. As noted above, incentive-based regulation provides DNSPs with incentives to adopt cost-effective new technologies because they are able to retain the benefits for a period of time, while also sharing the benefits with customers. The incentives driving cost-savings are at the heart of incentive-based regulation.

Secondly, the regulatory framework offers flexibility over time as the landscape changes in relation to network services. The AER has discretion over a range of components of the regulatory framework, including:

- Adapting incentive schemes; and
- revising service classifications as part of its framework and approach for each periodic regulatory review.

The AEMC notes that Synergies questioned whether the current arrangements would be able to reclassify services from regulated to contestable fast enough to keep pace with market developments.³ The current regulatory framework enables services to be reclassified on a regular basis (each regulatory period). Ausgrid considers this to be an appropriate balance between adapting to new technologies, and providing a stable regulatory environment for market participants, including both DNSPs and customers. It establishes a consultative process, and allows the key regulatory variables to be set with a degree of certainty and stability for that period.

If the economic framework moves towards greater flexibility to adopt new technologies and allow contestability in new areas, this may have implications for network regulation and pricing. The costs of investment may need to be recovered via either a shorter asset life (recognising that the economic life of a regulated asset may be shorter due to technological change) and/or a higher return on investment, reflecting the risk of assets being stranded as technology changes.

6 Flow-on effects of changes to the regulatory framework

Changes to individual aspects of the regulatory framework could lead to significant damaging flow-on effects elsewhere in the framework. For example, if service classifications are changed in the middle of a regulatory period, it will require complex adjustments to a range of variables such as allowed revenue, the regulatory asset base, and prices. This leads to uncertainty for DNSPs and customers, increases risks for DNSPs and erodes the incentive properties of the regulatory framework. This option should be rejected by the AEMC.

7 Consistency with other regulatory reviews and regulatory changes

As noted by the AEMC there are several reviews being undertaken or implemented by the AEMC and the AER. The industry needs a coherent, coordinated approach to these reviews to ensure that the changes are made in a consistent manner and consider the incentive properties of the regulatory framework as a whole.

For example, DNSPs will be implementing the AER's ring-fencing guideline this year, and this guideline addresses many of the alleged concerns put forward by the proponents in relation to the behaviour of DNSPs in potentially contestable markets. It is premature to propose further change before the guideline has been fully implemented and its impact has been assessed.

Ausgrid is concerned about the level of uncertainty in the market created by the proposals and encourages the AEMC to clearly articulate the problem to be assessed and the range of options being considered in future consultation.

³ AEMC, Consultation Paper, National Electricity Amendment (Contestability of energy services) Rule 2016, 15 December 2016, p4.

3 Response to AEMC Consultation Questions

This section responds to the specific questions raised in the AEMC consultation paper.

Question 1

- (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?**

Overall Ausgrid does not consider that there is a problem with the current process for distribution service classification, and strongly disagrees with any suggestion to allow reclassification within the regulatory period. The potential to allow reclassification will undermine investment and lead to extra costs for customers.

In our opinion, the current approach does not suffer from a lack of clarity over service classification. There is a high level of continuity in the service classifications between different regulatory control periods, while the current Rules have the benefit of permitting changes to classifications where appropriate at the start of each period.

This flexibility is important as Ausgrid's view is that a sufficiently granular analysis of each electricity distribution service needs to be conducted at the time of each determination, against the relevant criteria in the NER. This analysis needs to take into account jurisdictional differences, the specific characteristics of each service and the expected local market conditions in the next control period. There is a risk that in grouping similar sounding services and applying a common approach to classification and regulatory control, such factors would not be taken into account. For example, the contestability framework in NSW differs from other DNSP jurisdictions in that if a retail customer is funding the design and/or construction of connection assets, they can choose an accredited service provider (ASP) to undertake that work.⁴

Any move towards more nationally uniform service descriptions would need to consider carefully how to adequately reflect important differences in circumstances and jurisdictional legislation across different networks. Furthermore, it is not clear what benefits would accrue to customers from requiring greater uniformity in service classifications across different jurisdictions, where underlying characteristics suggest that these classifications should differ.

- ii. **does the timing of the framework and approach process (in advance of each distribution determination) inhibit stakeholder engagement on service classification decisions?**

The evidence does not support the COAG Energy Council assertion that the framework and approach process attracts little engagement from stakeholders.

During the framework and approach process for the current Ausgrid determination, the AER received over 50 submissions from a diverse set of stakeholders on a range of different issues. We expect that more stakeholders are now aware of this process and will participate in the consultation process in future.

Furthermore, there could well be less stakeholder engagement on service classification if the AER's consideration of classification were to be merged into the general distribution determination processes and combined with all the other issues.

⁴ The NSW Government introduced contestability for certain electricity distribution network connection services in 1995. The Electricity Supply Act 1995 and the Electricity Supply (General) Regulation provide a framework for retail customers to choose a third party accredited service provider (ASP) to undertake electricity connection works. The Electricity Supply (General) Regulation 2001 covers the accreditation process.

(b) Would a distribution service classification guideline increase clarity regarding distribution service classification?

Ausgrid considers that the option of a guideline requires further consultation during the rule determination process. The merit of a guideline will depend on whether other changes are made to the regulatory arrangements being considered. There may be greater merit of having a guideline if the AEMC decides to provide greater discretion to the AER in relation to service reclassification.

The concerns raised by the proponents seem to relate to the situation where a network business installs the technology to assist in providing regulated services (eg, demand response) and then attempts to offer other incremental services to the customer which are enabled by the technology. In such a situation, the AER would need to consider how to classify the incremental services and whether they are distribution services. A guideline could potentially help to provide direction to stakeholders as to how the AER would consider these issues.

(c) To what extent does service classification being locked in over the regulatory control period create a lag in appropriate reclassification of services?

In Ausgrid's view, the COAG Energy Council is mistaken in suggesting that by keeping service classification constant over a regulatory control period, the regulatory arrangements fail to keep pace with technological change. Furthermore, allowing the AER to reclassify within the regulatory control period undermines the five year control period and its associated incentive properties. The rule change proposal does not provide any examples where the current arrangements create an inappropriate lag which disadvantages customers.

In our opinion, the issues raised by the COAG Energy Council relate not to the reclassification of existing services, but instead whether the current process facilitates new incremental services driven by regulatory investment in emerging technology during the regulatory period. In relation to the prospect of technological change, there are two factors to consider:

- First, in proposing services for classification, DNSPs have a strong incentive to ensure that the list of services classified is complete and fit for purpose for the forthcoming regulatory control period. This incentive has been reinforced by the AER decision to base its ring-fencing obligations on service classification. Failure to have a service classified for the next period will mean that the DNSP cannot recover the costs through regulated revenue and will result in such services being considered as competitive services for the purposes of ring-fencing. Therefore there is an onus on DNSPs to consider potential technology advances and identify potential new regulated services at the start of the regulatory control period.
- Secondly, the proposal to allow reclassification reflects a confusion between a service and an asset. Technological advances may enable a DNSP to provide their regulated services using different solutions to those originally envisaged, but the characteristics and essence of the regulated service will remain the same for the customer, and hence the classification remains appropriate. In fact, the regulatory framework encourages DNSPs to utilise new technology where it is more efficient to do so. Therefore technological advances provide new means to provide services, but should not change the role of a DNSP and the scope of its regulated services.

In addition, Ausgrid considers that it is inappropriate to focus solely on the question of whether there is a lag in the AER's ability to classify services consistent with market conditions. Service classification is an integral component of the economic regulatory framework applying to networks and cannot be viewed in isolation. Under the NER, service classification is tied to the form of control which in turn determines the approaches and methodologies employed by the AER to assess the efficiency of revenue proposals.

Therefore the timing of the AER's ability to reclassify services is dependent on the view taken of the appropriate length of the regulatory control period. Allowing the AER to reclassify within the

regulatory control period undermines the five year control period and its associated incentive properties.

(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?

In Ausgrid's view, permitting reclassification of services within a regulatory control period will fundamentally change the application of the economic regulatory framework. We agree with the list of changes that the AEMC identified would be required in section 4.3 of the consultation paper. In addition to these changes, any reclassification would also have implications for:

- Annual Pricing Processes and the application of the over/unders account;
- Application of any pass-through adjustments and the identification of those customers subject to those adjustments; and
- Ring-fencing obligations.

Importantly, any reclassification would need to be subject to a robust and transparent consultation process together with an appropriate transition period for DNSPs and stakeholders to implement the changes. The consultation process cannot be limited to the proposed reclassification but must also allow for stakeholder consultation on all the potential impacts of the reclassification (ie, form of control and prices). In addition, sufficient time would need to be provided to allow for appropriate notification to customers of any price adjustments. This will be important for alternative control services.

Given the timing required for an effective consultation and transition period, Ausgrid questions whether reclassification within a period would be practically workable. Reclassification would effectively result in a material re-opening of the five year determination process.

(e) What would be the costs and benefits of allowing reclassification of services within a regulatory control period?

Ausgrid doubts there are significant benefits to customers from allowing the reclassification of services within a regulatory period, and cannot envisage a situation where reclassifying would be in the long term interests of customers.

The costs of any reclassification include both the administrative costs of processing a reclassification and the economic costs relating to the increase in uncertainty and its associated risks. Ausgrid is very concerned about the damage to investment and the resulting costs for customers. If changes can be made within a regulatory period, it is a less certain investment environment, which could lead to less investment, and/or a higher required rate of return.

DNSPs make investments in order to provide network services to an agreed standard, on the basis of a regulated rate of return. Investments are considered and planned in accordance with the five year regulatory period. If service classifications can change within a regulatory period this creates uncertainty regarding the treatment of expenditure and increases the risk of under-utilised or stranded assets.

The ability of regulated networks to undertake investment (and, more generally, to continue operating) depends on their having good access to capital markets. In turn, this requires that investors in regulated businesses have a reasonable expectation of and certainty regarding the operation of the regulatory regime over the regulatory control period.

Ausgrid also notes that the costs of allowing reclassification will depend on the particular service involved and its original classification. There are differences between the scenario where a standard control service is reclassified to an alternative control service, versus the scenario where a negotiated service is reclassified to an unclassified distribution service.

Question 2

(a) Does the definition of distribution services provide clear guidance regarding which services are distribution services and which are not?

From Ausgrid's perspective the current application of the NER definitions appears to be effective in providing clear guidance to the market. Further guidance would only be required if the AER does not have the ability to interpret the relevant terms contained within the NER, consistent with the long term interests of customers and the objectives of the economic regulatory framework set out in the NEL and NER.

The proponents do not provide sufficient justification that the AER does not have this ability to so. The AER will consider the scope of distribution services at the start of each regulatory period and will determine the appropriate regulatory treatment for any services provided by DNSPs in related to distributed energy resources.

The definition of distribution services plays an important role in the economic regulatory framework as it defines the scope of services performed by a network business which are central to the supply of electricity and which are therefore required to be subject to regulation in order to protect customers.

The service classification framework set out in Chapter 6 of the NER enables distribution services to be sub-divided into different categories so that the nature of regulation can be adapted to the particular characteristics of different type of services.

An assessment of the definition of distribution service cannot be done independently from the other definitions in the NER of distribution network and distribution system, as those terms are used within the definition of distribution service. Ausgrid understands that collectively these terms mean that the scope of distribution services includes:

- Services provided by means of a distribution network; that is, services relating to apparatus, equipment, plant and buildings used to convey, and control the conveyance of, electricity to customers;
- Connection services; and
- Any service provided in connection with the distribution system.

The question being raised by the proponents is whether, in the context of new and emerging technologies changing the nature of how electricity is used and produced, the term "in connection with" is causing confusion as to scope of regulated network services in relation to DER. The COAG Energy Council states the use of the term "in connection with" is contributing to a lack of clarity around the boundary between the regulated network services sector and the competitive part of the energy market. In a different context the AEMC itself considered there is some ambiguity in the interpretation of the definition of distribution service due to this term "in connection with".⁵

The question of whether the definitions provide clear guidance needs to be considered within the context of how the regulator applies the NER to determine the scope of services, and then how this is subsequently understood by stakeholders. Ausgrid does not see any problem in relation to these matters. At the start of each regulatory period, the AER makes it very clear which set of services performed by network business are subject to the regulatory framework under Chapter 6, and the nature of obligations applied to each service.

Therefore Ausgrid recognises that the term "in connection with" confirms that not all distribution services are required to be provided via the distribution system (ie, the distribution network and connection assets). This provides important flexibility to enable both:

⁵ AEMC, Integration of storage: Regulatory Implications, Final report, 3 December 2015, p13.

- a) networks to consider what options would be the most economically efficient solution to meet their regulatory obligations towards providing electricity supply towards customers; and
- b) the AER to regulate services provided by networks where doing so is in the interests of customers. This point was confirmed in the decision by Justice Logan in relation to the regulation of street lighting services provided by DNSPs.⁶

Therefore any option which seeks to limit the flexibility provided under this term will have substantial consequences for the regulation of network services.

In addition, when considering this question, the AEMC needs to consider and explain what would be the purpose and hence benefits to customers from providing greater guidance on the definition of distribution services. The proponents' position seems to be based on an assertion that clearer guidance is essential to promote the development of the competitive market in new technologies, because they consider that the boundary between the regulated sector and non-regulated sector is unclear.

However this assertion fails to recognise the fundamental purpose of classifying distribution services – that is, to protect customers through applying appropriate regulation of the costs incurred by network businesses.

An asset which is used by the DNSPs for regulated purposes will have different characteristics, functionality and value propositions than an asset purchased by the customer in the competitive market. For example, if a DNSP installs battery storage BTM for network support purposes and to manage peak demand, then the DNSP will need to ensure that it has the first option to utilise the stored electricity. This constrains the ability of the customer to use the battery storage and will limit the nature of the any related services that DNSP could offer in the competitive market from that asset. In addition, the Rules regarding network planning, ring-fencing and shared assets already provide sufficient power to the AER to regulate the ability of DNSPs to offer incremental services to customers using regulated assets.

Further, DNSPs' proposals for investment in DER assets for regulated purposes will only be deemed efficient if the AER considers that there will be insufficient DER capability provided through the competitive market needed to address the network limitation. The bulk of the benefit derived from these technologies can only be captured by the customer since they are exposed to the full costs of the electricity supply chain and any demand management activities by networks would sensibly seek to leverage a customer's investment rather than replace it.

(b) What types of changes could be made to clarify the term?

Ausgrid considers that any changes to clarify the term must:

- be consistent with the definitions in the National Electricity Law (NEL); and
- allow choice in technology.

First, any amendments to the definitions relating to distribution services in the NER must be consistent with the relevant definitions contained in the NEL. The NEL defines electricity network service as “a service provided by means of, or in connection with, a transmission system or distribution system”.

Therefore any rule changes being considered to clarify the scope of distribution services should be limited to those which help to provide interpretation and guidance on the meaning of the term “in connection with”. Amendments which seek to either confine the boundary of the distribution system or prohibit certain technologies from being classified - as proposed by the COAG Energy Council and

⁶ Ergon Energy Corporation Ltd v AER [2012] FCA 393 (Ergon Energy Case)

AEC - should not be considered as they would be inconsistent with the economic regulatory framework for network businesses as set out in the NEL.

On this matter, Ausgrid notes that Western Power has submitted a rule change concerning clarification of the scope of distribution services in relation to non-network options. This rule change is related to the issues discussed in this consultation paper and it will be important that these proposals are considered in a concurrent and consistent manner. We question why the AEMC has not included the issues raised by the Western Power rule change proposal in this consultation paper.

Secondly, any change to the term being considered must not be specific to certain types of assets or investments. Trying to regulate for certain outcomes through greater prescription on new technologies will undermine the robustness of the NER and is likely to create technology biases and unintended consequences. The definition of distribution services must maintain the current flexibility for the network to consider how to provide regulated services in the most economically efficient manner.

(c) What would be the pros and cons of changing the definition of distribution services?

Ausgrid is concerned about the regulatory impacts and uncertainty caused by changing the definitions relating to service classification. Classification is important to electricity customers because it determines the need for, and scope of, regulation applied to distribution services central to electricity supply.

Ausgrid considers that the current arrangements have been proven to work well and any changes to the current arrangements will have material impacts across the regulatory framework, which will ultimately lead to extra costs for consumers.

We also support the AEMC's comments that changing the service classification arrangements will not address the perceived concerns raised by the proponents. Ausgrid agrees with the AEMC that changing the definitions to exclude certain assets and new technologies from being classified as direct control services would prohibit DNSPs from being able to use these assets in providing regulated network services as the costs will not be able to be included into the revenue allowance under Chapter 6 of the NER.

Attempting to impose a more precise scope of distribution services through amending the definitions is likely to result in an arbitrary confinement on the scope and nature of the services provided by a distribution business. The concerns raised by the proponents are driven by the possibility that a DER technology - such as battery storage - is capable of simultaneously providing value streams to both consumers and networks. However we consider that it is likely to be too difficult to practically achieve a precise boundary of regulated network services through the definition, and attempting to do so may impede the DNSP from deploying efficient solutions.

In Ausgrid's view the proponents have not provided evidence of any harm which needs to be addressed. The regulatory framework as a whole provides a consistent set of incentives and obligations which encourage DNSPs to adopt the most cost-effective means to provide network services, without impeding the development of new technologies or competitive markets in contestable services. A prescriptive approach which limits the ability of DNSPs to own particular types of assets at particular locations may actually reduce the ability of DNSPs to deploy non-network solutions and new technologies to provide network services.

Therefore it is more appropriate for the AER to make the decision on the scope of distribution services during the regulatory determination and the associated framework and approach process, taking into account relevant factors and the nature of the services offered by DNSPs.

Question 3

(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?

Ausgrid believes the underlying intent of the form of regulation factors is appropriate, as is the AER's approach to applying those factors. Any uncertainty about the manner in which the AER applies the form of regulation factors could be reduced by the AER publishing a guideline, which Ausgrid would support subject to further consultation with stakeholders regarding its development and content.

There is a need for the AEMC to take a coherent and consistent approach across the various components of the service classification framework and to maintain the principle that the AER has the flexibility to apply and adapt the form of regulation to the characteristics of the particular service.

The purpose of classifying network services between different categories is to enable the framework for regulation of revenues and prices to be adapted to the specific characteristics and nature of the services being provided. This avoids, for example, all of the services provided by the network service provider being subject to a full building block methodology to determine allowed revenues. The current form of regulation factors and NER clause 6.2.2 act to ensure this.

The COAG Energy Council is concerned that the classification process is not keeping pace with technological changes, but Ausgrid considers this concern to be misguided. There is no reason to believe that the form of regulation factors become less 'fit for purpose' in the face of technological change. Furthermore, the reassessment of service classifications at each regulatory review provides the flexibility for the AER to respond to changes over time.

(b) Should the requirement to not change service classification unless a new classification is clearly more appropriate be removed?

Ausgrid does not support removing the requirement to not change service classification unless a new classification is clearly more appropriate. Regardless of the genesis of this provision, it is sound regulatory practice to require evidence that changes to the regulatory framework - including reclassifying services - will be preferable (or more appropriate) than existing arrangements. Reclassifying services can have a significant impact on both DNSPs and customers, so it is appropriate that changes must be justified.

Ausgrid's view is that the NER already gives the AER ample discretion to reclassify services, through the regulatory review process, and ensures that reclassification occurs only after consultation with stakeholders and consideration of the likely benefits and costs of reclassification. No evidence has been provided of problems with the current requirement to show that a proposed change in service classification is clearly more appropriate. The AER has reclassified many services in the past. As noted by the AEMC, "large customer connection services in Queensland are only one of many services that the AER has reclassified away from standard control services to support the provision of such services by contestable markets. Others include metering services, connection services, public lighting and ancillary services".⁷

Ausgrid supports the current provision in the NER, which appropriately puts the onus on the AER to maintain stability in service classifications until they can demonstrate the benefits of any change.

⁷ AEMC, Consultation paper, National Electricity Amendment (Contestability of energy services) Rule 2016, 15 December 2016, p.28.

Question 4

- (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?**

Ausgrid would not object to more guidance being given if there is widespread concern that the principles set out in the NER to guide the classification of direct control services as standard or alternative do not provide sufficient guidance, but we would need to consider and respond to more specific proposals if they are developed. Similarly, there may be benefit in the AER developing guidelines to clarify its approach to classifying services in order to minimise market uncertainty.

- (c) **Should the requirement to not change service classification unless a new classification is clearly more appropriate be removed?**

See our response to question 3(b). Ausgrid does not support removal of this requirement.

Question 5

- (a) **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.**

Ausgrid does not see a need to establish a specific 'objective' for service classification in the NER, but does not necessarily oppose such an approach, as long as the objective is carefully worded. Any objective developed needs to be consistent with the form of regulation factors. Furthermore we note that while an objective may seem attractive in theory, in practice it may not provide much value and could lead to increased uncertainty.

The COAG Energy Council suggests the NER should be more explicit in providing that only services which exhibit natural monopoly characteristics should be economically regulated. However, the AEMC noted in its consultation paper that the AER has taken practical factors into account in addition to broad economic principles – these practical considerations could include jurisdictional legislation or market conditions and market development.

It is important to take these practical factors and jurisdictional characteristics into account in classifying services to ensure that the form of regulation adopted is the most appropriate and works in the long term interests of customers. An objective which overly constrains the AER's ability to apply economic principles in light of practical considerations would not be of benefit to customers.

One alternative to formulating an objective could be to add a clause in 6.2.1 of the NER along the lines of the following: "when considering classifying a distribution service must consider the potential impact on competition in contestable services".

- (b) **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?**

For clarity, we address this question in two parts:

- Should service classification be based on market characteristics rather than on the form of regulation that currently applies?; and
- Should service classification be based on market characteristics rather than on the form of regulation *factors*?

In regard to the first issue, under clauses 6.2.1 and 6.2.2 of the NER, the AER is required to have regard to the form of regulation which currently applies to a service when considering its future classification. Ausgrid does not consider this requirement to be onerous or overly inflexible. Rather it

recognises that the regulation of services should be relatively stable over time unless there is good reason to change the approach. The NER provides scope for such change because it also requires the AER to have regard to a range of other factors.

For example, clause 6.2.1 requires the AER to have regard to the form of regulation factors in the NEL, which go to the market characteristics of the service such as barriers to entry and the countervailing power of network service users. In other words, in answer to the second issue above, the form of regulation factors themselves take account of market characteristics.

In addition, clause 6.2.3 requires the AER, in classifying a direct control service as standard or alternative, to have regard to a range of other factors in addition to the existing form of regulation applied to a service, including:

- the potential for development of competition in the relevant market and how the classification might influence that potential;
- the possible effects of the classification on administrative costs
- the extent the costs of providing the relevant service are directly attributable to the person to whom the service is provided; and
- any other relevant factor.

As a result Ausgrid believes that the NER already balance the interests of stability (the existing service classification) with an examination of other factors including market characteristics, which enables the changing market landscape to be taken into account when service classifications are reviewed.

(c) Within this framework, should new classification(s) be added?

Ausgrid is unable to form a view on the desirability of new service classifications in the absence of more specific proposals regarding the nature of such classifications and the implications for economic regulation of those services.

(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?

Service classification is central to the treatment of services for the purposes of economic regulation, and this extends to matters such as distribution ring-fencing, cost allocation and shared asset guidelines. Ausgrid would argue that the distribution ring-fencing, cost allocation and shared asset guidelines all form a part of the economic regulation of distribution services rather than being 'other forms of regulation'.

The ring-fencing obligations are applied through service classification. Legal separation and cost allocation requirements are applied at the distribution services level, while the functional and staff separation plus the non-discrimination provisions are applied at the level of direct control services. Any changes to the service classification arrangements resulting under these rule changes could consequentially impact on the implementation of the ring-fencing obligations.

The AER ring-fencing guideline effectively recognises two types of unregulated services – unregulated distribution services and unregulated non-distribution services. In the past any unclassified service was deemed to be unregulated irrespective of whether or not it was a distribution service. It is unclear how the AER will consider what constitutes an unregulated distribution service as opposed to an unregulated non-distribution service.

It may be necessary for the AER to provide a comprehensive list of all services considered to meet the definition of distribution services in its framework and approach paper. This issue is further

complicated by a separate rule change from Western Power which is seeking to clarify that non-network options meet the definition of distribution services.

It is important not to undermine the logic established in the NER for determining the regulation of different services. This logic requires first that the AER classify services using the criteria identified in clauses 6.2.1 and 6.2.2 of the NER, and then the NER require the AER to determine the form of control mechanisms which should apply to each service depending on its classification.

Where problems are identified in relation to the provisions for cost allocation, shared assets or ring-fencing, changes should be made to these provisions directly. In developing these provisions and associated guidelines the AEMC and the AER should have regard to the interaction of these factors on the regulatory framework and the incentive mechanisms as a whole.

(e) Are the NER clear as to what can and cannot be classified? If not, what changes would be required?

This question is similar to the issues raised under question 2(a) and we refer the AEMC to our response to that question.

Question 6

(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?**

(b) Is the problem unique to demand response, network support and other inputs provided by means of assets 'behind the meter'?

Ausgrid does not believe there is a problem with DNSPs having service delivery discretion, as we have already discussed in this submission. In our view the proponents have not demonstrated that problems exist (or are likely to emerge) as a result of this discretion, so we welcome the AEMC's request for more evidence.

As we have already noted above, the incentive-based regulatory framework has at its heart a reliance on incentives for efficiency, and recognises that while DNSPs benefit in the short term from any efficiency gains, in the longer term these efficiencies are shared by customers and are thus in the long term interests of customers.

Proposals to limit the discretion of DNSPs in relation to the way they organise and procure the inputs to deliver network services run counter to the incentive-based framework. Increasing the prescriptiveness of the regulatory framework may result in less efficient modes of service delivery and ultimately in higher costs or less reliable service to customers.

Ausgrid is particularly concerned about the potential for unintended consequences which restrict or prevent DNSPs from continuing to offer load control tariffs to residential customers.

DNSPs require assets that provide services with high reliability, and need to ensure that any contractual arrangements provide this reliability. End use consumers will buy batteries at much higher levels than a DNSP would ever be likely to install, as consumers are driven by reducing their electricity bill. Since they face the full supply chain cost, they have the potential to capture significant savings as the price and capability of battery storage evolves. By contrast DNSPs would only have an incentive to install batteries to defer growth capex, which is only relevant in a limited number of locations at any one time. Any demand management activities by networks would sensibly seek to leverage a customer's investment rather than replace it. However, in order to contract for the services required by the DNSP, the customer would lose some of the value of the battery they would otherwise derive.

This assessment is supported by the fact that domestic consumers have led the market well ahead of any other market participant. Ausgrid currently has no embedded generation or energy storage assets located behind customer meters (aside from load control associated largely with hot water energy storage), while there are about 500-1000 battery systems and more than 100,000 embedded generators installed directly by customers. There are currently about 60 customer-owned batteries installed per week in the Ausgrid supply area, so there is already a healthy competitive battery market emerging within the current regulatory framework. It is noteworthy that many of the businesses promoting these batteries are not retailers, suggesting that a diverse (albeit embryonic) competitive market for batteries appears to be developing. Therefore NSP investment in DER assets should be viewed as additional to, and not a substitute for, customer services relating to DER.

We also note that there are already more than 1 million privately owned energy storage devices in NSW - being hot water heaters. This is evidence that networks have little interest in owning the appliance itself but rather only the enabling device which allows customers, networks and retailers to benefit. And while the bulk of these small enabling devices are currently network devices, they will progressively be replaced by the functionality offered by market led smart meters.

Question 7

(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?**

Overall Ausgrid considers that the regulatory framework provides balanced incentives for DNSPs in relation to the factors outlined in points i) to vi) above. We do not believe the proponents have provided adequate evidence of problems in the incentive framework, and in the absence of such evidence changes to the NER cannot be justified. In particular, any changes must be based on the long term interests of customers rather than other parties in the electricity market.

Given the very open-ended and general nature of this question, our response is relatively high-level. We look forward to making further submissions and contributions if and when the AEMC decides to consider these issues in more detail, or in relation to specific options or proposals.

In relation to the choice between network and non-network options, we note the AEMC's decision on the local generation rule change, where the AEMC concludes that:

Following rule changes in recent years, the National Electricity Rules (NER) contain a number of mechanisms to incentivise efficient investment in, and use of, distributed energy resources, including embedded generation. These mechanisms are generally effective in incentivising efficient investment in embedded generation. They are targeted at the circumstances where embedded generation (and other non-network solutions) can reduce network costs. The AEMC considers it imperative that the Rules enable the energy market to evolve, rather than trying to impose a solution based on one specific view of the future.⁸

Ausgrid agrees that the Rules provide appropriate incentives for DER. We also agree that the Rules should focus on the incentives for efficiency and the flexibility to allow the market to evolve, rather than opting for prescriptive outcomes which may not ensure efficient outcomes over time.

⁸ AEMC, Final Rule Determination, National Electricity Amendment (Local Generation Network Credits) Rule 2016, 8 December 2016, p16.

Similarly, we consider that the regulatory framework has a number of characteristics which work together to provide efficient incentives. A primary feature of incentive-based regulation is that DNSPs are given incentives and rewards to discover the most efficient way in which to provide network services to the required standard. For this reason DNSPs also have an incentive to seek out new cost-saving technologies and to encourage competition in new products such as storage batteries.

Ausgrid's focus is on providing a secure, reliable network service in the most cost effective manner and in our view the evidence supports this conclusion. We note the following evidence in support of this conclusion, which has already been noted elsewhere in our submission:

- While batteries are being installed by customers within the Ausgrid network, they are being installed by customers independently of Ausgrid, as could be expected given that the value of batteries is currently much higher for customers than DNSPs.
- Significant storage assets are already located BTM in Ausgrid's network, in the form of hot water storage. Ausgrid has not sought to own the hot water storage assets (as would be implied if it was simply seeking to increase its regulatory asset base). Rather, Ausgrid's interest has been in setting tariffs that encourage reduced consumption at peak times, and in ensuring that there is an appropriate 'enabling device' that facilitates the consumption of power for these devices at different times of the day.

In relation to the alternatives of 'in-house' versus third party procurement, we note that there are valid efficiency reasons why Ausgrid may choose to provide services in-house in some cases, such as the potential increased risk and complexity involved in obtaining some services from third parties.

Ausgrid would be concerned if the NER was changed to be more prescriptive with respect to non-network alternatives. While Ausgrid typically procures non-network services from external parties, it would be inappropriate to attempt to prescribe solutions or methodology. This reduction in discretion has the potential to increase the costs for non-network alternatives and so reduce rather than increase the amount of demand management activity by networks.

We also note that there has been considerable progress on information provision by networks to assist external parties in developing non-network options, as discussed in the following question.

Question 8

(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?**
- iii. Provide examples?**

The AEC proposes a number of substantial changes to the Regulatory Investment Test for distribution (RIT-D), including:

- a reduction in the threshold for requiring a regulatory test prior to distribution investment from \$5m to \$50,000. A 'truncated' RIT-D is proposed for these smaller projects.
- the outcome of the RIT-D should be binding on DNSPs by:
 - prohibiting capital expenditure not approved under a RIT-D being rolled into the regulatory asset base; and
 - authorising the AER to remove investments in the RAB which have not been subject to the RIT-D above a new \$50,000.00 threshold.
- increased information provision by DNSP to facilitate the capacity of other entities to provide services to the network

Ausgrid does not support the proposed changes to the RIT-D. The planning framework works in concert with the overall framework for incentive-based economic regulation. These incentives drive DNSPs to seek out the most efficient means of meeting their service standards, whether these are network solutions or non-network solutions. For larger capex projects over \$5m these incentives are further supported by the regulatory investment test (RIT-D), which establishes a process for DNSPs to consider alternative investment options (including non-network options and deferral of network investment) and to follow an extensive public consultation process.

The RIT-D and network planning arrangements are the subject of another rule change process and we refer the AEMC to Ausgrid's submission to that process.⁹ If replacement expenditure became subject to the RIT-D process under that rule change, and was combined with the AEC's proposal to reduce the threshold of the RIT-D to \$50,000, it would substantially increase the regulatory burden on DNSPs. There would be substantial transaction costs involved in reducing the threshold for RIT-D assessments, as well as the risk of delays which undermine the reliability and security of network services.

The AEC has not outlined the specific nature of the 'truncated process' proposed for smaller projects, and without this information it is difficult to provide meaningful comments as to the impact. However, we do not see any basis to lower the threshold in this way, since there is no evidence that the current Rules are inadequate, and the existing incentives work to encourage networks to select the least cost solution.

Ausgrid does not support the proposals to make the outcome of the RIT-D binding, which would fundamentally change the nature of the economic regulation framework including the risks and obligations borne by DNSPs in relation to investment projects.

The AEC also proposes increased information provision by DNSP to facilitate the capacity of other entities to provide services to the network. It considers the AER proposed ring-fencing obligation on information disclosure is not enough and that these additional obligations are required to ensure that all necessary information is provided to competitors.

Depending on the detail of any new obligations, it could significantly increase the administrative burden on DNSPs. Also the AEMC has already decided to include additional information requirements on distribution networks under its local generation network credits rule change.

Given the changes that are already in the process of being implemented, we consider it premature to contemplate yet further changes. Once these changes have been fully implemented and their impact has been assessed, it will be possible to identify whether further changes are warranted.

Ausgrid reports on its future expenditure plans through a range of different mechanisms, as outlined in its submission to the replacement expenditure planning rule change. While we concur with the principle that information should be available in a timely manner and in a form that is useful for those offering non-network solutions, we are concerned to avoid a proliferation of different reporting documents which result in a heavy compliance burden on DNSPs while failing to offer stakeholders concise useful information about the network and potential opportunities for non-network alternatives. Further analysis is required to identify if and where information gaps exist, to ensure that obligations are well targeted and proportionate, and avoid duplication.

We also note that the absence of a RIT-D process does not imply that the DNSP does not consider different alternatives for lower cost projects, including non-network alternatives. Ausgrid investigates non-network alternatives for all capacity driven projects and all replacement projects above \$1M.

The consultation document also uses the example of the network owner being both the decision-maker in relation to investment decisions as well as the asset owner (except in Victoria). If changes to

⁹ Ausgrid's submission can be found on the AEMC website at <http://www.aemc.gov.au/getattachment/9432c1b2-bfde-4b76-8db2-1ad867e70f1b/Ausgrid.aspx>

this arrangement are mooted as an option then Ausgrid would like to provide further detail and comment on this issue. This is a fundamental characteristic of the current arrangements and any proposal to change would require an extensive consultation process. It raises issues relating to market complexity, transaction costs, and investment risk.

Question 9

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?

In Ausgrid's opinion, the cost allocation arrangements under the NER are complete and adequately prevent electricity customers from paying for the costs of providing other services. The arrangements ensures that any expenditure is linked to the appropriate service classification and that price of regulated services properly reflects the cost of providing these services.

Ausgrid considers that the AEC has failed to provide evidence or examples to support their assertion that cost allocation relating to assets that can provide network support and demand response might be deemed efficient under the current principles when, in fact, they are not. In our view, the principles need to be sufficiently high level to cover all scenarios with the detail provided in the DNSPs CAM that is approved by the AER.

Where a DNSP undertakes expenditure in relation to assets which provide multiple services, the DNSP has to allocate the shared costs across the various services based on the appropriate allocator as described in the CAM and approved by the AER. Technology changes may require DNSPs to review their current allocators and potentially amend their CAMs to include new allocators. Any amendments must be approved by the AER. In addition, DNSP must amend their CAM where the amendment is required by the AER to take into account any change to the Cost Allocation Guidelines. Ausgrid considers that these are appropriate arrangements which ensure that the CAM remains fit for purpose in the event of technology advances.

Therefore we consider that cost allocation arrangements comprehensively deal with all expenditure including any expenditure on assets that can provide both regulated and non-regulated services.

Question 10

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. What is the source of the issue?**
- ii. What is the extent of the issue?**
- iii. Provide examples?**

This question reflects a mistaken interpretation of the role of the shared asset guideline. The guideline relates to the treatment of existing regulated assets where the use of that asset has subsequently changed and the original cost allocation no longer properly reflects the shared use of that asset.

Ausgrid considers that the current shared asset guideline is effective and should not be within the scope of consideration relating to the issues raised in these rule changes proposals. We would be concerned with any amendments which lead to an inflexible approach or which complicate the use of shared assets and may inadvertently prevent the efficient use of shared assets for the benefit of all customers.

In the case of distributed energy resources (DER) assets, we consider it unlikely that the potential for additional services would only emerge after the original investment, and not have been recognised at the time of initial cost allocation and service classifications. The guideline does not apply to any new investment which provides both direct control services and other services. For new investments, only that portion of the asset that will be used to provide regulated services is rolled into the regulated

asset base, and this is determined using the CAM. For these assets, the shared asset guidelines would have no role.

The current shared asset guideline is effective at providing DNSPs with a commercial incentive to pursue commercial opportunities while ensuring that regulated customers are not disadvantaged, and are adequately compensated for the existence of any other services. It is important for stakeholders to recognise that the possibility that a demand response asset could provide additional services will not be a primary consideration into the network planning appraisal.

While the possibility of earning additional revenue through other services may affect the relative costs compared to other options, such additional revenue may not materialise due to operational constraints, contractual issues, customer preferences or ring-fencing implications. Fundamentally, the asset must reliably perform the required regulated services for the DNSP to decide to invest in the asset and also for the AER to allow the costs to be recovered through the regulated revenue.

As previously recognised by the AEMC and discussed above, the current economic regulatory framework set out in NER Chapter 6 and supported by Chapter 5, provides robust incentives for DNSPs to invest in those assets which are the most economically efficient at providing regulated services and addressing network limitations. This applies to all assets, irrespective of whether the asset could also provide additional unregulated services.

The AER's recently published ring-fencing guideline also addresses concern about the potential for DNSPs to use their status as a regulated business to skew competition in contestable activities. As noted by the AER, "the objective of ring-fencing is to provide a level playing field for third party providers in new and existing markets for contestable services, such as those for metering and energy storage services, in order to promote competition in the provision of electricity services".¹⁰

Therefore it is crucial that DNSPs have the ability to assess all credible options (as it is required to do so under the RIT-D) which could resolve the network limitations. Reforms which either confine the scope of options to be considered or dictate the outcomes of the planning and investment process will not be in the interests of customers.

¹⁰ AER, Electricity distribution Ring-fencing Guideline, Explanatory statement, November 2016.