

Australian Energy Market Commission

DRAFT RULE DETERMINATION

Contestability of energy services

Rule Proponents

COAG Energy Council
Australian Energy Council

29 August 2017

RULE
CHANGE

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Citation

AEMC, Contestability of energy services, Draft determination, 29 August 2017, Sydney.

About the AEMC

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Summary

A draft rule supporting consumer choices and facilitating competition

The Australian Energy Market Commission (Commission) has made a draft more preferable rule (draft rule) that facilitates competition in the emerging contestable energy services market through the introduction of restrictions on distribution network service providers' (DNSPs) ability to earn regulated returns on assets located "behind the meter".¹ The draft rule also improves the responsiveness of the service classification framework to technology changes in the market as well as improving clarity, transparency and regulatory predictability for stakeholders in relation to the operation of the service classification framework.

The draft rule is made in response to rule change requests submitted by the COAG Energy Council and the Australian Energy Council (AEC)² and is based on aspects of the proposal from both COAG Energy Council and the AEC. The rule change requests focus on the regulation of services provided by assets capable of providing value streams in both the contestable and regulated segments of the electricity sector. Both rule change requests sought to facilitate competition in the emerging energy services market. The Commission consolidated the rule change requests on 8 August 2017.

Context for the Commission's decision

A changing technological environment

The uptake of rooftop solar photovoltaic systems, battery storage, electric vehicles and other technologies at the distribution level in Australia's electricity sector is having a significant impact on the way that consumers use electricity. Technological innovation is making the functions these devices perform smarter, cheaper and more accessible to a wider range of users. This change is greatly expanding the choices that consumers have to manage their energy needs – and it is likely to continue in the future.

Against this backdrop of change, it is important that the economic regulatory framework remains robust and flexible, and continues to support the efficient operation of the energy market. The Commission's work program is contributing to the market evolution in key areas by establishing and recommending frameworks that are in the long-term interests of consumers. The key work program area that is most relevant to this rule change request is the continual support for the development of the contestable energy services market.

¹ In this draft determination, "behind the meter" refers to the location behind a retail customer's connection point.

² The AEC is an industry body representing generators and retailers.

The Commission's desired outcome

The Commission considers that as a general rule, the best outcomes are achieved when consumers make choices based on their own interests or values. Since the Commission's Power of Choice reform program started in 2012, the Commission's review recommendations and rule determinations have focused on increasing the ability of consumers to control how they use electricity and manage costs.

The Commission considers that the best way to support consumers' ability to express their preferences and make meaningful choices is through robust, well-functioning and competitive markets. This draft rule follows this overarching philosophy of placing consumers in the centre of the decision making process by facilitating competition in the growing energy services market.

In addition to facilitating competition in the energy services market, the Commission also considers it is important that DNSPs are able to access the services provided by new technologies offered by the market. However, DNSPs must access these services in a way that does not risk distorting competition in the energy services market.

Overview of the draft rule

The key features of the draft rule are summarised below.

With respect to the introduction of restrictions on DNSPs earning a regulated return on assets located behind a retail customer's connection point, the draft rule:

- prohibits a DNSP from including in its regulatory proposal and regulatory asset base, capital expenditure for assets that are located behind a retail customer's connection point (a 'restricted asset'), except in certain limited circumstances (e.g. where the expenditure is for the refurbishment of such an asset or where the Australian Energy Regulator (AER) has provided an exemption from the prohibition)³
- in general terms, defines a restricted asset as a piece of equipment that is electrically connected to a retail customer's connection point at a location that is on the same side of the connection point as the customer's meter (i.e. the opposite side from which electricity is being supplied from the distribution network to the connection point), but excludes network devices⁴ or assets at a connection point where the retail customer is the DNSP⁵
- requires the AER to have regard to the likely impacts on the development of competition in markets for energy related services when determining whether to grant an exemption⁶

³ See new definition of 'restricted asset' in Chapter 10 under the draft rule; See rule 6.4B under the draft rule.

⁴ See amended definition of 'network device' in Chapter 10 under the draft rule.

⁵ See new definition of 'restricted asset' under Chapter 10 under the draft rule.

⁶ See clause 6.4B.1(b) under the draft rule.

- requires, if the DNSP wishes to seek an exemption, the DNSP to submit an exemption application along with its regulatory proposal or, in the case of an exemption in respect of a cost pass through or reopening of a distribution determination for capital expenditure, at the same time as making the application for the cost pass through or reopening⁷
- provides that the DNSP must include in any exemption application, details of (among other things) a description of the asset or class of asset to which the proposed exemption would apply (including location and anticipated cost), details of the standard control services that would be provided by the asset and an assessment by the DNSP of the likely impacts of the exemption on competition in markets for energy related services⁸
- requires the AER to develop and publish guidelines (the Asset Exemption Guidelines), which set out the AER's approach to granting exemptions from the prohibition⁹
- requires the AER to provide reasons for any departure it makes from the Asset Exemption Guidelines when determining whether to grant an exemption.¹⁰

With respect to the process for classifying distribution services, the draft rule:

- requires the AER to develop and publish guidelines (the Distribution Service Classification Guidelines) that set out the AER's proposed approach to (among other things) determining whether to classify a distribution service as a direct control service and how it distinguishes between distribution services and the operating and capital inputs that are used to provide such services¹¹
- requires the AER to provide reasons for any departure it makes from the Distribution Service Classification Guidelines when classifying a distribution service¹²
- removes the existing requirements under clauses 6.2.1(d) and 6.2.2(d) that the AER must, when classifying a distribution service, not depart from a previous classification or the previously applicable regulatory approach (as the case may be) when classifying a distribution service, unless that different classification is "clearly more appropriate"

⁷ See clause 6.6.1(c1) and 6.6.5(b1) under the draft rule.

⁸ See clause 6.4B.1(b) under the draft rule.

⁹ See clause 6.4B.1(c) under the draft rule.

¹⁰ See clause 6.2.8(c) under the draft rule.

¹¹ See clause 6.2.3A under the draft rule.

¹² See clause 6.2.8(c) under the draft rule.

- amends the existing threshold that must be satisfied before the AER can change a service classification or control mechanism between a framework and approach paper and the distribution determination – the existing threshold of “unforeseen circumstances” has been changed to “a material change in circumstances”¹³.

The Commission’s reasons for the draft determination

Restrictions on DNSPs’ ability to earn regulated returns on assets located “behind the meter”

Safeguarding competition in an emerging market

The Commission considers consumers’ ability to make choices in relation to energy services is best met through a robust and competitive market.

However, such a market can only develop if all market participants are able to compete on a level playing field. In the *Integration of Energy Storage*¹⁴ report, the Commission highlighted three types of actions from DNSPs that have the potential to weaken competition to the detriment of consumers. These actions are:

- The ability to cross-subsidise a competitive service from its regulated activities
- The ability to use information gained through the provision of regulated services to gain advantage in competitive markets
- The ability to restrict competition in a competitive market by restricting access to infrastructure or providing access on less favourable terms than to its affiliate.

The Commission considers that the ring-fencing requirements that have been recently introduced by the AER will be effective in addressing the first two behaviours. However, on the third issue, the Commission is concerned that additional safeguards need to be introduced to limit DNSPs’ ability to exert control and impact competition in the energy services market.

Commission’s concerns about DNSPs’ potential to distort competition

As both COAG Energy Council and the AEC have stated in their rule change requests, new technologies that are becoming prevalent in the energy market are capable of providing multiple value/revenue streams – both in the regulated and non-regulated segments of the electricity system. It is important that DNSPs are able to access the services provided by these new technologies in order to provide network services more efficiently, but they must do so in a way that does not risk distorting competition in the energy services market.

¹³ See clause 6.12.3(b) and (c1) under the draft rule.

¹⁴ AEMC, *Integration of Energy Storage Regulatory Implications*, p. 11.

In most cases, the assets embodying these technologies are not capable of providing the multiple value/revenue streams simultaneously. Therefore, an entity that has control of such assets will need to make decisions regarding trade-offs, both at the time of operating these assets and at the time of investment (e.g. choosing the capabilities of the asset that is installed). In an increasingly connected energy sector, the Commission considers that the concept of efficiency must be considered not only in one part of the sector (e.g. distribution networks), but across the entire energy sector. The Commission considers that if DNSPs are in control of such assets, they may favour network benefits at the expense of maximising the value across the electricity system as a whole.

Further, the nature of the assets is such that once installed at a customer's premises, the customer is not likely to install additional assets of the same type. The Commission is therefore concerned that DNSPs, with their incumbent status as monopoly operators of distribution networks, are able to adversely affect the level of competition in the energy services market through the ability to install (and operate) these assets and recover the costs of those assets through regulated revenues.

The Commission therefore considers that it is important to limit DNSPs' ability to own and operate these assets to prevent adverse outcomes in the competitive energy services market.

Improvements to the processes of classifying distribution services

Promoting responsiveness in a changing environment

It is important the regulatory framework is responsive to the rapidly changing environment. The draft rule promotes the regulatory framework's responsiveness to changes through the removal of the provisions in the National Electricity Rules (NER) preventing the AER from departing from previous service classification unless a different classification is clearly more appropriate. It allows the AER to classify services based on their characteristics and the relevant tests in the law and rules, not a previous classification decision. The draft rule also provides the AER with additional flexibility to respond to changes by lowering the threshold for the AER to change service classification during a determination process from "unforeseen circumstances" to "a material change in circumstances".

Improving clarity, transparency and regulatory predictability

As distribution service classification is a key aspect of the regulatory determination process, the draft rule's requirement on the AER to publish a service classification guideline will provide stakeholders with clarity, transparency and regulatory predictability on the service classification process. The draft rule retains the AER's discretion to make service classification on a DNSP by DNSP basis so that service classification decisions are appropriate to the circumstances faced by the relevant DNSP.

Next steps and further consultation

The Commission recognises that the draft rule proposes significant changes to Chapter 6 of the NER and DNSPs' method of procuring services. The Commission has put in the following measures to allow stakeholders to consider the draft rule and provide feedback:

- **Extended consultation period.** The consultation period on the draft rule is nine weeks. Stakeholders are encouraged to make submissions in response to the draft rule by **31 October 2017**.
- **Stakeholder workshop.** The Commission will also be holding a stakeholder workshop in late September 2017. Further details on date and location will be published on the Commission's website as well as through stakeholder emails.

Transitioning to the draft rule's new requirements

This draft determination describes the Commission's proposed approach to the implementation of the draft rule. However, the draft rule itself does not contain savings or transitional provisions. The Commission will publish a separate paper to set out, and seek stakeholder feedback on, the Commission's proposed savings and transitional rule to implement the draft rule by **19 September 2017**.

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1 The rule change requests

1.1 The rule change requests

1.1.1 COAG Energy Council's rule change request

On 2 September 2016, the COAG Energy Council submitted a rule change request to the Commission. The request seeks to:

- promote the development of competitive markets for new technologies that are capable of providing services in both regulated and contestable markets¹
- amend provisions in Chapter 6 of the National Electricity Rules (NER) to improve clarity, transparency and regulatory predictability, and to allow for the timely reclassification of distribution services²

COAG Energy Council submitted this rule change request in response to issues identified by the Commission in its Storage Report in relation to storage technologies.³ Nonetheless, the solutions proposed in the rule change request go beyond storage technologies and are broadly relevant to new and emerging technologies.⁴

1.1.2 The Australian Energy Council's rule change request

On 20 October 2016, the Australian Energy Council (AEC) - an industry body representing generators and retailers - submitted a rule change request seeking to require distribution network service providers (DNSPs) to procure certain services, such as demand response and network support, from third parties instead of owning assets that provide such services. To achieve this, the AEC proposed to change the provisions in the NER relating to distribution service classification. The AEC also proposed a number of changes to Chapters 5 and 6 of the NER to require DNSPs to procure such services from third parties or ring-fenced affiliates.

1.2 COAG Energy Council Rule change request

COAG Energy Council asked the Commission to consider the following policy issues and solutions in relation to its rule change request. It also asked the Commission to consider any other relevant changes which may be in line with the policy solutions sought by COAG Energy Council.⁵

¹ COAG Energy Council, Rule change request Contestability of energy services, p. 3.

² *ibid.*

³ [http://www.aemc.gov.au/Markets Reviews Advice/Integration of storage/Final/AEMC Documents/AEMC Integration of Energy Storage Final report](http://www.aemc.gov.au/Markets%20Reviews%20Advice/Integration%20of%20storage/Final/AEMC%20Documents/AEMC%20Integration%20of%20Energy%20Storage%20Final%20report)

⁴ COAG Energy Council, Rule change request Contestability of energy services, p. 5.

⁵ *ibid.*, p. 4.

1.2.1 Procurement of inputs that are capable of providing multiple value streams in both the regulated and contestable spheres

Current arrangements and background, and rationale for the rule change request

COAG Energy Council noted that new technologies are currently expanding the choices consumers have to meet and manage their energy needs.⁶ It noted that these new technologies have the capability to provide multiple services/revenue streams across the electricity sector.⁷

COAG Energy Council noted that these new technologies could be provided by regulated network businesses or alternatively, by a range of companies, such as retailers or third party providers, that coordinate and monetise multiple value streams from a single asset.⁸

COAG Energy Council also noted that the Hilmer reforms focus on separating out the competitive elements from the “natural monopoly” elements of the electricity sector. New technologies that result in assets that provide multiple services across the regulated and unregulated elements of the electricity sector therefore challenge the existing separation between regulated and unregulated services.⁹

Solutions proposed

In light of the above, COAG Energy Council proposed that technologies which provide multiple value streams in both the regulated and contestable markets should be contestable services under the regulatory framework, unless it can be established that the competitive market is unlikely to efficiently and effectively deliver the service. COAG Energy Council stated that it is anticipated that this would only occur in a few exceptional circumstances.¹⁰

1.2.2 Service classification processes

Approach to service classification and the classification guidelines

Current arrangements and background

Distribution service classification is the first step in the economic regulatory framework for DNSPs under the NER because it determines which services will be economically regulated and in what form. This is a key input into DNSPs’ regulatory proposals and the AER’s distribution determinations.

The Australian Energy Regulator (AER) commences the distribution service classification process at the Framework and Approach (F & A) stage of each DNSP’s distribution determination. The AER makes distribution determinations on a DNSP by DNSP basis and as such, distribution determinations occur on different timelines in different jurisdictions.

⁶ *ibid*, p. 6.

⁷ *ibid*.

⁸ *ibid*.

⁹ *ibid*.

¹⁰ *ibid*, p. 3.

As a result of these arrangements, stakeholders wishing to make submissions in relation to the AER's proposed approach to distribution service classification at the F & A stage would need to make submissions in relation to each F & A paper for each DNSP's distribution determination, even where these submissions may relate to the same service.

Rationale for the rule change request

COAG Energy Council considered that the current business by business approach to service classification has resulted in a lack of transparency and certainty around the AER's approach to service classification.¹¹ Furthermore, COAG Energy Council stated that the current F & A process attracts little engagement from stakeholders as it is conducted very early in the determination process when stakeholders are ill-prepared to participate and/or there may be limited understanding amongst some stakeholders that this process underpins service classification.¹²

Solutions proposed

COAG Energy Council proposed that the AER be required to develop and maintain a service classification guideline (classification guideline) which sets out the AER's standard approach to applying the service classification framework.¹³ It proposed that the development of, and any amendment to, the classification guideline be subject to the distribution consultation procedure already provided for in the NER so that there is broad consultation on the guideline.¹⁴ COAG Energy Council proposed that the classification guideline be binding unless the AER considers an alternative approach is clearly more appropriate.¹⁵

Reclassification of services

Current arrangements and background, and rationale for the rule change request

Service classifications are first determined as part of the F & A process approximately two years before the commencement of a regulatory control period. The AER may change a service classification until a final determination is issued but the NER do not allow for the reclassification of services within a regulatory control period. As a result, services are "locked in" for the duration of a regulatory control period, which is a minimum of five years. The effect of these processes and provisions is that service classifications can be set for a period of up to seven years.

Given the duration of this period, COAG Energy Council considered that service classifications may not reflect market conditions and the emergence or potential for competition in relation to the service towards the end of a regulatory control period.¹⁶ As a

¹¹ *ibid*, p. 15.

¹² *ibid*.

¹³ *ibid*.

¹⁴ *ibid*.

¹⁵ *ibid*.

¹⁶ *ibid*, p. 16.

result, COAG Energy Council stated that the current regulatory framework does not allow for the timely reclassification of services given the pace of technology change highlighted in its rule change request. COAG Energy Council considered that this leads to ‘regulatory’ lag, the effect of which negatively impacts the development of competition in the new and emerging energy services market.¹⁷

Solutions proposed

COAG Energy Council proposed that the NER be amended to specify the circumstances in which within-period classification decisions may be appropriate and the process involved, while recognising that there are significant potential complexities and flow on implications of changing service classifications within a regulatory period.¹⁸ Nonetheless, COAG Energy Council considered that, despite these complexities, there is considerable potential benefit for consumers from removing or reducing the ‘regulatory lag’ associated with classification decisions.¹⁹ Furthermore, COAG Energy Council noted that the Commission may wish to consider addressing a within period mechanism in the proposed classification guideline.²⁰

1.2.3 Definitions

Current arrangements and background and rationale for the rule change request

A “distribution service” is defined in the NER as “a service provided by means of or in connection with a distribution system”.²¹ COAG Energy Council considered that this definition is very broad, which has resulted in a lack of clarity in relation to the boundaries of a DNSP’s regulated service.²² Specifically, COAG Energy Council reiterated what the Commission noted in its *Integration of Storage*²³ Report, that the words “in connection with” appear to imply that the service does not itself need to utilise assets that fall within the scope of the distribution system, and that it potentially allows for services provided behind-the-meter to be defined as a distribution service.²⁴

COAG Energy Council also noted that the definitions of standard control service and alternative control service do not refer to the characteristics of the service;²⁵ instead they refer to either the manner in which the DNSP can recover the costs associated with providing that service, or having that classification because they are not classified as another type of service. COAG Energy Council considered that this approach is potentially contributing to a lack of clarity in relation to the definitions and what services are captured, as well as their practical application.²⁶

17 *ibid.*

18 *ibid.*

19 *ibid.*

20 *ibid.*

21 NER, Chapter 10, glossary.

22 COAG Energy Council, Rule change request Contestability of energy services, p. 11.

23 AEMC, *Integration of Energy Storage Regulatory Implications, Final Report*, 2015.

24 *ibid.*

25 *ibid.*, p. 13.

26 *ibid.*, p. 13.

Solutions proposed

COAG Energy Council did not propose a specific solution in respect of the issues raised in relation to the definition of a distribution service. It considered that a spatial approach has some logic however may be overly simplistic in the current context of current market developments where services are capable of being provided remotely and a focus on the physical asset may be inconsistent with the service-based approach to regulation favoured by COAG Energy Council.²⁷

Nonetheless, it has requested that the Commission consider changes to the definitions and related provisions in response to a number of issues set out in their rule change request.²⁸ This is discussed in detail in Chapter 4 of this draft determination.

1.2.4 Principles in classifying services

Current arrangements and background

The service classification process occurs over a number of stages. A service must first be a distribution service within the meaning contained in the NER. If it is a distribution service, the AER must have regard to the factors set out in clause 6.2.1(c) of the NER in classifying a distribution service as a direct control service or a negotiated distribution service. The factors set out in clause 6.2.1(c) of the NER include consideration of the form of regulation factors, which are set out in section 2F of the National Electricity Law (NEL). The AER must then have regard to the factors set out in clause 6.2.2(c) of the NER in further classifying a direct control service as either a standard control service or an alternative control service.

Certain parts of clause 6.2.1 and 6.2.2 of the NER require the AER to consider previous service classifications and/or previous regulatory approaches when classifying distribution services. Clause 6.2.2(c)(3) of the NER requires the AER to consider any regulatory approach applicable to a service immediately before the commencement of the distribution determination for which the classification was made. Clauses 6.2.1(d) and 6.2.2(d) of the NER provide that when the AER is classifying a distribution service and a direct control service, respectively, that has previously been classified (e.g. in a previous regulatory control period), then there should be no departure from the previous classification unless a different classification is “clearly more appropriate”. Similarly, if there has been no previous classification, then the classification should be consistent with the previously applicable regulatory approach, unless a different classification is “clearly more appropriate”.

²⁷ *ibid*, p. 12.

²⁸ *ibid*, p. 14.

Rationale for the rule change request

COAG Energy Council stated that clauses 6.2.1 (d), 6.2.2(c)(3) and 6.2.2(d) of the NER restrict the AER's discretion to reclassify services, maintaining a bias towards favouring the status quo.²⁹ COAG Energy Council considered that the wording in these clauses is therefore contrary to the policy aim of promoting the development of effective competition over and above the economic regulation of services.³⁰

Solutions proposed

COAG Energy Council did not make any specific proposals to change the factors in section 2F of the NEL, but requested that the Commission analyse whether the form of regulation factors remain appropriate in the context of a changing energy market.³¹

COAG Energy Council proposed changes to the wording of clauses 6.2.1(d) and 6.2.2(c)(3) and (d) to remove prescription around the AER's consideration of services that had been previously regulated.³² Nonetheless, COAG Energy Council did not specify what this exact wording should be.

1.3 The AEC rule change request

1.3.1 Current arrangements

This section provides a high level overview of the existing arrangements for the regulation of standard control services, the distribution planning framework and the separation of direct control services from other services. For further explanation of these arrangements, Chapters 4 and 5 of the Consultation paper provide a detailed explanation.

Incentive regulation

Where services are classified by the AER as standard control services through the distribution service classification process they are then subject to the economic regulatory framework under Chapter 6 of the NER.

The key feature of economic regulation of standard control services provided by DNSPs in the National Electricity Market (NEM) is that it is based on incentives. The total revenue requirement is locked in at the start of each regulatory period. It is based on the AER's estimate of the efficient costs that a DNSP would incur to meet its reliability standards and other regulatory obligations.

If a DNSP spends less than the estimated efficient cost, it will retain the difference for the remainder of the regulatory control period. This incentivises it to operate more efficiently and reduce costs. Conversely, if the DNSP spends more than the estimated efficient costs, it

²⁹ *ibid.*

³⁰ *ibid.*

³¹ *ibid.*, p. 13.

³² *ibid.*, p. 14.

will not be allowed to recover the additional spending during the remainder of the regulatory control period.

Under this approach, funding is not approved for DNSPs' specific projects or programs. Rather, a total revenue requirement is set, which is based on forecasts of total efficient expenditure. Once a total revenue is set, it is for the DNSP to decide which suite of projects and programs are required to deliver services to consumers while meeting its regulatory obligations.

The existing framework provides DNSPs with discretion to provide standard control services by using any combination of:

- network or non-network options
- operating or capital expenditure
- a wide variety of technologies
- assets that are positioned in many locations, including “behind” or “in-front of the meter”
- in-house or procuring the services from third parties or related entities

Planning framework

In addition to the incentive-based regulatory framework, DNSPs must meet planning requirements under Chapter 5 of the NER. Two key components of the Chapter 5 planning arrangements in the NER are the requirements for DNSPs to:

- Undertake a regulatory investment test for (major) distribution (RIT-D) projects. This is additional to the AER's assessment of efficient capital expenditure for the regulatory control period. Currently, the RIT-D applies for projects where expenditure exceeds \$5 million. This process is designed to test whether the DNSPs' proposed investment is the most efficient solution (e.g. whether it is the most efficient way to meet the applicable reliability standards) and give providers of non-network solutions an opportunity to propose alternative approaches
- Undertake an annual planning review and publish a distribution annual planning report (DAPR) setting out the outcomes of the annual planning review.³³ DNSPs must also publish a system limitation report that is complementary to the DAPR using a template prepared by the AER³⁴

³³ NER, clause 5.13.1(d).

³⁴ NER, Schedule 5.8.

Separation of direct control services from other services

The arrangements for the separation of DNSPs' provision of direct control services from its provision of other services operate as in tandem. In particular:

- Service classification is the basis for the application of ring-fencing, cost allocation and asset sharing arrangements
- The AER's cost allocation guideline and a DNSP's cost allocation methodology (CAM) form the basis for the allocation and attribution of its costs between its distribution services. The obligations in the AER's ring-fencing guideline complement the obligations in the cost allocation guideline by requiring DNSPs to also allocate costs between distribution services and other services which DNSPs provide
- The shared asset guideline adjusts the level of revenue a DNSP can recover from its standard control services. It modifies a DNSP's cost allocation where its cost allocation methodology no longer accurately reflects how its assets are used
- The AER's ring-fencing guideline:
 - Addresses the risk of a DNSP cross-subsidising other services with revenue earned from distribution services. The guideline does this by, amongst other requirements, requiring legal separation between a DNSP and an affiliated entity seeking to provide non-distribution services
 - Addresses the risk of a DNSP using its provision of direct control services to favour its provision of negotiated services or unclassified distribution services, or an affiliated entity's service provision over potential competitors' services. The guideline does this by imposing "behavioural" obligations on DNSPs, including restrictions on sharing and co-locating staff and information, and on co-branding

1.3.2 Rationale for the rule change request

The AEC rule change request starts from the position that competition, where practical, is the best mechanism for providing services to customers at an efficient cost. It does so by offering customers a choice of services and encouraging innovation to continuously improve services. Regulation is seen as a second-best approach.³⁵

The AEC considered the NER do not reflect this principle because it is not clear that the NER provide for the competitive delivery of an emerging class of energy services. The AEC characterised these services as those that typically operate "behind the meter". They benefit the customers on whose premises they are located, but can also offer benefits to the network (e.g. peak demand reduction, voltage support). The AEC identified embedded generation, storage and demand management tools as such services.³⁶

³⁵ AEC, Rule change request Contestability of energy services demand response and network support, p. 1.

³⁶ *ibid*, p. 1.

The AEC considered that the NER are unclear as to whether DNSPs and TNSPs can directly supply and/or own the assets that deliver these services. It seeks to clarify the issue by requiring that such assets must be procured from third parties or (properly) ring-fenced affiliates.³⁷

In addition to addressing this core principle, the AEC highlighted a number of other issues that it considers exist within the current network regulatory framework, including:

- DNSPs are biased towards capital expenditure approaches over operating expenditure approaches³⁸
- DNSPs are biased towards in-house approaches over outsourced approaches³⁹
- DNSPs are biased towards their own ring-fenced affiliates over third party providers⁴⁰

1.3.3 Solution proposed in the rule change request

The AEC rule change request took a three-step approach to solving the issues identified.

Step 1: To achieve the primary focus, restrict networks from using capital expenditure to provide certain services:⁴¹

- these services would include, but not be restricted to “behind the meter” services, for example network support and demand management
- implement this restriction through creation of a new service classification type named “contestable services”
- require contestable services to only be procured through operating expenditure

The AEC has not proposed how the contestable services classification would operate within the distribution service classification framework.

Step 2: To address the secondary issues identified, which the AEC considers would likely result in DNSPs using traditional network solutions instead of using opex to procure ‘behind the meter’ services:⁴²

- lower the regulatory investment test for distribution (RIT-D) threshold to \$50,000, with some form of shortened RIT-D process applying to these investments
- make the outcome of the RIT-D binding on DNSPs through prohibition of capital expenditure not approved under a RIT-D being rolled into the regulatory asset base

³⁷ *ibid*, p. 1.

³⁸ *ibid*, p. 4.

³⁹ *ibid*, p. 4.

⁴⁰ *ibid*, p. 10.

⁴¹ *ibid*, p. 1.

⁴² *ibid*, p. 6.

Step 3: Require DNSPs to publish all relevant information, so that third parties can compete for contestable services on an equal basis with DNSPs' ring fenced affiliates.⁴³

1.4 Relevant background

This section outlines the context for the two rule change requests in terms of:

- changes in the energy sector
- changes to the rules and regulations that govern the sector

1.4.1 Market developments

The electricity supply chain has changed substantially in recent years and is continuing to change. The previous supply model of one-way flows from large generators through transmission and distribution networks to customers is changing to a model of bi-directional flows. Customers have increasing opportunity to change their electricity demand, and to supply electricity, in response to price signals.

This changing environment is a key reason for the AEC and COAG Energy Council rule change requests. In particular, the requests highlight a lack of clarity of the regulatory treatment of an increasing number of assets located on customers' premises that are capable of providing multiple value streams in both regulated and unregulated markets.

1.4.2 Recent reviews

The above changes to the energy sector have been considered in recent reviews by both COAG Energy Council and the Commission.

Scenario analysis

In 2015, the COAG Energy Council commissioned Synergies to undertake scenario analysis of how the economic regulatory framework would deal with different potential technology changes in the future. The scenario analysis identified a number of potential barriers to development of competition in unregulated markets, where those services would act as an alternative to investment in the network. In particular, the analysis questioned whether the current arrangements would be able to reclassify services from regulated to contestable fast enough to keep pace with market developments.⁴⁴

Integration of storage

The Commission is conducting a work program focused on new technologies. The program explores whether the existing regulatory framework is flexible and resilient enough to respond to changes in the availability and cost of new energy technologies. As part of this

⁴³ *ibid*, p. 9.

⁴⁴ Policy Advice to the COAG Energy Council, Electricity Network Economic Regulation: Scenario Analysis, June 2015.

work program, the Commission investigated the regulatory implications of the growing take-up of energy storage in Australia's energy markets.

On 3 December 2015 the Commission published its final report on the integration of energy storage, which recommended that:⁴⁵

- storage devices located “behind the meter” that a DNSP seeks to use for network support should generally be sourced from the contestable market (i.e. contracted from a third party or ring-fenced business)
- DNSPs should only be allowed to own storage “behind the meter” through an effectively ring-fenced affiliate that separates contestable market activities from the provision of the regulated service
- the same prohibition on DNSPs investing in storage technology “on their network” (as part of the regulated service) should not apply because the existing incentives in the framework should lead DNSPs to select the most efficient service delivery option for the provision of network services

The Commission recommended that the COAG Energy Council task the Commission with reviewing what changes to the NEL would be required to give effect to these recommendations.

1.5 The rule making process

On 15 December 2016, the Commission published notices advising of its commencement of the rule making process and consultation in respect of each of these rule change requests.⁴⁶ A consultation paper identifying specific issues for consultation was also published. Submissions closed on 9 February 2017.

The Commission received 19 submissions as part of the first round of consultation. The Commission considered all issues raised by stakeholders in submissions. Issues raised in submissions are discussed and responded to throughout this draft determination. Issues that are not addressed in the body of this document are set out and addressed in Appendix A.

On 8 August 2017, the Commission decided to consolidate the COAG Energy Council and AEC rule change requests under section 93 of the NEL in order to deal with overlapping issues between the two requests.

⁴⁵ AEMC, *Integration of Energy Storage, Regulatory Implications, Final Report*, 3 December 2015, p.iv.

⁴⁶ This notice was published under s.95 of the NEL.

1.6 Consultation on draft determination

The Commission invites submissions on this draft determination, including the draft rule, by 31 October 2017.

Any person or body may request that the Commission hold a hearing in relation to the draft determination. Any request for a hearing must be made in writing and must be received by the Commission no later than 5 September 2017.

Submissions and requests for a hearing should quote project number ERC0206 and may be lodged online at *www.aemc.gov.au* or by mail to:

Australian Energy Market Commission

PO Box A2449

SYDNEY SOUTH NSW 1235

2 Draft rule determination

2.1 The Commission's draft rule determination

The Commission's draft rule determination is to make a more preferable draft rule that improves clarity, transparency and regulatory predictability under the distribution service classification process for stakeholders, and facilitates competition in the contestable energy services market through the introduction of restrictions on DNSPs' ability to own and control assets "behind the meter".⁴⁷

The draft rule is based on aspects of the proposals from both the COAG Energy Council and the AEC.

The Commission did not make a draft rule in relation to the following:

- Certain aspects of COAG Energy Council's rule change request in relation to service classification definitions, in particular:
 - New technologies that are capable of providing multiple services/revenue streams should generally be classified as contestable services (i.e. unclassified under the regulatory framework).⁴⁸ The Commission considers that this request is better addressed by the draft new restriction on DNSPs' ability to own and control assets, which is based on a proposal in the AEC rule change.
 - Reclassification of services within a regulatory control period.⁴⁹ The Commission considers that the costs of this change would outweigh the benefits.
- In relation to the AEC's rule change request:
 - Creation of a new contestable services classification.⁵⁰ The Commission considers that this request is better addressed by the draft new restriction on DNSPs' ability to own and control assets.
 - Changes to the RIT-D to ensure competitive non-network solutions are considered for the widest practical range of investment decision, changes to the planning framework for DNSPs to subject DNSPs to additional "standard access obligations" in relation to solutions at or near supply points, and changes to include new principles on cost allocation.⁵¹ The Commission considers that these issues are less material in light of the draft new restriction on DNSPs' ability to own and control assets, and that any additional changes to

⁴⁷ In this draft determination, "behind the meter" refers to a location behind a retail customer's connection point.

⁴⁸ COAG Energy Council, Rule change request Contestability of energy services, p. 14.

⁴⁹ *ibid*, p. 16.

⁵⁰ AEC, Rule change request Contestability of energy services, pp. 3 5.

⁵¹ *ibid*, pp. 6 10.

address these issues should be assessed as part of a broader review of the overarching design of the incentive regime, which the Commission will undertake as part of its 2018 electricity network economic regulatory framework review.

The Commission's reasons for making this draft determination are set out in Chapters 3 to 6.

This chapter outlines:

- the rule making test for changes to the NER and Commission's consideration of the draft rule against the national electricity objective (NEO)
- the assessment framework used by the Commission when considering the rule change request
- the Commission's consideration of the draft rule against its strategic priorities.

2.2 Rule making test

This section outlines the rule making tests that the Commission must apply when making a determination.

From 1 July 2016, the NER, as amended from time to time, apply in the Northern Territory, subject to derogations set out in regulations made under the Northern Territory legislation adopting the NEL.⁵² Under those regulations, only certain parts of the NER have been adopted in the Northern Territory.⁵³ As the proposed rule relates to parts of the NER that apply in the Northern Territory, the Commission has assessed the draft rule against additional elements required by Northern Territory legislation. The additional tests are also set out in the sections below.

2.2.1 The National Electricity Objective

Under the NEL, the Commission may only make a rule if it is satisfied that the rule will, or is likely to, contribute to the achievement of the NEO. This is the decision making framework that the Commission must apply.

The NEO is:⁵⁴

to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:

⁵² National Electricity (Northern Territory)(National Uniform Legislation)(Modifications) Regulations

⁵³ For the version of the Electricity Rules that applies in the Northern Territory, refer to: [http://www.aemc.gov.au/Energy Rules/National electricity rules/National Electricity Rules \(Northern Territory\)](http://www.aemc.gov.au/Energy Rules/National electricity rules/National Electricity Rules (Northern Territory)).

⁵⁴ Section 7 of the NEL.

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

Additional test for Northern Territory

The National Electricity (Northern Territory) (National Uniform Legislation) Act 2015⁵⁵ allows for an expanded definition of the national electricity system in the context of the application of the NEO to rules made in respect of the Northern Territory. The Commission must regard the reference in the NEO to the “national electricity system” as a reference to whichever of the following the Commission considers appropriate in the circumstances having regard to the nature, scope or operation of the proposed rule:

- (a) the national electricity system
- (b) one or more, or all, of the local electricity systems
- (c) all the electricity systems referred to above.

For this draft determination, the Commission has determined that the reference to the national electricity system is “all the electricity systems referred to above”.

2.2.2 Revenue and pricing principles

In addition to having regard to the NEO, the Commission must take into account the revenue and pricing principles in making a rule with respect to (among other things) the regulation of revenue earned, or that may be earned, by DNSPs from provision of services that are the subject of a distribution determination.⁵⁶ The Commission has taken into account the revenue and pricing principles in making this draft determination - see Appendix B for detailed discussion.

2.2.3 Making a more preferable rule

Under section 91A of the NEL, the Commission may make a rule that is different (including materially different) to a proposed rule (a more preferable rule) if it is satisfied that, having regard to the issue or issues raised in the rule change request, the more preferable rule will or is likely to better contribute to the achievement of the NEO. The Commission’s reasons for making a more preferable rule are set out in section 2.4 below.

2.2.4 Making a differential rule - additional Northern Territory test

The National Electricity (Northern Territory) (National Uniform Legislation) Act 2015 provides the Commission with the ability to make a differential rule that varies in its terms between the national electricity system and the Northern Territory’s local electricity system. The Commission may make a differential rule if, having regard to any relevant Ministerial

⁵⁵ Section 32A.

⁵⁶ Refer to section 88B and Items 25 26J of Schedule 1 of the NEL. The revenue and pricing principles are set out in section 7A of the NEL.

Council of Energy (MCE)⁵⁷ statement of policy principles, determine that a differential rule will, or is likely to, better contribute to the achievement of the NEO than a uniform rule. A differential rule is a rule that:

- (a) varies in its term as between -
 - (1) the national electricity system; and
 - (2) one or more, or all, of the local electricity systems; or
 - (b) does not have effect with respect to one or more of those systems
- but is not a jurisdictional derogation, participant derogation or rule that has effect with respect to an adoptive jurisdiction for the purpose of s.91(8) of the NEL.

The Commission has considered whether a differential rule is required for the Northern Territory electricity service providers and concluded that it is not required in this instance. This is because the Commission considers that the draft rule will be able to operate in the Northern Territory without special arrangements.

2.3 Assessment framework

In assessing the rule change request against the NEO, the Commission has considered the following criteria:

- **Facilitating competition in the provision of energy services.** In assessing this rule change request, the Commission considered whether changes to the regulatory framework would facilitate competition in the energy services market. The energy market has seen significant growth in the range of technology and energy services options in recent years. This growth is likely to continue as the energy market continues to evolve. Where competition is effective, energy services providers will have strong incentives to provide products and services that consumers value.
- **Promote clarity, transparency and regulatory predictability in the distribution service classification framework.** The distribution service classification framework should provide clarity, transparency and regulatory predictability on how distribution services are classified by the AER. The Commission considered whether there is a need for greater transparency and regulatory predictability in the distribution service classification process in a rapidly changing environment.

⁵⁷ The MCE is a legally enduring body comprising the Federal, State and Territory Ministers responsible for Energy. On 1 July 2011 the MCE was amalgamated with the Ministerial Council on Mineral and Petroleum Resources. The amalgamated council is now called the COAG Energy Council.

- **Balance between responsiveness and regulatory and administrative burden.** The Commission considered whether the potential solutions to the issues raised in the rule change requests provide a balance between a responsive regulatory framework and regulatory and administrative burden. Any change to the regulatory framework should not impose unnecessary administrative and compliance cost on the AER, DNSPs and third parties providing energy services.

2.4 Summary of reasons for making a more preferable rule

2.4.1 Key features of the draft rule

Having considered the rule change request against the assessment framework set out in Section 2.3 and having considered the NEO, the Commission decided to make a draft more preferable rule. The draft rule is published with this draft determination.

The key features of the draft rule are summarised below.

With respect to the process for classifying distribution services, the draft rule:

- requires the AER to develop and publish guidelines (the Distribution Service Classification Guidelines) that set out the AER's proposed approach to (among other things) determining whether to classify a distribution service as a direct control service and how it distinguishes between distribution services and the operating and capital inputs that are used to provide such services⁵⁸
- requires the AER to provide reasons for any departure it makes from the Distribution Service Classification Guidelines when classifying a distribution service⁵⁹
- removes the existing requirements under clauses 6.2.1(d) and 6.2.2(d) that the AER must, when classifying a distribution service, not depart from a previous classification or the previously applicable regulatory approach (as the case may be) when classifying a distribution service, unless that different classification is "clearly more appropriate"
- amends the existing threshold that must be satisfied before the AER can change a service classification or control mechanism between a framework and approach paper and the distribution determination – the existing threshold of "unforeseen circumstances" has been changed to "a material change in circumstances"⁶⁰.

⁵⁸ See clause 6.2.3A under the draft rule.

⁵⁹ See clause 6.2.8(c) under the draft rule.

⁶⁰ See clause 6.12.3(b) and (c1) under the draft rule.

With respect to the introduction of a restriction on DNSPs earning a regulated return on assets located behind a retail customer's connection point, the draft rule:

- prohibits a DNSP from including in its regulatory proposal and regulatory asset base, capital expenditure for assets that are located behind a retail customer's connection point (a "restricted asset"), except in certain limited circumstances (e.g. where the expenditure is for the refurbishment of such an asset or where the AER has provided an exemption from the prohibition)⁶¹
- in general terms, defines a restricted asset as a piece of equipment that is electrically connected to a retail customer's connection point at a location that is on the same side of the connection point as the customer's meter (i.e. the opposite side from which electricity is being supplied from the distribution network to the connection point), but excludes network devices⁶² or assets at a connection point where the retail customer is the DNSP⁶³
- requires the AER to have regard to the likely impacts on the development of competition in markets for energy related services when determining whether to grant an exemption⁶⁴
- requires, if the DNSP wishes to seek an exemption, the DNSP to submit an exemption application along with its regulatory proposal or, in the case of an exemption in respect of a cost pass through or reopening of a distribution determination for capital expenditure, at the same time as making the application for the cost pass through or reopening⁶⁵
- provides that the DNSP must include in any exemption application, details of (among other things) a description of the asset or class of asset to which the proposed exemption would apply (including location and anticipated cost), details of the standard control services that would be provided by the asset and an assessment by the DNSP of the likely impacts of the exemption on competition in markets for energy related services⁶⁶
- requires the AER to develop and publish guidelines (the Asset Exemption Guidelines), which set out the AER's approach to granting exemptions from the prohibition⁶⁷
- requires the AER to provide reasons for any departure it makes from the Asset Exemption Guidelines when determining whether to grant an exemption⁶⁸.

⁶¹ See new definition of "restricted asset" in Chapter 10 under the draft rule; See rule 6.4B under the draft rule.

⁶² See amended definition of "network device" in Chapter 10 under the draft rule.

⁶³ See new definition of "restricted asset" under chapter 10 under the draft rule.

⁶⁴ See clause 6.4B.1(b) under the draft rule.

⁶⁵ See clause 6.6.1(c1) and 6.6.5(b1) under the draft rule.

⁶⁶ See clause 6.4B.1(b) under the draft rule.

⁶⁷ See clause 6.4B.1(c) under the draft rule.

⁶⁸ See clause 6.2.8(c) under the draft rule.

2.4.2 Reasons for making this decision

The Commission's reasons for making a more preferable rule

Having regard to the issues raised in the rule change requests and in submissions, the Commission is satisfied that the draft rule will, or is likely to, better contribute to the achievement of the NEO than the proposed rules for the following reasons:

- **Facilitating efficient competition.**
 - The Commission considers that in an increasingly connected energy sector, the draft rule will contribute to the achievement of efficiency not only in one part of the sector (in this case, the distribution network), but across the entire energy sector. The restrictions on DNSPs controlling assets “behind the meter” are likely to deliver long term benefits to consumers as the decision on investment in technologies are made based on benefits to the entire supply chain. Given the emerging state of the energy services market and the possibility that it will grow to include as yet undefined services, the draft rule enshrines the principle that that open contestability and competition as the most efficient way of discovering and valuing new services.
 - The Commission considers that an absolute prohibition on all “behind the meter” investment is not likely to be in the long term interest of consumers as there may be situations where such investment may be the most efficient solution for a network issue and that investment is not capable of providing benefits to the contestable market.⁶⁹ The draft rule therefore provides the AER to grant exemptions in certain circumstance. In deciding whether to grant an exemption, the AER must have regard to the the exemption’s likely impact on the development of competition in markets for energy related services.
- **Balances the development of energy services market with the need for DNSPs’ service discretion.** The draft rule adapts the principle of incentive regulation and service discretion to a rapidly changing market. Under the draft rule, DNSPs retains a significant degree of service discretion. The draft rule does not create a blanket prohibition on network businesses using new technologies and energy management services to efficiently provide monopoly distribution services. Under the draft rule, distribution businesses are able to procure these services from ring-fenced affiliates or third parties through operating expenditure to support their provision of distribution services and recover those costs through regulated revenues where it is efficient to do so.
- **Providing clarity, transparency and regulatory predictability on service classification.** Distribution service classification is a key aspect of the regulatory determination process. The draft rule’s requirement on the AER to publish a service

⁶⁹ In its rule change request, the AEC proposed the introduction of an absolute prohibition on direct “behind the meter” investment by network service providers. See page 6 of the AEC’s rule change request.

classification guideline will provide stakeholders with clarity, transparency and regulatory predictability on the service classification process. The draft rule retains the AER's discretion to make service classification on a DNSP by DNSP basis so that service classification decisions are appropriate to the circumstances faced by the relevant DNSP.

- **Balance between responsiveness and regulatory and administrative burden.**
 - The draft rule promotes the regulatory framework's responsiveness to changes through the removal of the provisions in the NER that require the AER to maintain an existing service classification from a previous regulatory control period. It allows AER to classify services based on their characteristics and the relevant tests in the law and rules, not a previous classification decision.
 - The draft rule's restriction on a distribution business's ability to control assets "behind the meter" is likely to require changes to the AER's and distribution businesses' procedures in relation to the regulatory determination process. However, the Commission considers that embedding these requirements within the existing regulatory determination process is likely to limit the administrative burden on both the AER and distribution businesses. Further, the Commission considers that the additional regulatory burden is outweighed by the benefits derived from facilitating the development of a competitive energy services market.
 - Currently, clause 6.12.3(b) requires the AER, when making distribution determinations, to maintain its classification of distribution services as set out in the relevant framework and approach paper unless it considers unforeseen circumstances justify a departure. The draft rule lowers the threshold from "unforeseen circumstances" to "a material change in circumstances". The Commission considers this provides the AER with additional flexibility to respond to changes in a changing environment.

The Commission's reasons for not making a draft rule on certain aspects of the rule change requests

In relation to COAG Energy Council's request that new technologies that are capable of providing multiple services/revenue streams should generally be classified as contestable services (i.e. unclassified under the regulatory framework) and the AEC's request to create an "energy related" or "contestable services" service classification, the Commission's reasons for not making a draft rule are as follows:

- **The proposed solutions do not address the issue of control.** As discussed in the consultation paper, the service classification framework classifies services provided by network businesses to network users, and not inputs to those services that are procured by network businesses. As many new and emerging technologies are likely to be inputs to services, changes to service classification as proposed by COAG

Energy Council and the AEC would not achieve their stated objectives of preventing distribution businesses from investing in (and by extension, controlling) assets that are located “behind the meter”.

- **The proposed solutions potentially create an adverse outcome.** As discussed in the consultation paper, distribution businesses are not able to use regulated revenues to recover the cost of services that are not classified as direct control services. Accordingly, if a technology was able to be classified as “unclassified” or “contestable”, the service classification framework would prevent a DNSP from using regulated revenue to recover the cost of investing in the asset (capex) as well as the cost of procuring such an asset from the contestable market (opex), even though such an asset may provide the most efficient solution to a network problem. This outcome appears to be the opposite of what the COAG Energy Council and AEC were seeking to achieve, which was to encourage DNSPs to procure these services from the competitive market. It has the potential to create adverse incentives for distribution businesses to undertake inefficient poles and wires expenditure instead of procuring non-network solutions using new technologies.

In relation to COAG EC’s proposal to allow reclassification of services within a regulatory control period, the Commission’s reason for not making a draft rule is as follows:

- While the Commission acknowledges that changing market environment has seen the emergence of new technologies that may lead to a need to reclassify services more frequently, it considers the cost of reclassification within a regulatory control period significantly outweighs the benefits. Allowing for within period reclassification would reopen large parts of the distribution determination, a process which would be lengthy and involve a significant investment of resources by DNSPs and the AER. Reclassification within a regulatory control period would also have significant implication on DNSPs’ planning and business decisions. The Commission therefore considers that this request would not be in the long term interest of consumers.

In relation to the AEC’s proposal to change the RIT-D and planning framework and introduction of new principles to cost allocation, the Commission’s reasons for not making a draft rule are as follows:

- The Commission considers that these issues are less material in light of the draft new restriction on DNSPs’ ability to own and control assets.
- The Commission considers the AEC’s proposed changes to the RIT-D, planning framework, cost allocation and shared asset mechanism are designed to address perceived biases exhibited by DNSPs under the existing regulatory framework. These biases relate to the incentives provided to DNSPs through the incentive regulation framework and are separate from the core focus of the rule change requests – the introduction of contestable frameworks for services related to “behind the meter” (and other specific) assets.

- The Commission has recently made a number of changes to the RIT-D and planning framework through the *replacement expenditure planning arrangements* and *local generation network credits* rule changes.
- The Commission therefore considers that any additional changes to RIT-D and the planning framework need to be assessed within a broad review of the overarching incentive design, not within a rule change request targeted at contestability of energy services. Accordingly, the Commission does not consider it is appropriate to make changes to the NER relating to these issues within this rule change request. The Commission will be undertaking this analysis in its 2018 electricity network economic regulatory framework review.
- If changes to address these additional issues were made as part of this rule change, that would require considerable additional work to investigate the most appropriate solution. That would delay the implementation of this rule change and mean that it could not be implemented in time for the next round of AER distribution determinations.

2.5 Strategic priority

This rule change request relates to the Commission's strategic priority relating to the encouragement of efficient investment and flexibility in markets and networks. The purpose of this strategic priority is to allow transmission and distribution networks to evolve to accommodate changes, such as those driven by technology and consumers, while still being able to operate and invest in the infrastructure and services required to provide network services.

3 Reasons for imposing restrictions on DNSPs' ability to own and control assets "behind the meter"

This chapter discusses the Commission's reasons for imposing restrictions on DNSPs earning a regulated return on assets located behind a retail customer's connection point. It is intended to provide the context for the Chapters 4, 5 and 6 of the draft determination. It also provides the context in which the draft rule determination is made, views expressed by the proponents and stakeholders, and discusses the Commission's positions on issues raised in the rule change requests.

3.1 Context for the Commission's decision

3.1.1 The changing technological environment

The past decade saw significant changes in the way the electricity was produced and used in Australia. The NEM has moved from large-scale, centralised electricity generation to greater amounts of smaller, distributed generation. Technologies such as solar photovoltaic (PV) and battery storage are also becoming cheaper and better, and as a consequence, more widespread and viable at a small scale.

Between 2009 and 2015, the installed capacity of small-scale solar PV in the NEM increased from 0.14 GW to 4.24 GW - a more than thirty-fold increase, with the majority of this capacity installed in the residential sector. Battery technologies also saw rapid growth in recent years, with total battery storage capacity growing from a negligible level in 2014 to 59 MW in 2016.

The changes described above are not a passing fad – they are expected to continue in the future. There is expected to be a large future demand for distributed energy resource technologies, such as solar PV, energy storage and electric vehicles.⁷⁰

A significant quantity of these technologies are also expected to be deployed "behind the meter". For example, recent reports published by the Australian Energy Market Operator (AEMO) indicate that:

- embedded solar PV uptake is forecast to triple by 2030, with 16 GW of installed capacity across the NEM, which equates to approximately 50 per cent of projected average daytime demand⁷¹
- by 2035-36, nearly 4 GW of this rooftop PV capacity is expected to have integrated battery storage, providing 6.6 GWh of energy storage potential⁷²
- the number of electric vehicles will significantly increase, from around 2,000 vehicles

⁷⁰ This expected uptake is driven by factors such as the falling costs and increasing functionality of these technologies, more sophisticated information and control technologies, fast and cheap computing platforms, and changing consumer attitudes to electricity supply.

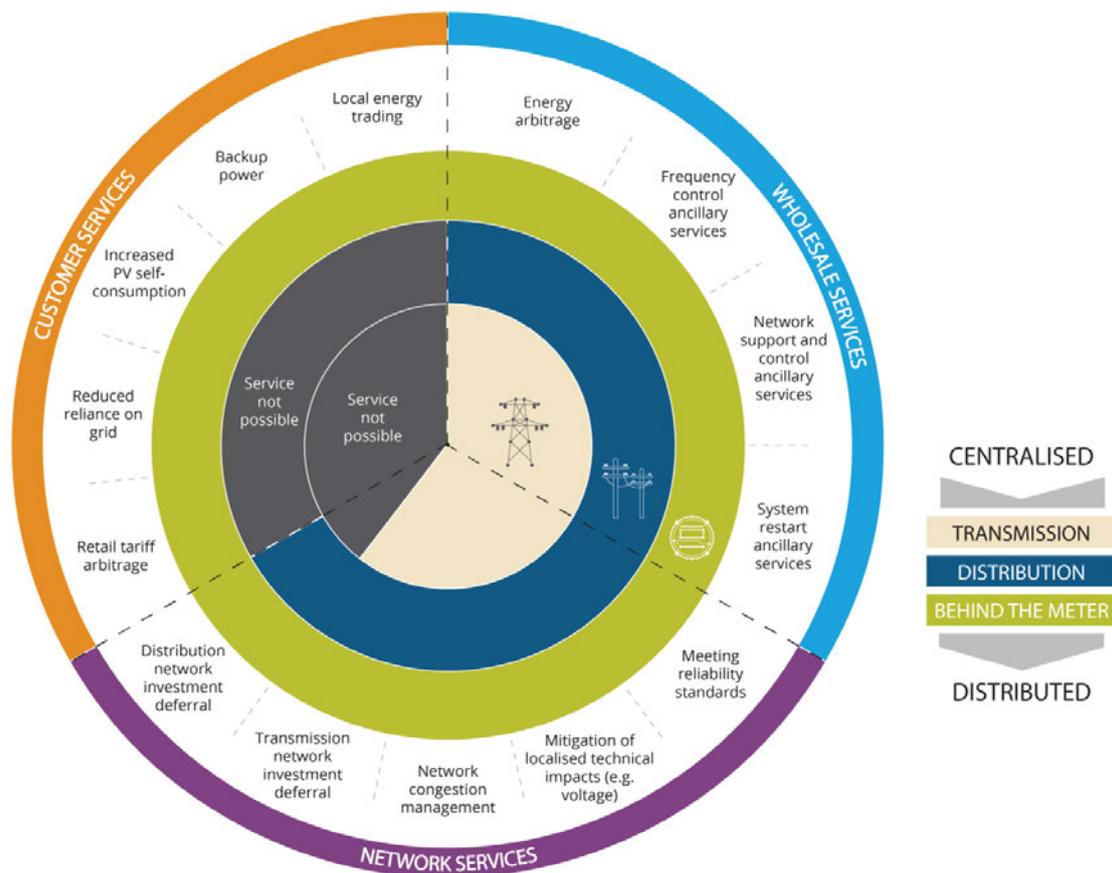
⁷¹ AEMO, *National Electricity Forecasting Report 2016*.

⁷² AEMO, *National Electricity Forecasting Report 2016*.

currently to around 255,000 in 2030, providing a total charging load of around 1,800MW.⁷³

A significant distinguishing feature of the growth in distributed energy resources is that they are capable of providing multiple value streams and providing benefits to participants across the entire electricity supply chain. Figure 3.1 below provides some examples of the multiple value streams that can be provided by distributed energy resources. It is also important to note that distributed energy resources are able to be deployed at different levels of the energy network.

Figure 3.1 The multiple value streams of distributed energy resources



Source: Adapted from the Rocky Mountain Institute for the Australian context.⁷⁴

As part of the Commission's *Distribution Market Model* research project⁷⁵ and the *2017 Electricity Network Economic Regulatory Framework Review*,⁷⁶ the Commission has examined the growth, penetration and use of distributed energy resources in the Australian context.

⁷³ AEMO, *Emerging technologies information paper 2015*.

⁷⁴ The diagram should be read from the outer edges inwards. The coloured concentric circles in the centre illustrate where the distributed energy resource is connected. The grey areas indicate where the physical location of a distributed energy resource means it cannot provide particular services. For example, a battery storage system connected at the distribution or transmission level cannot help an individual consumer reduce their reliance on the grid.

⁷⁵ For more information on this project, go to: [http://www.aemc.gov.au/Markets Reviews Advice/Distribution Market Model](http://www.aemc.gov.au/Markets%20Reviews%20Advice/Distribution%20Market%20Model).

⁷⁶ For more information on this review, go to: [http://www.aemc.gov.au/Markets Reviews Advice/Electricity Network Economic Regulatory Framework](http://www.aemc.gov.au/Markets%20Reviews%20Advice/Electricity%20Network%20Economic%20Regulatory%20Framework).

Appendix 2 of the *2017 Electricity Network Economic Regulatory Framework Review* report provides some examples of how distributed energy resources and the new technologies associated with them have been adopted by consumers, retailers and network businesses. The report also examined some of the new services and business models that have emerged from the growth of distributed energy resources.

3.1.2 The Commission’s overarching philosophy: making decisions that support consumer choice

Against this backdrop of change, it is important that the economic regulatory framework remains robust and flexible, and continues to support the efficient operation of the energy market. The Commission’s work program is contributing to the market evolution in key areas by establishing and recommending frameworks that are in the long-term interests of consumers. The key work program area⁷⁷ that is most relevant to this rule change request is the continual support for the development of the contestable energy services market.

The Commission considers that as a general rule, the best outcomes are achieved when consumers make choices based on their own interests or values. Since the Commission’s Power of Choice reform program started in 2012, the Commission’s review recommendations and rule determinations have focused on increasing the ability of consumers to control how they use electricity and manage costs.

In the context of supporting the development of the energy services market, the Commission considers that the best way to support consumers’ ability to express their preferences and make meaningful choices is through robust, well functioning and competitive markets. It is in this context that the Commission has considered the rule change requests submitted by COAG Energy Council and the AEC.

3.2 The proponents’ views

3.2.1 Overall aim of the rule change requests

The rule change requests were submitted in the context of the changing environment discussed in Section 3.1 above and seek to promote the development of the competitive energy services markets.

Both COAG Energy Council and the AEC considered that competitive markets are the most efficient way of delivering services to customers and regulation should only apply where competition is not effective.⁷⁸ Both COAG Energy Council and the AEC held concerns that it is unclear whether the NER appropriately provides for the competitive delivery of an emerging class of energy services.

⁷⁷ Other key areas under the Commission’s work program are: the integration of energy and emission reduction policy, redesigning the east coast gas market to free up gas trading and promoting systems security as the market transitions to new technologies and renewables.

⁷⁸ COAG Energy Council, Rule change request Contestability of energy services, p. 3; AEC, Rule change request Contestability of energy services network support and demand response, p. 1.

3.2.2 Additional issues raised by the AEC

In addition to concerns about the service classification framework, the AEC is also concerned with the issues described in the following paragraphs.

DNSPs will not appropriately value non-network value streams⁷⁹

The AEC considered that if DNSPs own assets capable of providing value to both DNSPs and contestable markets, networks will not value non-network value streams appropriately. For example, the entity that owns assets that are capable of providing multiple value stream would need to consider both “network peak” and “energy peak” when deciding the type of asset or technology to invest in. The AEC considered that DNSPs are not the best parties to make investment decisions in such assets.

The AEC considered the DNSPs’ inability to value non-network value streams justifies the adoption of a different procurement model for certain inputs to network services. Such a model would need to be designed to incentivise efficient investment in demand response and network support, and would require networks to source inputs to network services from a entities in the contestable market that are independent of the DNSPs.

DNSPs will use their monopoly position to obtain advantages in contestable markets⁸⁰

The AEC was concerned with the possibility that DNSPs will utilise their monopoly power in network service provision to inappropriately favour affiliated businesses or otherwise distort competition in contestable markets. Specifically, the AEC was concerned that networks would restrict access to information to disadvantage third party providers of network inputs and game incentive schemes to favour an affiliate.

To this end the AEC considered that the provision of cost reflective tariffs by networks would resolve these issues by providing transparent price signals to third party providers regarding the value of particular inputs to network services, and therefore resolve concerns regarding the favouring of affiliates. However, it will take some time to implement fully cost reflective tariffs.

Networks are fixated on growing their RAB⁸¹

The AEC considered that DNSPs are “fixated on growing the RAB”. Furthermore, the AEC believes that the shared asset guideline provides a further incentive for networks to invest in assets that can provide value to both network services and unregulated services.

⁷⁹ *ibid.* pp. 4, 7, 9.

⁸⁰ *ibid.*, pp. 11, 13.

⁸¹ *ibid.*, p. 4.

3.2.3 Solutions proposed by COAG Energy Council and the AEC

To address their concerns, COAG Energy Council and the AEC proposed two categories of changes to the NER:

- **Service classification framework**
 - COAG Energy Council: ensuring that, as a general rule, the service classification framework reflects the policy position that technologies that are prevalent in competitive markets and capable of providing multiple value streams should be classified as contestable services under the regulatory framework, unless it can be established that the competitive market is unlikely to efficiently and effectively deliver the service⁸²
 - AEC: creation of a new service classification called “energy-related services” or “contestable services” to support the development of a competitive energy services market⁸³
- **Restricting DNSPs direct investment in “behind the meter” assets.** In addition to the creation of a new service classification, the AEC also proposed to exclude DNSPs from direct investments in “behind the meter” assets. To prevent DNSPs from using traditional network solutions instead of procuring energy services from the competitive market, the AEC also proposed the following complimentary measures:
 - lower the RIT-D threshold to \$50,000, with some form of shortened RIT-D process applying to these investments
 - make the outcome of the RIT-D binding on DNSPs through prohibition of capital expenditure not approved under a RIT-D being rolled into the regulatory asset base
 - require DNSPs to publish all relevant information, so that third parties can compete for contestable services on an equal basis with DNSPs’ ring fenced affiliates.

COAG Energy Council’s rule change request also identified issues in relation to the process of service classification. Accordingly, it proposed changes that would improve the transparency and regulatory predictability of the service classification process. Chapter 7 provides a detailed discussion on the Commission’s analysis and conclusions relating to COAG Energy Council’s proposals on the service classification process.

⁸² COAG Energy Council, Rule change request Contestability of energy services, p. 3.

⁸³ AEC, Contestability of energy services network support and demand response, p. 4.

3.3 Stakeholders' views

This section outlines the views of stakeholders on issues relating to DNSPs ability to invest in assets “behind the meter”. Stakeholders' views on changes to the service classification process are discussed in Chapter 7.

3.3.1 Retailers

Retailers generally considered that allowing network service providers (NSPs) to make investments in assets that are capable of providing contestable services was tantamount to allowing NSPs to actually provide contestable services.⁸⁴ Furthermore, retailers considered that the cost allocation mechanism and shared asset guideline are sufficiently manipulable that DNSPs will be able to effectively cross-subsidise their ring-fenced affiliates when making investments in assets that provide value streams across regulated and unregulated segments of the electricity sector.⁸⁵

Retailers also considered that the current regulatory framework encourages DNSPs to preference the use of capital expenditure over operating expenditure.⁸⁶ The current framework is also seen to be focused on efficient network expenditure and fails to appropriately consider the impact of particular incentive schemes on competition in contestable markets.⁸⁷

3.3.2 The AER

The AER considered that ring fencing can only be used to enforce functional and legal separation between regulated and contestable services, and is not suited to requiring networks to source inputs from another entity. It also noted that as part of the process of preparing the AER's recent ring-fencing guideline, “it became apparent that interactions between regulated and contestable business activities are becoming more complex”.⁸⁸

3.3.3 DNSPs

DNSPs considered that investments in “behind the meter” assets by DNSPs are likely to only have a minor impact on contestable markets, and that fears of an exercise of market power in contestable markets are unfounded. DNSPs considered that network investment will only ever be relevant to a minority of such assets.⁸⁹ Further, DNSPs submitted that they do not seek to inappropriately increase the size of their RABs through investment in contestable components.⁹⁰

DNSPs considered that they should retain service delivery discretion in relation to whether to invest in assets located “behind the meter” or pay third parties for inputs provided by

⁸⁴ Submissions to the Consultation paper: AGL, p. 1; Red Energy & Lumo Energy, p. 1; Origin Energy, p. 3.

⁸⁵ AGL, Submission to the Consultation paper, p. 4.

⁸⁶ Submissions to the Consultation paper: AGL, p. 5; Origin Energy, p. 7.

⁸⁷ AGL, Submission to the Consultation paper, p. 5.

⁸⁸ AER, Submission to the Consultation paper, p. 1.

⁸⁹ Ausgrid submission to the Consultation paper, p.2.

⁹⁰ *ibid.* p. 16.

such assets. DNSPs considered that service delivery discretion is an important principle within the service based incentive regulatory framework in the NER.⁹¹ For example the ENA proposed a number of principles for assessing the rule change requests, including:⁹²

- **Reliance on flexible incentives to drive efficient expenditure solutions.** Commercial incentives to drive efficient outcomes will outperform and deliver more flexible outcomes that benefit customers than inflexible, pre-designed regulatory ‘fixes’ or narrow prohibitions on service inputs.
- **Regulatory interventions in network service delivery should be the minimum necessary to address clearly established problems.** This principle matches the Hilmer Committee’s competition principles relating to government interventions in infrastructure service markets.

Furthermore, DNSPs submitted that it can be difficult to enter contracts that deliver particular outcomes or quality of service with third parties and that it is therefore sometimes more efficient for a DNSP to provide particular inputs itself. DNSPs considered that even when it is possible to write contracts that ensure procured inputs are of a particular quality, DNSPs believe that writing contracts where a counter party bears all of the risk of non-delivery may not be efficient, or may itself deter other parties from providing inputs to a regulated network service.⁹³

DNSPs also noted that the current planning framework does not prohibit efficient utilisation of assets that provide multiple value streams, and that networks are currently capable of realising multiple value streams efficiently. DNSPs cited evidence relating to the ownership of load control,⁹⁴ or other assets in front of the meter.⁹⁵

Energy Networks Australia (ENA) also argued that any rule change in this space should focus on the efficiency of network service delivery. To this end, the ENA argued that the Commission should not sacrifice efficiency in network service delivery in exchange for the promise of competition. It noted that competition should be considered a means to an end, specifically the efficient delivery of network services.⁹⁶

⁹¹ Submissions to the Consultation paper: Ausgrid, p. 15; SA Power Networks, Citipower & Powercor, p.3; United Energy, p.2; Energy Queensland, p.8; AusNet Services, p.2; Endeavour Energy, p.10.

⁹² ENA, Submission to the Consultation paper, p. 3.

⁹³ ENA, Submission to the Consultation paper, p. 9.

⁹⁴ Ausgrid, Submission to the Consultation paper, p. 4.

⁹⁵ AusNet Services, Submission to the Consultation Paper, p. 4.

⁹⁶ ENA, Submission to the Consultation paper, pp. 7 8.

3.4 The Commission’s reasons for restricting DNSPs’ ability of own and control “behind the meter” assets

3.4.1 Enabling a competitive energy services market

In Section 3.1 above, the Commission explained that against the backdrop of change, the Commission’s recent reforms and rule determinations have focused on increasing the ability of consumers to control how they use electricity and manage costs. In the context of this rule change request, the Commission considers consumers’ ability to make choices in relation to energy services is best met through a robust competitive market.

However, a robust competitive market can only develop if all market participants are able to compete on a level playing field. In the *Integration of Energy Storage*⁹⁷ report, the Commission highlighted three types of actions from DNSPs that have the potential to weaken competition to the detriment of consumers. These actions are:

- the ability to cross-subsidise a competitive service from its regulated activities
- the ability to use information gained through the provision of regulated services to gain advantage in competitive markets
- the ability to restrict competition in a competitive market by restricting access to infrastructure or providing access on less favourable terms than to its affiliate

The Commission considers that the ring-fencing requirements that have been recently introduced by the AER will be effective in addressing the first two behaviours. However, on the third issue, the Commission is concerned that additional safeguards need to be introduced to limit network businesses’ ability to exert control and impact competition in the energy services market.

3.4.2 Why is the Commission concerned about DNSPs’ ability to exert control?

As both COAG Energy Council and the AEC have stated in their rule change requests, new technologies that are becoming prevalent in the energy market are capable of providing multiple value and revenue streams – both in the regulated and non-regulated segments of the electricity system. It is important that network businesses are able to access the services provided by these new technologies in order to provide network services efficiently, but they must do so in a way that does not risk distorting competition in the energy services market.

In most cases, the asset embodying these technologies is not capable of providing the multiple value and revenue streams simultaneously. Therefore, an entity that has control of such assets will need to make decisions regarding trade-offs, both at the time of operating these assets and at the time of investment (for example, choosing the capabilities of the asset that is installed) in these assets. In an increasingly connected energy sector, the Commission considers that the concept of efficiency must be considered not only in one part

⁹⁷ AEMC, *Integration of Energy Storage Regulatory Implications*, p. 11.

of the sector (for example, distribution networks), but across the entire energy sector. The Commission considers that if DNSPs are in control of such assets, they may favour network benefits at the expense of maximising the value across the electricity system as a whole.

Further, the nature of the assets is such that once installed at a customer's premises, the customer is not likely to install additional assets of the same type (for example, a customer is unlikely to install a second battery storage unit). The Commission is therefore concerned that DNSPs, with their incumbent status as monopoly operators of distribution networks, are able to adversely affect the level of competition in the energy services market through the ability to install (and operate) these assets and recover the costs of those assets through regulated revenues.

3.4.3 The Commission's decision

Having regard to the issues in the rule change requests, submissions from stakeholders and the Commission's concern as described in Section 3.4.2 above, the Commission considers that it is important to limit DNSPs' ability to own and control "behind the meter" assets that can provide contestable energy services to prevent adverse outcomes in the competitive energy services market.

However, the Commission has concluded that changes to the service classification framework proposed in the rule change requests are not likely to address the issues raised in the rule change requests. The Commission considers that the proposed changes to the service classification framework do not address the issue of DNSP control and potentially create adverse outcomes for the reasons discussed in Chapter 4.

The Commission considers that a draft rule that restricts DNSPs' ability to earn regulated returns on assets located behind a retail customer's connection point is a more effective and more proportionate response to the issues raised by COAG Energy Council and the AEC. Importantly, the draft rule does not restrict DNSPs' ability to utilise new behind-the-meter technologies in order to deliver regulated network services more efficiently, it simply requires DNSPs to procure those services from third-parties or from their own ring-fenced affiliates rather than owning and controlling the assets. Details on the restriction and the implementation of the draft rule is discussed in further detail in Chapters 5 and 6.

4 Service classification framework: defining the boundaries and scope of DNSPs' services

This chapter discusses the Commission's analysis and conclusions in relation to both COAG Energy Council's and the AEC's proposals relating to using the service classification framework to limit DNSPs' involvement in contestable energy services markets.

As discussed in Chapter 3, the Commission has concerns regarding the adverse impact on the level of competition in the energy services market if DNSPs are able to own and operate assets "behind the meter". However, the Commission has concluded that the changes to the distribution service classification framework proposed in the rule change requests are not likely to achieve the intended outcomes of those requests.

Instead, the Commission considers that the aspects of the more preferable draft rule discussed in Chapter 5 better address the issues raised by the proponents.

4.1 Proponents' views

4.1.1 Issues the rule change requests seek to address

Both the COAG Energy Council and the AEC considered that competitive markets are the most efficient way of delivering services to customers and regulation should only apply where competition is not effective.^{98, 99}

The AEC considered that the advent of "behind the meter" technologies that have the ability to provide demand response and network support services blurs the traditional boundaries between what is a service that forms part of a DNSP's monopoly distribution service versus what is a service that should be determined by competitive market forces.¹⁰⁰ The AEC also considered that the definitions in the NER, and particularly the definition of distribution service, are vague and imprecise. The AEC stated that the effect of this that the application of the AER draft ring fencing guideline¹⁰¹ is uncertain, and therefore subject to avoidance.¹⁰²

Similarly, COAG Energy Council considered that new technologies that are capable of providing multiple revenue streams have the potential to blur the boundaries between "traditional" regulated network services and emerging "non-traditional" services.¹⁰³ COAG Energy Council further stated that it considers that current service classification definitions lack sufficient clarity and this leads to the absence of regulatory certainty with respect to the treatment of new technologies. COAG Energy Council considered this could have

⁹⁸ COAG Energy Council, Rule change request Contestability of energy services, p. 3.

⁹⁹ AEC, Rule change request Contestability of energy services network support and demand response, p. 1.

¹⁰⁰ *ibid*, p. 2.

¹⁰¹ When the AEC submitted the rule change request, the AER had only published the draft ring fencing guideline. The final ring fencing guideline was published on 30 November 2016.

¹⁰² AEC, Rule change request Contestability of energy services network support and demand response, p. 4

¹⁰³ COAG EC, Rule change request Contestability of energy services, p. 5.

detrimental impacts for investment in new technologies in both the regulated and contestable market segments.¹⁰⁴

COAG Energy Council considered one of the key contributors to the lack of clarity is the broad definition of a “distribution service” in the NER. COAG Energy Council noted that the “in connection with” nexus of the definition appears to imply that the service does not itself need to utilise assets that fall within the scope of the distribution system, and that it potentially allows for services provided behind-the-meter to be defined as distribution services.¹⁰⁵

COAG Energy Council also considered the definitions of direct control services (including standard control service and alternative control service) and negotiated distribution service do not refer to the characteristics of the service, but instead refer to the manner in which the DNSP can recover the costs associated with providing that service. COAG Energy Council considered this approach is potentially contributing to a lack of clarity in the definitions and their practical application.

COAG Energy Council noted the key challenge of accommodating new technologies into the service classification framework is that the investment may be capable of providing multiple services/revenue streams in both the regulated and contestable market; and the need at the same time to ensure the regulatory framework continues to provide strong separation of regulated and competitive services.¹⁰⁶

4.1.2 Solutions proposed in the change requests

Solution proposed by the AEC

The AEC proposed that a new service classification called “energy-related services” or “contestable services” be created. The aim of the new service classification would be to support the development of a competitive market in services which are or should be contestable,¹⁰⁷ and to accelerate innovation and efficient investment.¹⁰⁸ The AEC did not consider that the new service classification is or should be captured by the current definition of unclassified services as the NER currently appears to define unclassified services as residual services (services not classified as direct control services or negotiated services).¹⁰⁹

The AEC stated that the definition of “energy related” or “contestable” services would preclude the AER from having a role in regulating the prices charged for contestable distribution services. However, the AEC considered that the AER would have a role in determining from time to time what services are to be included within this category of

¹⁰⁴ *ibid*, p. 10.

¹⁰⁵ *ibid*, p. 11.

¹⁰⁶ *ibid*, p. 12.

¹⁰⁷ AEC, Rule change request – Contestability of energy services – network support and demand response, p. 3.

¹⁰⁸ *ibid*, p. 4.

¹⁰⁹ “Unclassified services” is not a service classification within the current service classification framework. However, in practice, the AER have used the term “unclassified” to denote distribution services that are not regulated. An example of such services is type 1 4 metering services.

services, as well as determining whether a NSP's cost for procuring those services are prudent and efficient.

The AEC considered clause 6.17.2(b)¹¹⁰ of the NER would be an appropriate place for the new definition to be included.¹¹¹

Solution proposed by COAG Energy Council

COAG Energy Council stated that its rule change request seeks to re-enforce the competition principle that services should only be regulated where competitive market forces cannot efficiently deliver those same services.¹¹² It did not propose a particular solution to the issues raised, but requested the Commission to consider changes to the service classification definitions and related provisions to deliver the following outcomes:

- (a) implement the policy intent that new technologies that are becoming prevalent in the contestable market and capable of providing multiple services/revenue streams should as a general rule be classified as contestable services i.e. unclassified under the regulatory framework
- (b) reflect COAG Energy Council's position that there should not be a blanket prohibition on services provided by these new technologies being classified as regulated where this can be reasonably justified (e.g. where the technology will entirely be used for network support or where competition does not exist)
- (c) ensure the standard control services definition (and/or associated rules) more clearly reflect the intent that the relevant services (or allowable inputs to standard control services) must have natural monopoly characteristics
- (d) reflect the growing number and complexity of services in the electricity market, including if possible the capability of new technology investments to provide multiple services i.e. in both the regulated and contestable markets with a view to enhancing certainty for market participants and new investors
- (e) provide more clarity and certainty around how the AER interprets and applies the service classification definitions and associated rules.¹¹³

¹¹⁰ This clause details the content requirement of the the AER's distribution ring fencing guidelines.

¹¹¹ AEC, Rule change request Contestability of energy services network support and demand response, p. 5.

¹¹² COAG EC, Rule change request Contestability of energy services, p. 3.

¹¹³ *ibid*, p. 14.

4.2 Stakeholders comments

4.2.1 Changes to the service classification framework

A number of stakeholders noted that COAG Energy Council's and the AEC's proposed solutions would not address the issues raised as the service classification framework requires the AER to classify services rather than inputs to services:

- Ausgrid noted that changes to the approach to service classification are not the appropriate means to address the proponents' concerns as economic regulation is based on services, not assets. Ausgrid also noted that the location of an asset is not the key factor in determining whether it is associated with a service that is either regulated or not regulated.¹¹⁴
- Endeavour Energy considered that the proponents have incorrectly identified the service classification framework as the means of addressing the issues they have raised. Endeavour Energy noted that some of the concerns raised by stakeholders stem from the lack of understanding that it is services that are classified rather than the underlying technology or assets.¹¹⁵
- The ENA stated that the focus of the classification process should be appropriately classifying services delivered to customers, not inputs to services provided to customers. This recognised the fact that asset-based definitions of network services would be unworkable given the capacity of a range of existing network assets to provide multiple services with different classifications.¹¹⁶

AGL supported the objective of the rule change proposals and the underlying principle that, where feasible, contestability and the competitive delivery of services will promote choice and lead to better price and service outcomes for consumers. AGL stated that distributed energy resources (DER) that can be installed behind-the-meter and have the potential to offer multiple value streams (including services that support the management of the network) do not exhibit natural monopoly characteristics and that they lend themselves to contestable provision by a service provider who can provide service offers that optimise the various potential value streams available. AGL was concerned that the current regulatory framework does not require DNSPs to draw on competitive markets to deliver network support and demand management solutions and a framework that allows DNSPs to directly deploy DER creates a barrier to the development of well-functioning markets in DER related products and services.¹¹⁷

The Total Environmental Centre (TEC) stated that it found no support in the NER for the Commission's assertion that the service classification framework only classifies services

¹¹⁴ Ausgrid, submission to the Consultation paper, p. 2.

¹¹⁵ Endeavour Energy, submission to the Consultation paper, p. 7.

¹¹⁶ ENA, submission to the Consultation paper, p. 11.

¹¹⁷ AGL, submission to the Consultation paper, pp. 1 2.

provided by DNSPs to customers.¹¹⁸ However, it argued that it is time to reconsider the service classification regime and to come up with a more DER-friendly approach - its submission provided two possible options. The TEC believed the service classification regime should begin by identifying the services valued by consumers. It considered that some of the services could only be best provided by monopoly distributors while others could be provided through the competitive markets.¹¹⁹

4.2.2 Changes to the definition of distribution service

Stakeholders from various sectors of the market, including Endeavour Energy, Energy Queensland, Red and Lumo, the AEC, Origin Energy and the AER, agreed that the definition of a “distribution service” lacks clarity.

Both the AER and Origin Energy noted that the “in connection with” aspect of the definition lacks clarity. The AER noted that this phrase could be interpreted very broadly and that potentially almost any service provided with resources otherwise used to provide distribution services could be considered to be a distribution service.¹²⁰ The AEC considered that in an evolving market and technological environment, the lack of clarity in the definition does not promote regulatory certainty or efficient market outcomes.¹²¹

Origin Energy stated that the lack of clarity in the definition could be resolved with a more binding definition of the phrase “in connection with” and “distribution system” Furthermore, Origin Energy considered that a number of definitions underpinning the classification framework need to be better defined to make clear where the distribution system ends. Origin Energy considered that the definition of a distribution system would not capture behind-the-meter technologies, as they are beyond the agreed point of supply and therefore not part of the distribution system.¹²²

However, stakeholders such as Endeavour Energy and Ausgrid stated that the definition of a “distribution service” does not require an amendment. Ausgrid considered that the current definitions are 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. Ausgrid considered that the proponents do not provide sufficient justification that the AER does not have this ability to so.¹²³

Red and Lumo and Endeavour Energy noted that the Commission should consider whether the ‘in connection with’ aspect of the definition implies that there must be a physical connection to the distribution system for a service to be classified as a distribution service.¹²⁴

¹¹⁸ TEC, submission to the Consultation paper, p. 3.

¹¹⁹ *ibid*, pp. 4-6.

¹²⁰ AER, submission to the Consultation paper, p. 5.

¹²¹ AEC, Rule change request – Contestability of energy services – demand response and network support, pp. 3-4.

¹²² Origin Energy, submission to the Consultation paper, pp. 2-3.

¹²³ Ausgrid, submission to the Consultation paper, p. 9.

¹²⁴ Submissions to the Consultation paper: Red and Lumo, p. 4; and Endeavour Energy, p. 6.

Both stakeholders noted that the issue is being considered in the *Alternatives to Grid Supply* rule change request, and that clarity on this issue could be provided in that rule change request.¹²⁵

4.3 Commission's analysis and conclusions

As discussed in Chapter 3, the Commission considers that a robust and competitive market is the best mechanism to support consumer choice in the energy services sector. The Commission's position therefore aligns with that of COAG Energy Council and the AEC that competitive markets are the most efficient way of delivering services to customers and regulation should only apply where competition is not effective.

The Commission also sets out in Chapter 3 its concerns regarding DNSPs' ability to exert control (through ownership and operation of "behind the meter" assets) that could adversely affect the level of competition in the energy services market and discusses the need to curtail such actions.

After undertaking extensive analysis and having regard to the issues raised in the rule change requests and in submissions, the Commission concludes that changes to the service classification framework are not likely to be effective in addressing the Commission's, COAG Energy Council's or AEC's concerns regarding the regulatory treatment of behind-the-meter assets and other new technologies and the boundary between regulated and contestable services. The sections below set out the Commission's analysis of why the proposed changes to service classification are unlikely to be effective in addressing the concerns raised by the proponents and would not promote the NEO.

The Commission has decided that a more effective way to address the concerns raised in the rule change requests is to place a new restriction on DNSPs' ability to earn a regulated return on assets located behind a retail customer's connection point. Details of this draft new restriction are set out in Chapter 5 and 6.

4.3.1 The service classification framework: clarification

The economic regulatory framework sets out a framework for determining which services will be economically (price/revenue) regulated, which services will be subject to a negotiate/arbitrate framework (negotiated services) and which services will be subject to contestable service provision. This occurs through the distribution service classification process set out in the NER.

The current incentive regulation framework regulates services provided by DNSPs.¹²⁶ Where a service provided by a relevant DNSP is regulated, the DNSP has discretion in relation to how the service is provided, so long as the DNSP chooses the most efficient

¹²⁵ For more information on this rule change request, go to http://www.aemc.gov.au/Rule_Changes/Alternatives_to_grid_supplied_network_services.

¹²⁶ Clause 6.2.1(a) states that the AER may classify a distribution service to be provided by a DNSP as a direct control service or a negotiated distribution service.

means to do so.¹²⁷ Therefore, under the current framework, inputs – that is, generally speaking, the various components which a DNSP uses to provide a distribution service (including assets used to provide the services) – cannot be classified under the NER.

Similarly, services provided to DNSPs by network users (for example, network support provided by some large network users to the DNSP under a contract) are not services that can be classified, as they are not a service provided *by* the DNSP *to* the distribution network user.

In order to understand the purpose of service classification, and the implications of changes to service classification, it is important to understand the role of service classification in the broader economic regulatory framework for distribution networks. Service classification is a key initial step in the process adopted by the AER in regulating distribution services under a distribution determination. Any changes to service classification have significant flow-on effects for the application of the rest of the regulatory framework, in particular in relation to the revenues that DNSPs can recover and the prices they can charge for regulated services.

4.3.2 Services vs inputs

Having clarified the purpose and scope of the service classification framework, the Commission then considered the distinction between services and inputs. Specifically, the Commission considered whether the services provided by new and emerging technologies can be considered as a service under the service classification framework.

Services and inputs generally

The Commission discussed the distinction between services and inputs in detail in the consultation paper and during the public forum on 25 January 2017.¹²⁸

In some cases, the distinction between a service and an input is relatively clear. In order to be a distribution service that can be classified by the AER, the service must be provided by a DNSP to a customer. If something is provided by a customer or a third party to a DNSP, then it is not a distribution service that can be classified, but it may be an input that the DNSP uses to provide a distribution service.

The consultation paper gave the following examples of this distinction:¹²⁹

- It is the services provided by DNSPs to customers that are classified within distribution service classification. The inputs that a DNSP uses in providing distribution services to customers are not classified. Equivalently, services that are provided to the DNSP as inputs to providing services to customers are not classified.

¹²⁷ Having regard to definition of ‘distribution service’ in the NER and its application throughout the regulatory framework, the Commission considers that a distribution service is necessarily one that is provided by a DNSP to a distribution network user.

¹²⁸ See the consultation paper and forum presentations on the AEMC’s website.

¹²⁹ AEMC, Contestability of energy services Consultation paper, p. 16.

For example:

- To provide network services, a DNSP will usually need to trim trees surrounding its network. The DNSP may procure a third party or related entity to trim the trees, or use its own staff and assets to trim the trees. Regardless of which approach is taken, tree trimming for the purpose of maintaining the network is not a separate service that can be classified. This is because it is not a service being provided to a customer, it is an input to providing network services to customers.
- If a customer owns a storage device and uses it to provide a DNSP with network support, this cannot be classified because the customer is providing the DNSP with a service, not the other way around. Similarly, if a DNSP invests in storage assets and uses them to provide network support, this is not a service that can be classified, because it is an input to network services and not a separate service provided to a customer.

In some circumstances the distinction between a service and an input can be less clear. This primarily arises where something is supplied by a DNSP to a customer, but it would be possible to classify that thing as a separate service or as part of the standard control service.

In these cases, the Commission considers that one of the key determinants of whether an activity is a service is the concept of “distinctness” - that is, whether the activity in question could provide value to specific customers if supplied separately from the core service. The Commission considers that for an activity to be considered a service, it must be possible to demonstrate that a customer would receive a benefit in return for procuring that activity on a stand-alone basis. Using voltage support as an example, if it is to be considered as a separate service from the core service of providing common distribution service, the first consideration is whether voltage support, provided as a stand-alone activity, would provide value to network users.

In these more difficult cases, the AER has an appropriate amount of discretion as to what it considers to be a separate service as opposed to an input into another service. In exercising that discretion, the AER is likely to bear in mind the role of service classification in the broader regulatory regime as discussed above and whether the benefits of separating something into a separate service outweigh the costs of doing so.

For example, type 5 and 6 metering (manually read meters) had been previously treated as an input into the standard control service but the AER determined that these should be separate alternative control services in distribution determinations in 2015 and 2016. Separating out these services involved costs as it had significant implications for the rest of the determination, including the need to remove metering assets from the RAB and set separate prices for these services. However, it also had significant benefits in promoting competition for metering services and making it easier for consumers to make informed choices whether to obtain a regulated type 5 or 6 metering service from a DNSP or a competitive type 4 metering service (remotely read metering) from a retailer and compare

the prices for those services.¹³⁰

Application to new and emerging technologies

Having established a framework to consider whether an activity is a service, the Commission then considered functionality provided by new and emerging technologies.

As discussed in Chapter 3 (and as discussed in the rule change requests by COAG Energy Council and the AEC), new and emerging technologies are capable of providing multiple value streams across both the regulated and contestable segments of the energy sector. In consultation with the AER, the Commission analysed a number of technologies using the test of whether something is provided by a DNSP to a customer and applying the concept of “distinctness” above and concluded that the functions provided by new technologies (and indeed new business models) in the regulated segment of the electricity sector are not able to be classified as stand-alone distribution services.

Instead, they are inputs to DNSPs’ standard control service (the service referred to by the AER as “common distribution services” in recent distribution determinations).

These assets are also capable of providing other services in the contestable segment of the electricity sector. For example:

- A storage device has the ability to provide network support to a DNSP to relieve network congestion and is also capable of providing retail bill management services to a retail customer.
- In the context of network support, this is not a stand-alone network service that is provided by the DNSP to a customer and that the customer can derive value from, but rather it is provided by the owner of the storage device to the DNSP in providing the common distribution service. When used in that capacity, it is therefore an input to a service rather than a service and thus cannot be classified under the service classification framework.
- If the storage device was being used to provide retail bill management services to a retail customer, then that is a separate service. If that service is provided to the customer by a person other than the DNSP, then it cannot be classified by the AER as the AER can only classify and regulate services provided by the DNSP. If the DNSP was providing that service to the customer using a storage device connected to its network, then the AER may classify that as a service (depending on whether the AER considered that it was a “distribution service”). It is likely that if the AER decided that this was a distribution service, the AER would determine that this is an unclassified service, ie an unregulated contestable service.

¹³⁰ After the commencement of the competition in metering rule change on 1 December 2017, no new type 5 or 6 meters can be installed, so this issue is only relevant until the commencement of that rule change.

Why changes to service classification would not address the issue and would have significant negative consequences

Despite the above, if changes could be made so that a technology (for example behind-the-meter storage devices) is able to be classified as “contestable service” or an unclassified distribution service, the role of the service classification framework in the overall regulatory regime would mean that this approach would not achieve the outcomes sought by the proponents. Indeed, such an approach would be likely to have the opposite effect to that intended by prohibiting DNSPs procuring these new technologies from the contestable market.

Classifying these technologies as a separate unregulated service would not only prevent a distribution business from using regulated revenues to recover the cost of investing in the asset (capital expenditure), but would also prevent it procuring the functionality provided by such an asset from the contestable market and recovering the costs of doing so (operating expenditure), even though such an asset may provide the most efficient solution to a network problem.

This outcome has the potential to create adverse incentives for distribution businesses to undertake inefficient expenditure or investment and is likely to force distribution businesses to invest in traditional poles and wires assets rather than procure new technologies from the contestable market. This is likely to increase costs for consumers.

Based on the above analysis, the Commission concludes that service classification is not the appropriate area of the regulatory framework to address the issue of DNSPs’ control of “behind the meter” assets or other new technologies. The Commission considers the issue is better addressed by imposing a direct restriction on a DNSP’s ability to earn regulated return on assets behind a retail customer’s connection point. This restriction is discussed in more detail in Chapters 5 and 6.

The key benefit of this approach over a service classification based approach is that it can be designed in such a way that it limits DNSPs’ ability to own and control these assets without also preventing DNSPs from using regulated revenues to procure the functionality provided by these assets from the contestable market.

In relation to stakeholders’ concerns on the distinction between services and inputs, the Commission considers that clarity, transparency and regulatory predictability of the service classification process can be achieved through the AER developing and publishing a service classification guideline without the need for rule changes in this area. Accordingly, the draft rule requires the AER to set out in the classification guidelines, an explanation of its approach to distinguishing between distribution services (including those that are classified as direct control services) and the operating and capital inputs that are used to provide such services. A more detailed discussion about the classification guidelines is set out in Chapter 5.

4.3.3 Definition of distribution services

While the Commission acknowledges COAG Energy Council and stakeholders' concerns that the term distribution service in the NER may be uncertain in its scope, it has decided not to make a rule to amend the definition of distribution service.

The Commission considers that changes to the definition of distribution service are likely to lead to inconsistencies between that term in the NER and the defined term "electricity network service" in the NEL and, more generally, the AER's economic regulatory functions or powers under the NEL. Any such inconsistency between a rule made by the Commission and the Law may result in such a rule being invalid.

In addition, the Commission does not consider that any such change to the definition would address the issues identified by COAG Energy Council or stakeholders' concerns for similar reasons to those discussed above.

As discussed in section 4.3.1 and 4.3.2 above, the service classification framework provides for the classification of distribution services rather than inputs to those services. It appears that the functionality provided by new and emerging technologies that are the subject of this rule change are likely to be inputs to distribution services. Therefore, a revised definition of distribution service would not necessarily prevent a DNSP from deploying and controlling assets "behind the meter" as they would be considered inputs to distribution services. Such a change would also prevent DNSPs from using regulated revenues to procure the functionality provided by these assets from the contestable market.

Further, the Commission considers that in a rapidly changing market, the service classification framework should provide the AER with sufficient flexibility and discretion to determine service classification appropriate to the market condition at the relevant point in time.

Similarly, the Commission considers applying functional characteristics to the definitions of standard control services and alternative control services would limit the AER's discretion when classifying services. Currently, when the AER classifies a direct control service either as a standard control service or alternative control service, it must have regard to those factors set out in clause 6.2.2 of the NER, which provides the AER with discretion to take into account jurisdictional differences as well as the state of the market relevant to the DNSP.

The Commission considers the introducing a functional characteristic would reduce the AER's discretion without improving clarity to stakeholders. The Commission considers that improvement in clarity, transparency and regulatory predictability is best achieved through the AER's publication of the service classification guideline.

5 Regulation of “behind the meter” assets

Chapter 3 sets out the Commission’s policy position that DNSPs should not be able to control assets located “behind the meter” that are capable of providing contestable energy services. This chapter focuses on the method of specifying such a restriction under the draft rule. It splits the specification of the restriction into three key components:

- (a) control of assets
- (b) located “behind the meter”
- (c) that are capable of providing contestable services

It also discusses the Commission’s decision to not make a rule incorporating the following aspects of the AEC’s rule change request:

- proposed changes to the RIT-D, planning framework and cost allocation frameworks
- application of these changes to TNSPs

5.1 Control of assets

Rule change request

The AEC stated in its rule change request that the objective of the rule change is to support the long term interests of consumers through the development of competitive markets in services which are or should be contestable. To achieve this the AEC proposed that DNSPs be precluded from (or penalised for) making capital expenditure investments in, or taking a direct role in, providing “behind the meter”, network support or demand management services via their end customers to various parts of their electricity supply system.¹³¹

The AEC proposed to prevent DNSPs from making capital expenditure investments by creating a new service classification named contestable energy services. The AEC did not propose how the contestable service classification would operate within the distribution service classification framework. However, it considered that DNSPs would not be able to make capital expenditure investments to provide this specific group of services, but would be able to procure such services from third parties through operating expenditure.¹³²

Commission’s analysis

Context

Chapter 4 set out the operation of the distribution service classification framework. In particular, it highlighted that functions such as network support and demand management

¹³¹ AEC, Rule change request – Contestability of energy services – demand response and network support, October 2016, p. 6.

¹³² *ibid.* p. 1.

are inputs to the provision of standard control services that DNSPs provide to customers. The Commission highlighted that these inputs cannot be classified within distribution services classification because they are not services provided by DNSPs to customers. Instead, the Commission considers that any such restriction must be implemented through the regulatory framework for the provision of standard control services – i.e. primarily through the building block determination process in Chapter 6 of the NER.

Commission's position

The Commission has considered a range of options for achieving the control restriction. The Commission's preferred approach is to restrict DNSPs earning a regulated return on and of capital expenditure on such assets (subject to exemptions). This restriction on capital expenditure directly links to control of assets by DNSPs because the accounting principles that underpin DNSPs' capitalisation procedures identify control as one of the key features of capital expenditure.¹³³ For example, Australian Accounting Standards define an asset as:¹³⁴

“A resource:

- (a) controlled by an entity as a result of past events; and
- (b) from which future economic benefits are expected to flow to the entity.”

These principles are then reflected in DNSPs' capitalisation procedures. For example, Energex's capitalisation procedure defines an asset as:¹³⁵

“Asset: To satisfy the definition of property plant & equipment as an asset, there must be:

- recognition the asset has a cost that can be measured reliably
- the asset has physical substance and could be expected to be used over more than one financial year
- *the asset will be in the control of Energex and will deliver future economic benefits to Energex.*”

¹³³ The Commission notes that it is possible that accounting standards and capitalisation policies may change over time and this would affect the application of the draft rule. However, the control element of capital expenditure is a well established principle within the accounting standards and therefore this risk is relatively low.

¹³⁴ Australian Accounting Standards Board, Glossary of defined terms (September 2015), p. 3. The definition of an asset is discussed in detail in paragraph 49-59 of the Framework for the Preparation and Presentation of Financial Statements (commonly known as the “Conceptual Framework”). In particular, paragraph 56-57 of the Conceptual Framework discuss the concept of “control” in further detail.

¹³⁵ See: <https://www.aer.gov.au/system/files/Energex%20%209.%20Energex%20Finance%20Policy%20Manual%20%28Capitalisation%20Extract%29%20%20October%202014.pdf>.

In addition to being directly linked to control of assets, tying the restriction to regulated revenue from capital expenditure has a number of other benefits. For example:

- (a) it links directly to the provision of standard control services which is the focus of the issues highlighted in Chapter 3. This means that:
 - (1) DNSPs will not be restricted from earning regulated revenue from capital expenditure on assets used to provide alternative control services. This is because the restriction operates primarily through the RAB and forecast capital expenditure in the building block proposal process, which only apply to standard control services.¹³⁶ This is important because DNSPs supply of many alternative control services is based on capital expenditure on the customer's side of the connection point. For example, DNSPs in many jurisdictions are required to supply type five and six metering services as alternative control services. The core element of the provision of these services is the provision of a type five or six meter located on the customer's side of the connection point. If the restriction was to apply to these services, DNSPs would effectively be required to tender out the supply of the service, which would defeat the purpose of the DNSP being required to provide the service.
 - (2) DNSPs will not be restricted from earning unregulated revenue from capital expenditure for the provision of negotiated or unclassified distribution services.¹³⁷
- (b) it leverages off existing NER frameworks, which maintains clarity and certainty.
- (c) enforcement will be able to be undertaken by the AER through established procedures, utilising existing information gathering techniques for monitoring (see Section 6.1.5).

The Commission considered other options for introducing the restriction, for example a blanket prohibition on DNSPs investing in such assets. However, such a restriction would involve introducing an entirely new approach because there are currently no direct prohibitions within the regulatory framework for the provision of standard control services. Furthermore, this would indirectly capture assets not involved in the provision of standard control services.

Application

The restriction applies to both returns on and of capital expenditure within the regulatory control period in which the capital expenditure is incurred, and to returns on and of capital expenditure in future regulatory control periods after investments are made. The draft rule achieves these restrictions through:

¹³⁶ See NER section 6.2 and clause 6.5.7.

¹³⁷ DNSPs would also be able to earn unregulated revenue on non distribution services where the AER's ring fencing guideline permits them to provide such services.

- (a) restrictions within period:
- (1) requiring that a DNSP must not include forecast capital expenditure for restricted assets in a building block proposal (subject to the exemption set out in section 5.3 below)¹³⁸
 - (2) requiring that a DNSP must not include forecast capital expenditure for restricted assets in a contingent project, cost pass through or determination re-opener application unless it has or is seeking an exemption from the AER
 - (3) requiring the AER to not accept a building block proposal, contingent project, cost pass through or determination re-opener application that includes forecast capital expenditure for restricted assets, other than where an exemption has been sought by the DNSP and granted by the AER¹³⁹
- (b) restrictions in future periods: by requiring the AER to not increase the RAB by the value of a restricted asset (other than when an exemption has been granted for that asset or class of asset) when undertaking the RAB roll-forward at the end of each regulatory control period¹⁴⁰

Chapter 6 provides detail on the process for implementing the restriction.

5.2 Behind the meter

Rule change request

The AEC proposed the restrictions apply to all “behind the meter” investments and to investments in front of the meter where the assets are capable of providing contestable energy services. The AEC did not specify what these assets would be, but indicated they would include all assets that are capable of providing network support or demand management.¹⁴¹

Commission’s analysis

Context

Chapter 3 sets out that the Commission considers the control issues relate to assets located “behind the meter” because these are the assets that are capable of influencing the consumer driven competitive energy services market. The key question then turns to moving from the “behind the meter” conceptual framework into a specific spatial restriction within the NER.

¹³⁸ See clause 6.5.7(b)(5) under the draft rule.

¹³⁹ See clause 6.5.7(c)(2) under the draft rule.

¹⁴⁰ See clause S6.2.1(e)(9) under the draft rule.

¹⁴¹ AEC, Rule change request Contestability of energy services demand response and network support, October 2016, p. 1.

Commission position

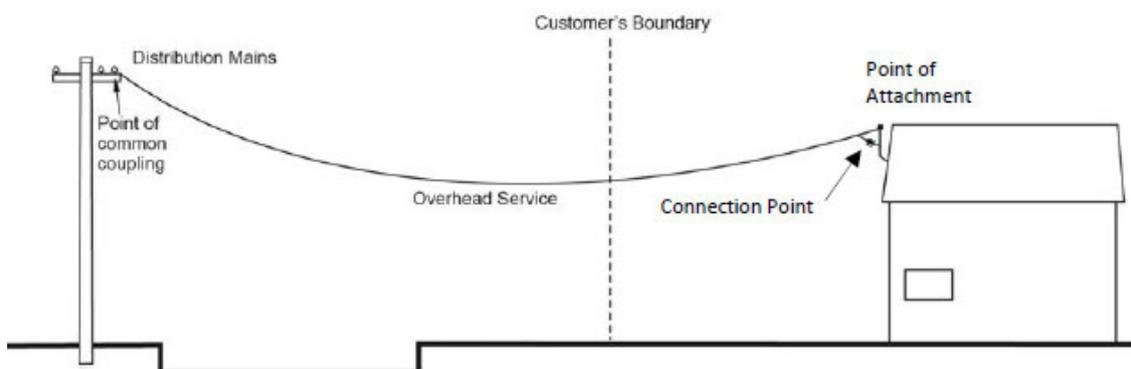
The Commission has considered a range of options for the spatial specification of “behind the meter”. The Commission’s preferred specification is a restriction on assets electrically connected to the network on the customer’s side of the connection point.¹⁴²

Connection point is defined in the NER as the agreed point of supply established between the NSP(s) and another registered participant, non-registered customer or franchise customer.¹⁴³ More generally, the connection point is commonly the point where responsibility for supply transfers from the DNSP to the customer and therefore represents the most logical boundary for the end of DNSP control and investment in assets.

While the current NER definition does not provide for a uniform point of connection for all customers, the Commission understands that the location of the connection point is generally established under connection contracts and that in many jurisdictions the exact location of the connection point for different customer types and situations is defined through jurisdictional instruments.

For example, in New South Wales, exact connection point locations are established through the Service and Installation Rules of New South Wales, prepared by the Division of Resources & Energy, Department of Planning and Environment (DRE). The Service and Installation Rules of New South Wales provide detailed examples of the location of the connection point for a wide range of scenarios. For example, Figures 5.1-5.3 display the connection point locations for customer connected through underground services from a substation on relevant land.¹⁴⁴

Figure 5.1 Connection point location - overhead service



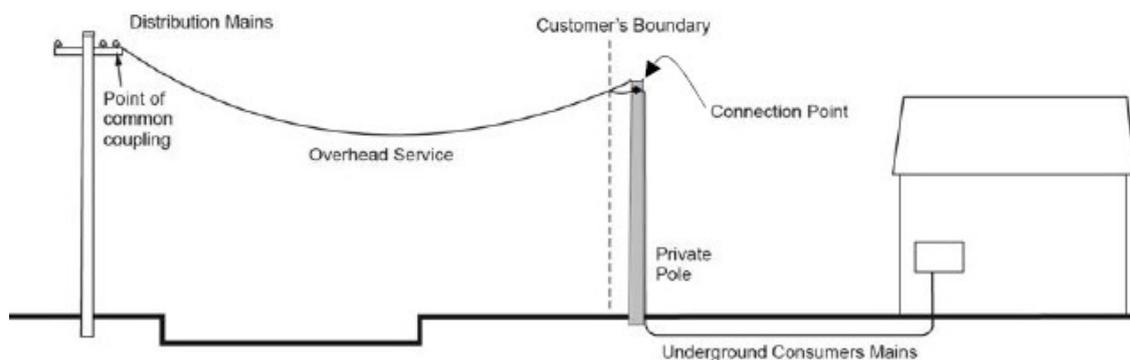
Source: DRE, Service and Installation Rules of New South Wales, November 2016, p. 9.

¹⁴² Note, this definition is set out in full in the application section below.

¹⁴³ NER Chapter 10, definition of “connection point”.

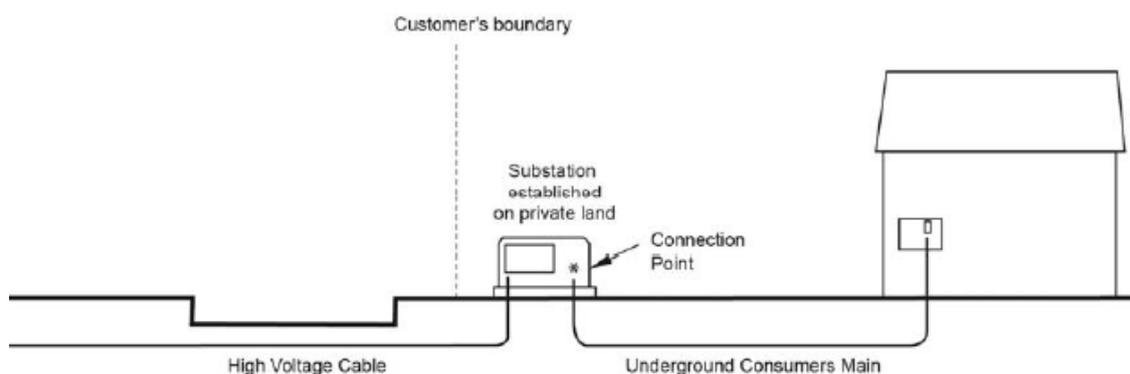
¹⁴⁴ See: http://www.resourcesandenergy.nsw.gov.au/data/assets/pdf_file/0008/672245/SIR_Nov_2016_Unmarked.pdf.

Figure 5.2 Connection point location - overhead service from underground mains



Source: DRE, Service and Installation Rules of New South Wales, November 2016, p. 9.

Figure 5.3 Connection point location - underground service from substation on relevant land



Source: DRE, Service and Installation Rules of New South Wales, November 2016, p. 12.

The Commission also considered the metering installation or customers' premises/boundary as spatial restrictions. However, the metering installation is the point at which consumption/pricing (i.e. metered consumption) is determined and therefore has limited relevance to where an appropriate boundary of the DNSP's network activities should lie. Similarly, the customers' premises/boundary is unlikely to be a practical delineation for a restriction because DNSPs may have significant network assets, such as substations, on customers' premises (for example, Figure 5.3 above). These assets are part of the shared network and are central to DNSPs to maintain the reliable supply of electricity.

Application

To give effect to the restriction on assets connected to the network on the customer's side of the connection point (i.e. the opposite side of the connection point from which electricity is supplied from the network to the connection point) the Commission's draft rule defines a restricted asset as:¹⁴⁵

¹⁴⁵ See Chapter 10 definition of "restricted asset" under the draft rule.

An item of equipment that is electrically connected to a *retail customer's connection point* at a location that is on the same side of that *connection point* as the *metering point*, but excludes:

(a) such an item of equipment where that *retail customer* is a *Distribution Network Service Provider* and that *Distribution Network Service Provider* is the *Local Network Service Provider* for that *connection point*; or

(b) a *network device*.

The Commission notes that the definition excludes assets located behind a connection point where the DNSP is the retail customer and LNSP at that connection point. The Commission considers these connection points are not related to the consumer driven competitive energy services market and an exclusion is necessary to allow DNSPs to undertake capital expenditure on assets such as land, buildings and equipment. The restriction also excludes network devices. The the reasons for this exclusion are described in section 5.3 below.

5.3 Capable of providing contestable services

Rule change request

The AEC proposed a restriction on all assets “behind the meter”. However, the AEC did note that it was not seeking to restrict NSPs from investing in assets that are used purely for the conveyance of energy as it considered these assets would not be able to provide contestable energy services.¹⁴⁶

Commission’s analysis

Context

In Chapter 3 the Commission set out that DNSPs should not be able to control assets “behind the meter” that can provide contestable energy services. The Commission highlighted a range of contestable energy services that it considered DNSPs should not be capable of influencing through control of assets. These included the wholesale and frequency control ancillary service markets run by AEMO, and services provided directly to consumers, such as the shifting of load or generation to minimise retail bills or maximise feed-in tariffs. This section discusses the Commission’s consideration on determining which specific assets DNSPs should not be able to control.

¹⁴⁶ AEC, Rule change request Contestability of energy services demand response and network support, October 2016, p. 1.

Commission position

The Commission considers that there are two possible methods of determining which specific assets DNSPs should not be able to control:

- (a) set out and define a specific set of contestable services and then set out and define the assets that are capable of providing those services and place a restriction on those assets
- (b) start with a restriction on all assets and provide for exemptions from such a restriction for assets not sought to be restricted

Given that the range of contestable energy services is continuously changing and that the technologies that can provide such services are developing over time, the first approach is unlikely to be flexible enough over time to achieve the desired restriction. The Commission therefore considers it is preferable to start with a restriction on all asset types that provide standard control services and allow for exemptions from the requirement. Furthermore, the Commission's understanding is that generally, DNSPs do not need to control assets on the customers' side of the connection point to provide standard control services. The Commission therefore considers that exemptions from the restriction are likely to be rare and a starting point of a restriction on all assets is appropriate.

The Commission considers there are three types of exemptions that are necessary from the overall restriction:

- (a) AER exemptions
- (b) Network devices
- (c) Existing assets and refurbishments of existing assets

These are set out below.

1. AER exemptions

With the starting point being that the restriction applies to all assets on the customer's side of the connection point that provide standard control services, there is a need for an exemption mechanism for incidental arrangements. For example, DNSPs that supply rural areas may need exemptions for some assets to supply extremely remote customers, or some exemptions may be needed for safety equipment for very large customers. The Commission considers that the circumstances under which such exemptions are provided need to be determined by the AER (having regard to certain considerations), not specifically set out in the NER, to provide flexibility. This is because they may need to change over time as technology, service classification and DNSPs regulatory obligations change. Furthermore, they may need to be specific to individual or groups of DNSPs.

Furthermore, with the potential range of situations and changing circumstances over time the Commission considers that the AER requires broad discretion to provide exemptions

from the restriction. The draft rule therefore only provides the AER with direction that in assessing exemptions it should have regard to the likely impacts on the development of competition in markets for energy related services in the DNSP invests in the assets that are the subject of the exemption application.¹⁴⁷ For example, this will allow the AER to grant exemptions for assets which are not able to provide energy related services other than standard control services.

The processes for the AER making such exemptions are set out in Chapter 6.

2. Network devices

In the Competition in metering final rule the Commission set out specific allowances for DNSPs to install network devices at or adjacent to the metering installation. Network devices were defined as:¹⁴⁸

Apparatus or equipment that:

(a) enables a *Local Network Service Provider* to monitor, operate or control the *network* for the purposes of providing *network services*, which may include switching devices, measurement equipment and control equipment; and

(b) is located at or adjacent to a *metering installation* at the *connection point* of a *retail customer*.

The intention of these provisions was to give DNSPs an ability to ‘bypass’ a Metering Coordinator in the event that they were unable to negotiate terms, conditions and/or prices for access to network-related services through the Metering Coordinator’s advanced meter. The Commission’s view was that these provisions would help to constrain any exercise of market power by Metering Coordinators when providing access to services that are of benefit to the network.¹⁴⁹ The Commission was particularly concerned that networks should be able to continue to operate and install hot water load control devices if there were unable to access load control services from the Metering Coordinator at a reasonable price, noting that load control services are not included in the minimum services specification for new and replacement meters.

The Commission considers that the ability to install network devices by the DNSP remains an important element in the introduction of the Competition in metering rule change and should not be affected by the new restricted asset provisions. The draft rule therefore excludes network devices from the restrictions imposed on restricted assets.¹⁵⁰

However, the Commission’s analysis of the network device provisions in this context has revealed that it could apply to a wide range of assets, including those which could have a

¹⁴⁷ See clause 6.4B.1(b)(1) of the draft rule.

¹⁴⁸ AEMC, *Expanding competition in metering and related services*, final rule, Chapter 10 definition of network device.

¹⁴⁹ AEMC, *Expanding competition in metering and related services*, Final rule determination, November 2015, p. 86.

¹⁵⁰ See Chapter 10 definition of “restricted asset” under the draft rule.

substantial impact on contestable energy related services. For example, by applying to any apparatus or equipment located at or adjacent to a metering installation that allows the DNSP to monitor, operate or control the network it could potentially apply to battery storage assets or embedded generators. The draft rule therefore tightens the network device provisions to exclude technologies that are capable of generating electricity.¹⁵¹ It does so by altering the definition of network device to include the following words:¹⁵²

...

(b) is located at or adjacent to a *metering installation* at the *connection point* of a *retail customer*; and

(c) is not, or does not have the capability of being, a *generating unit*.

Furthermore, the Commission notes that it will be undertaking a review of the arrangements for DNSP access to services provided by Metering Coordinators three years after the commencement of the substantive parts of the Competition in metering final rule, ie by 1 December 2020. At this time the Commission will assess the continued need for the network device provisions within the NER.¹⁵³

3. Existing assets

The Commission considers that the restriction should not apply to assets already in the RAB or in respect of which capital expenditure is incurred during the current regulatory control period and therefore all existing assets and investments in DNSPs' current regulatory control periods should be exempt from the restriction.¹⁵⁴ The restriction in the draft rule therefore does not affect investment decisions made by DNSPs in the past or before the draft rule comes into effect at the beginning of each DNSP's next regulatory control period.¹⁵⁵ Similarly, the draft rule is not designed to prevent DNSPs from undertaking capital expenditure for maintaining existing assets and therefore excludes refurbishment capital expenditure from the restriction.¹⁵⁶

¹⁵¹ Amended definition of network device in Chapter 10 under draft rule.

¹⁵² See Chapter 10 definition of network device under the draft rule.

¹⁵³ AEMC, Expanding competition in metering and related services, Final rule determination, November 2015, p. 81.

¹⁵⁴ The exemption from the restrictions for expenditure in all DNSPs current regulatory control periods will be introduced through transitional provisions. See section 9.2 for further details on the transitional mechanisms.

¹⁵⁵ The draft rule achieves the exemption for existing assets by only applying to additions to the RAB in the RAB roll forward process. See clause S6.2.1(e)(9) of the draft rule.

¹⁵⁶ The draft rule exempts refurbishment capital expenditure from the restriction through defining expenditure for a restricted asset as "Capital expenditure for a restricted asset, excluding capital expenditure for the refurbishment of that asset". See Chapter 10 definition of 'expenditure for a restricted asset' of the draft rule.

5.4 Complimentary changes

5.4.1 RIT-D, planning requirements, cost allocation and shared assets

Rule change request

Chapter 1 sets out how the AEC's main objective was proposed to be achieved through the restrictions on capital expenditure discussed and evaluated in sections 5.1-5.3. However, the AEC considered that with restrictions on capital expenditure investments, further complimentary changes to the NER are necessary.

The AEC considered that DNSPs are biased towards capital expenditure, in-house approaches and their own ring-fenced affiliates. Furthermore, the AEC considered that with DNSPs facing the capital expenditure restrictions set out above and exhibiting these biases, DNSPs may seek to undertake traditional network solutions rather than procuring inputs using operating expenditure from "behind the meter" assets – even when they are more efficient solutions. The AEC therefore proposed a number of supporting changes to mitigate these biases, including changes to:

- **RIT-D**¹⁵⁷
 - reduce the threshold for conducting a RIT-D from \$5 million to \$50,000 but apply the RIT-D in a truncated form
 - the truncated RIT-D would consist of the DNSP listing the asset, its location and its annualised cost on a website in reasonable advance of it having to be replaced or augmented
 - allow the AER to remove capital expenditure from the regulatory asset base which has not been subject to the RIT-D
 - capping the level of capital expenditure that is added to the regulatory asset base at the value revealed through the RIT-D
- **Planning framework.** To provide clarity and predictability in the market for new investment, the AEC proposed that DNSPs be subject to additional "standard access obligations" in relation to solutions at or near supply points. The AEC proposed that these include providing:¹⁵⁸
 - all necessary information (network performance data, load data) to competitors that will enable decisions to invest in generation or storage as an alternative to distribution capacity
 - technically equivalent access to the network to the competitors of any regulated or related business

¹⁵⁷ AEC, Rule change request – Contestability of energy services – demand response and network support, pp. 8-9.

¹⁵⁸ *ibid.* pp. 9-10.

- **Cost allocation.** The AEC considered that the cost allocation framework, including the cost allocation principles outlined in the NER and the AER’s cost allocation guideline offer little guidance beyond high level generic principles. It therefore considers 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. The AEC, therefore, considered that changes are necessary to the cost allocation provisions in the NER. The AEC does not propose specific changes to the NER, but notes that they should include new principles, developed in consultation, for the allocation of costs for assets that can provide both direct control services and network support or demand response.¹⁵⁹

Submissions

DNSPs opposed the changes to the RIT-D, planning framework and cost allocation mechanisms proposed by the AEC. DNSPs submitted there are a wide range of issues with the proposed changes, including:¹⁶⁰

- a lack of evidence of the purported biases or problem(s) with the existing framework
- a lack of clarity regarding the proposed “truncated RIT-D” and new information requirements in the planning framework
- significant costs of the reduced RIT-D threshold additional information requirements in the planning framework
- direct inconsistencies with recent decisions in the Commission’s recent local generation network credits and replacement expenditure planning arrangements rule change determinations
- they represent a move away from the incentive based regulatory framework to a cost of service framework, resulting in reduced strength in the incentives to provide network services efficiently

Retailers generally supported the AEC’s proposed changes to the RIT-D, planning framework and cost allocation mechanisms. Retailers considered that DNSPs do exhibit biases and that greater scrutiny of DNSPs service delivery decisions is warranted. Retailers also considered that greater information about network opportunities and a lower RIT-D threshold would increase the ability of third parties to provide network support and demand management to network expenditure.¹⁶¹

The Clean Energy Council (CEC) supported the truncated RIT-D with a lower threshold, considering that the current threshold limits the opportunities for providers of demand

¹⁵⁹ *ibid.* pp. 4 6.

¹⁶⁰ Submissions to the Consultation paper: ENA, p. 2; AusNet Services, p. 2; Energy Queensland, p. 17; Ausgrid, p. 1; Endeavour Energy, p. 2; Jemena, p. 3; SA Power Network, Citipower and Powercor, p. 1.

¹⁶¹ Submissions to the Consultation paper: AEC, pp. 2, 12 15; AGL, pp. 1 2, 4 5; Origin Energy, pp. 6 9; Red Energy and Lumo Energy, pp. 1, 5 7.

response and network support to realise potential network value.¹⁶²

Commission's analysis

The AEC's proposed changes to the RIT-D, planning framework and cost allocation are designed to address perceived biases exhibited by DNSPs under the existing regulatory framework. The Commission considers that these biases relate to the incentives provided to DNSPs under the incentive regulation framework and are separate from the core focus of the rule change requests – the introduction of contestable frameworks for inputs to standard control services related to “behind the meter” assets. The Commission considers that these broad issues need to be assessed within a review of the overarching incentive design, not within a rule change request targeted at contestability of energy services. Accordingly, the Commission does not consider it is appropriate to make changes to the NER relating to these issues within this rule change process. The Commission will be undertaking the review of the incentive framework within the *2018 Electricity network economic regulatory framework review*.

In coming to this conclusion the Commission has also considered a variety of other factors:

- The Commission recently considered changes to both the RIT-D threshold and information requirements in the distribution planning framework through the Local Generation Network Credits (LGNC) rule change.¹⁶³ The Commission added information provisions to the planning framework through requirements on DNSPs to produce system limitation reports. The Commission concluded changes to the RIT-D threshold would not meet the NEO.
- With the draft rule requiring DNSPs to procure inputs that assets located on the customer side of the connection point provide through operating expenditure (through the requirements set out in Sections 5.1-5.3) there is likely to be less reliance on the cost allocation and shared asset mechanisms and these proposed changes are likely to be less important.
- If the Commission, in its analysis of the incentives in the *2018 Electricity network economic regulatory framework review*, concludes that the current incentive regulation framework is not providing efficient incentives to DNSPs (e.g. between capital and operating expenditure), it is likely to be more appropriate to recommend that this incentive issue is addressed directly through changes to the incentive framework to balance the incentives.

¹⁶² CEC, submission to the Consultation paper, p. 2.

¹⁶³ AEMC, Local generation network credits, final rule determination, December 2016.

- If a direct approach is sought it may involve substantial research into alternative incentive designs, for example, a total expenditure framework. If such an approach was to be included in this rule change process it could delay the implementation of the service classification and capital expenditure restrictions set out in the draft rule, and mean that these changes are unlikely to be able to be implemented prior to the next round of AER determinations.

While the draft rule does not make the AEC's proposed changes to the planning framework (or cost allocation provisions), in analysing the planning framework, the Commission has noted that the obligation to follow the RIT-D and RIT-T processes are not subject to civil penalty provisions. Given the importance of a robust planning framework to efficient provision of network services and an efficient competitive energy services market, the Commission recommends that the COAG Energy Council make breaches of the RIT-D and RIT-T processes subject to civil penalty provisions. Further information on this recommendation is set out in Appendix B.

5.4.2 Application to TNSPs

Rule change

The AEC requested that the Commission consider both the contestable service delivery issues discussed in sections 5.1-5.3 and the complimentary changes discussed in section 5.4.1 to TNSPs.

Submissions

Transgrid and AusNet Services considered that their opposition to limitations on DNSP service delivery discretion are equally relevant to the consideration of TNSPs.¹⁶⁴ Other stakeholders did not comment on the application of the rule change requests to TNSPs.

Commission's analysis

The Commission's analysis in Chapter 3 demonstrates that the issues for contestable service provision are centered around DNSP control of assets "behind the meter". Given the very small number of customers directly connected to the transmission network and the larger size and sophistication of these customers, the Commission does not consider that these issues are material at the transmission level. The draft rule therefore does not make changes to Chapter 6A of the NER.

¹⁶⁴ Submissions to the Consultation paper: AusNet Services, p. 1; and Transgrid submission, p. 2.

6 Process for application of asset restriction

Chapter 3 set out the Commission’s policy to restrict DNSP control of certain “behind the meter” assets that can provide contestable services. Chapter 5 set out that this would be achieved through restrictions on DNSPs earning a return on or of capital expenditure on certain assets (subject to exemptions) electrically connected to the customers’ side of the connection point.

This chapter sets out the Commission’s proposed process for implementing that restriction. It is broken down into:

- the general process that will apply to DNSPs under the new framework
- the transitional arrangements

6.1 General process

The Commission proposes that the restriction be implemented through a four step process:

- (a) AER exemptions guideline (the Asset Exemption Guideline)
- (b) distribution determination (four step propose-respond) process for each DNSP
- (c) within regulatory control period exemptions in limited circumstances
- (d) RAB roll-forward

Each of these steps is set out below.

6.1.1 AER exemptions guideline

The first step in the application of the restriction will be for the AER to publish a guideline that sets out the approach it will take to granting exemptions from the restriction. The Commission considers an exemption guideline is important because it will allow DNSPs to make exemption applications within their regulatory proposals based on guidance provided by the AER. It will also allow for consultation on the approach to assessing exemptions with DNSPs and interested stakeholders.

Key features and benefits of the Asset Exemption Guideline within the draft rule include:

- The AER may choose to consolidate the Asset Exemption Guideline with the service classification guideline or any other guideline.¹⁶⁵ This will allow the AER to undertake consultation and analysis on exemptions jointly with other relevant decisions if it chooses to.

¹⁶⁵ See clause 6.4B.1(d) under the draft rule.

- The first Asset Exemption Guideline must be published by 30 September 2018.¹⁶⁶ This will allow the AER nine and half months to finalise the guideline following publication of the final rule. It will also allow the Asset Exemption Guideline to be incorporated into the Victorian, South Australian and Queensland DNSPs' next regulatory determinations processes without any specific transitional provisions for these jurisdictions (as set out in section 6.2.2).
- The AER must follow the distribution consultation procedures in developing the Asset Exemption Guideline.¹⁶⁷ This will allow DNSPs and other interested stakeholders an opportunity to have input to the approach for granting exemptions.
- The AER is required to set out the approach it will take to assessing proposals for exemptions in the Asset Exemption Guidelines. It is not required or able to grant exemptions within the Asset Exemption Guideline – this will be done DNSP by DNSP through the distribution determination, cost pass through and reopener processes (set out in sections 6.1.2 and 6.1.3 below).
- Consistent with other AER guidelines, the approach to assessing exemptions as set out in the Asset Exemption Guideline is not binding on the AER or DNSPs. However, the AER must set out reasons for any variation from that approach when making a decision on an asset exemption application and DNSPs must have regard to the guideline when making exemption applications.¹⁶⁸
- The AER must set out any information it will require DNSPs to submit with their exemption applications in the Asset Exemption Guideline and DNSPs will be required to provide such information in their exemption applications.¹⁶⁹

The Commission notes that while only the approach to assessing exemptions is required, the AER may choose to give guidance in the Asset Exemption Guideline on certain assets or classes of assets that it is likely to grant exemptions to DNSPs in their regulatory proposals. Similarly, it may also highlight which types of assets it is unlikely to give an exemption for. This will provide an opportunity for streamlining of the exemption process because these indications will provide DNSPs with guidance when considering making exemption applications.

¹⁶⁶ Note, this requirement will be introduced through transitional provisions. The Commission will be publishing a consultation paper on transitional arrangements (including proposed transitional rules) on 19 September 2017. Further information on the transitional provisions is set out in section 6.2.

¹⁶⁷ See clause 6.4B.1(c) under the draft rule.

¹⁶⁸ See clause 6.2.8(c)(2) under the draft rule.

¹⁶⁹ See clause 6.4B.1(c)(2) under the draft rule. Note that these information requirement are in addition to the prescribed contest for exemption applications set out in clause 6.4B.2(b)(1) (4).

6.1.2 Distribution determination

Process

The draft rule provides that exemption applications submitted by DNSPs and exemption decisions by the AER are to be made within the existing propose-respond four step process of the distribution determination cycle and that exemptions granted will apply for expenditure incurred within that regulatory control period. Each step of this process is set out below.

Step 1. Regulatory proposal

The draft rule requires DNSPs to submit an exemption application alongside their regulatory proposal and tariff structure statement if they are seeking any exemptions for the regulatory control period.¹⁷⁰ In doing so, DNSPs must set out:¹⁷¹

- a description of the asset or class of asset in respect of which the proposed asset exemption would apply, including the location and anticipated or known cost of the proposed asset or class of asset
- details of the standard control services that would be provided by the asset or class of asset in respect of which the proposed asset exemption would apply
- an assessment of the likely impacts on the development of competition in markets for energy related services if the DNSP invests in the assets the subject of the exemption
- information that the AER has set out in the exemption guideline

When making its regulatory proposal the draft rule requires that a DNSP must not include capital expenditure for a restricted asset in its forecast capital expenditure contained in its building block proposal, except where the DNSP has submitted an exemption application for that asset or class of asset.¹⁷² DNSPs may seek to provide the AER with information in their regulatory proposals regarding alternative solutions to those solutions involving capital expenditure on restricted assets that they have sought an exemption for. This would facilitate the AER making decisions regarding expenditure allowances on alternative solutions in its draft distribution determination if it rejects any of the exemption applications (see step 2).

Step 2. Draft distribution determination

The draft rule requires the AER to include a draft decision on exemptions in the draft distribution determination and not accept forecast capital expenditure on restricted assets contained in the DNSP's building block proposal, unless the DNSP has submitted an exemption application for that asset or class of asset and the AER has granted an exemption

¹⁷⁰ See clause 6.5.7(c)(5) under the draft rule. Note that DNSPs, in the cases of cost pass throughs and reopeners are also able to make exemption applications within the regulatory control period.

¹⁷¹ See clause 6.4B.2(b) under the draft rule.

¹⁷² See clause 6.5.7(a)(5)(ii) under the draft rule.

for the expenditure.¹⁷³ In making draft exemption decisions, the AER must:

- have regard to the likely impacts on the development of competition in markets for energy related services if the DNSP invests in the assets the subject of the asset exemption¹⁷⁴
- have regard to the Asset Exemption Guideline and if the AER has departed from its approach to assessing exemptions set out in the Asset Exemption Guideline it must set out its reasons for doing so in the determination¹⁷⁵

In making the draft determination, if the AER's draft exemption decision is to not approve any of the exemption applications a DNSP has made it will need to determine expenditure allowances without such capital expenditure. As with all alterations from a DNSP's regulatory proposal, it will do so in accordance with the capital and operating expenditure objectives, criteria and factors. This may include substituting the proposed restricted capital expenditure with increased expenditure allowances. For example, it is possible that the restricted asset capital expenditure may be the lowest cost option to provide the standard control service and without it a higher level of expenditure is required to provide the services.

Step 3. Revised regulatory proposal

Under the draft rule, DNSPs will be able to make submissions to the AER's draft distribution determination regarding both the AER's draft exemption decisions and any draft decisions on expenditure allowances the AER has substituted for capital expenditure on restricted assets for which the AER did not grant an exemption.¹⁷⁶ The submissions may include additional information regarding the requested exemptions or the need for/type of alternative capital and operating expenditure if exemptions are not approved. However, the draft rule does not provide a process for DNSPs to make revised exemption applications alongside their revised regulatory proposals. The Commission considers that DNSPs should not have the ability to make additional exemption applications.

When making its revised regulatory proposal the draft rule requires that a DNSP must not include capital expenditure for a restricted asset in its forecast capital expenditure, except where the DNSP has submitted an exemption application for that asset or class of asset.¹⁷⁷

Step 4. Distribution determination

The draft rule requires the AER to include a decision on exemptions in the distribution determination and not accept forecast capital expenditure on restricted assets contained in the DNSP's revised regulatory proposal, unless the DNSP has submitted an exemption application for that asset or class of asset and the AER has granted an exemption for the

¹⁷³ See clauses 6.12.1(2A) and 6.12.1(3A) under the draft rule.

¹⁷⁴ See clause 6.4B.1(b)(1) under the draft rule.

¹⁷⁵ See clauses 6.4B.1(b)(2) and 6.2.8(c)(2) under the draft rule.

¹⁷⁶ See NER clause 6.10.2(c).

¹⁷⁷ See clause 6.5.7(a)(5)(iii) under the draft rule.

expenditure.¹⁷⁸ Similar to the draft exemption decisions at the time of the draft determination, in making its final decision on exemptions in the distribution determination the AER must:

- have regard to the likely impacts on the development of competition in markets for energy related services if the DNSP invests in the assets the subject of the asset exemption¹⁷⁹
- have regard to the exemption guideline and if the AER has departed from its approach to assessing exemptions set out in the exemption guideline it must set out its reasons for doing so in the determination¹⁸⁰

Also similar to the draft determination, in making the final distribution determination, if the AER does not approve any of the exemption applications a DNSP has made it will need to determine expenditure allowances without such capital expenditure.

Commission analysis

The Commission considers that this implementation process has a number of key benefits:

- (a) By DNSPs making exemption applications at the same time as their regulatory proposals they will be at a stage where they have formulated their business plans for the upcoming regulatory control period and therefore have enough information to make informed and detailed applications to the AER. They will also be able to set out alternatives to the AER for their capital and operating expenditure requirements should exemptions not be granted.
- (b) DNSPs and the AER will be able to consult with stakeholders through the determination process in the same manner they consult on the distribution determination and tariff structure statements. This is likely to reduce administration costs for the AER, DNSPs and stakeholders.
- (c) The propose respond format will allow for two rounds of proposals, engagement, information sharing and analysis between stakeholders, the AER and DNSPs.

The Commission has also considered other options for the process for granting exemptions. For example, the Commission considered requiring DNSPs to make applications to the AER for exemptions within the framework and approach process (for example, three months before the final framework and approach paper is due). This would allow the AER to make decisions in the final framework and approach paper which would enable DNSPs to make their regulatory proposals with increased certainty because they would know the AER exemption decisions. However, on balance, the Commission considers this is not preferable because:

¹⁷⁸ See clauses 6.12.1(2A) and 6.12.1(3A) under the draft rule.

¹⁷⁹ See clause 6.4B.1(b)(1) under the draft rule.

¹⁸⁰ See clauses 6.4B.1(b)(2) and 6.2.8(c)(2) under the draft rule.

- (a) DNSPs may not be in a position at that early a stage to determine what they may need exemptions for
- (b) it would require a new process for the exemption applications to be made
- (c) it may result in less opportunity for consultation with stakeholders

6.1.3 Within period exemptions

The Commission has analysed whether DNSPs should be able to make additional applications for exemptions within their regulatory control periods. Generally, the Commission considers that DNSPs should not be able to do so. By giving DNSPs an opportunity to engage with the AER in the exemption guideline, and make exemption applications through the four step propose-respond model, DNSPs will have adequate opportunities to make applications. Furthermore, exemptions within period are likely to be administratively costly and difficult to assess for the AER because they would require a new process and the AER would not have the detailed information available to it that it has at the time of the distribution determination.

However, while the Commission considers that there generally should be no ability for within period exemptions, in cases of material changes that are not forecastable at the time of the distribution determination and where the existing framework provides for within period adjustments, the draft rule allows DNSPs to seek exemptions within the regulatory control period in certain limited circumstances. There are two instances where the Commission considers this is appropriate. These are described below.

1. Positive cost pass through events.

Context

A cost pass through may occur within a regulatory control period when a pre-defined event occurs that entails the DNSP incurring materially higher costs in providing direct control services (capital and/or operating expenditure) than it would have incurred but for that event occurring. In such circumstances, the AER may approve a positive pass through amount under the cost pass through provisions in clause 6.6.1 of the NER.¹⁸¹

Positive cost pass throughs exist in the NER as a mechanism to allow DNSPs to recover their efficient costs incurred as a result of events that could not be forecast as part of their regulatory or revenue proposal that otherwise would have a significant financial effect on the ability of network businesses to invest in and operate their networks. Cost pass through events currently include 'regulatory change events', 'service standard events', 'tax change events', 'retailer insolvency events' and any other event specified in a distribution determination as a pass through event (for example, natural disasters and terrorism events).¹⁸²

¹⁸¹ AEMC, Cost pass through arrangements for network service providers, final rule determination, August 2012, p. 2.

¹⁸² *ibid.*

Commission position

The Commission considers that because pass through events must be both material and not able to be forecasted at the time of the regulatory proposal, DNSPs should be able to apply for additional exemptions within regulatory control periods if they need to undertake additional capital expenditure when such events occur and they seek to incur expenditure on restricted assets in respect of the event.¹⁸³ For example, if the Commission introduces new regulatory obligations on DNSPs within a regulatory control period through a rule change and that potentially requires DNSPs to make capital expenditure on restricted assets, the Commission considers DNSPs should have the opportunity to apply for additional exemptions.

Process

In the case of a positive cost pass through event DNSPs make an application to the AER to pass through the increase in costs to consumers as a result of the event. The draft rule builds upon this existing process for the purposes of introducing an exemption application process for pass throughs and for introducing restrictions on capital expenditure for restricted assets in respect of positive pass through amounts. This includes:

- (a) When making an application seeking approval of a positive pass through amount, a DNSP must:
 - (1) also make an application for an exemption if it seeks to undertake capital expenditure on restricted assets in respect of the pass through amount¹⁸⁴
 - (2) not include in the proposed pass through amount or in a regulatory proposal forecast capital expenditure on restricted assets in respect of a positive pass through amount unless an exemption has been granted by the AER in respect of that expenditure¹⁸⁵
- (b) The AER, in making its determination on the pass through application, must:
 - (1) determine whether to grant the exemption and publish the reasons for its decision¹⁸⁶
 - (2) not approve capital expenditure on a restricted asset in respect of that pass through application, unless it has granted an exemption in respect of that expenditure¹⁸⁷

The pass through provisions in the NER provide that if the AER does not make a decision on a pass through application in forty business days it is taken to accept the pass through

¹⁸³ The draft rule does not allow DNSPs to make exemption applications for a negative pass through event because negative pass through events do not involve additional capital expenditure.

¹⁸⁴ See clause 6.6.1(c1) under the draft rule.

¹⁸⁵ See clause 6.5.7(c)(5)(ii) and 6.6.1(c1) under the draft rule.

¹⁸⁶ See clause 6.6.1(d)(2) and 6.6.1(d1) under the draft rule.

¹⁸⁷ See clause 6.6.1(d2) under the draft rule.

application.¹⁸⁸ The draft rule sets out that if this occurs the AER will also be taken to have accepted any exemption application submitted with the pass through application.¹⁸⁹ The Commission also notes that under the existing provisions the AER has the power to request additional information from the DNSP in assessing pass through applications.¹⁹⁰ The draft rule provides the AER with the ability to request additional information to assess exemption applications consistent with this existing power.

2. Reopening of the distribution determination for capital expenditure

Context

Under clause 6.6.5(a) of the NER a DNSP may apply to the AER to have its distribution determination revoked and substituted in very limited circumstances. This may only occur where:

- an event that is beyond the reasonable control of the DNSP has occurred and the occurrence of that event could not reasonably have been foreseen by the DNSP at the time of the making of the distribution determination, and
- no forecast capital expenditure was accepted or substituted by the AER for that period in relation to the event that has occurred, and
- the DNSP proposes to undertake capital expenditure to rectify the adverse consequences of the event, and
- the total of the capital expenditure required during the regulatory control period to rectify the adverse consequences of the event:
 - exceeds 5% of the value of the RAB for the relevant DNSP for the first year of the relevant regulatory control period, and
 - is reasonably likely to result in total actual capital expenditure for the regulatory control period exceeding the forecast capital expenditure as accepted or substituted by the AER, and
- the DNSP can demonstrate that it cannot reduce capital expenditure in other areas to avoid the above without materially adversely affecting the reliability and security of the relevant distribution system, and
- a failure to rectify the adverse consequences of the event would be likely to materially adversely affect the reliability and security of the relevant distribution system, and
- the event is not a pass through event or a contingent project.

¹⁸⁸ See NER clause 6.6.1(e).

¹⁸⁹ See clause 6.6.1(e)(3) under the draft rule.

¹⁹⁰ See NER clause 6.6.1(e1).

Commission position

Similar to cost pass through events, an event meeting the reopener criteria will be both material and unforecastable. The Commission therefore considers that DNSPs should be able to apply for exemptions in respect of such events during the regulatory control period.

Process

Similar to cost pass through events, under the existing NER DNSPs make an application to the AER to recover the costs of reopener events. The draft rule builds upon this process to allow exemption applications and to prevent approval of capital expenditure on restricted assets without an exemption. This includes:

- when making a reopener application a DNSP must:¹⁹¹
 - (1) also make an application for an exemption if it is seeking to undertake capital expenditure on restricted assets for the purposes of the capital expenditure it proposes to undertake to rectify the adverse consequences of the reopener event
 - (2) not include proposed capital expenditure on restricted assets for the purposes of the capital expenditure it proposes to undertake to rectify the adverse consequences of the reopener event unless it made an exemption application in respect of such event¹⁹²
- the AER, in making its determination on the reopener application, must:
 - (1) determine whether to grant the exemption¹⁹³
 - (2) not include an adjustment to forecast capital expenditure in the relevant determination, unless an asset exemption has been made in respect of such expenditure¹⁹⁴

Similar to the cost pass through provisions, the existing reopener provisions provide the AER with ability to request additional information from the DNSP in assessing reopener applications.¹⁹⁵ The draft rule provides the AER with the ability to request additional information to assess exemption applications consistent with this existing power.

6.1.4 RAB roll-forward

The final stage of the implementation of the restriction for each regulatory control period is through the RAB roll-forward arrangements. Under these arrangements, the AER, at the end of each regulatory control period adjusts the RAB. This includes additions to the RAB

¹⁹¹ See clause 6.6.5(b1) under the draft rule.

¹⁹² See clause 6.6.5(b1) under the draft rule.

¹⁹³ See clause 6.6.5(c) under the draft rule.

¹⁹⁴ See clause 6.6.5(f1) under the draft rule.

¹⁹⁵ See clause 6.6.5(g) under the draft rule.

for actual capital expenditure incurred in the regulatory control period and reductions to the RAB for depreciation and other matters. The draft rule sets out that in increasing the RAB for actual capital expenditure incurred within the period, the AER is required to exclude actual capital expenditure on restricted assets in respect of which no asset exemption has been granted.¹⁹⁶

6.1.5 Other matters

AER information gathering and enforcement

Context

The Commission has considered whether the AER has the necessary tools to gather information to apply and enforce the draft rule. This includes information to inform their decision on whether to grant exemptions, to provide for alternative expenditure allowances when exemptions are not granted and to exclude actual capital expenditure on restricted assets incurred during the relevant regulatory control period from adjustments to the RAB where no exemption was granted for such exemptions.

Existing provisions

Under the NEL the AER has information gathering powers, including:

- the ability to issue general regulatory information orders – orders requiring each regulated NSP of a specified class or related provider of a specified class to provide information to the AER specified in the order and/or prepare, maintain or keep information specified in the notice in a manner and form specified in the order.¹⁹⁷
- the ability to issue regulatory information notices – notices requiring a regulated NSP or related provider to provide the AER with information specified in the notice and/or prepare, maintain or keep information specified in the notice in a manner and form specified in the order.¹⁹⁸

Commission's analysis

In addition to the information required to be included in an exemption application under clause 6.4B.2 of the draft rule, the draft rule sets out that the AER may determine, through the exemption guideline, the information a DNSP must provide in making exemption applications.¹⁹⁹ Beyond this power, the Commission does not consider it necessary to add additional information gathering powers to the AER's existing suite of powers. The Commission considers that through its existing information gathering powers the AER will be able to apply and enforce the draft rule. The Commission notes that this may include updates or changes to regulatory information notices or orders to provide or keep

¹⁹⁶ See clause S6.2.1(e)(9) of the draft rule.

¹⁹⁷ See section 28C of the NEL.

¹⁹⁸ See section 28D of the NEL.

¹⁹⁹ See clauses 6.4B.2(5) of the draft rule.

information relating to expenditure on restricted assets.

With regard to enforcement, the Commission also notes that because restricted assets are located on the customer's side of the customer's connection point there is a high level of visibility of any capital expenditure undertaken by DNSPs on restricted assets. This means that if a DNSP undertakes material capital expenditure on restricted assets without an exemption it is likely to be noticed and reported to the AER by stakeholders (for example, retailers or metering providers).

Contingent projects

Context

Contingent projects are projects assessed by the AER as being reasonably required, but for which uncertainty exists regarding the timing or costs. The proposed contingent capital expenditure for a contingent project is therefore excluded from the forecast capital expenditure submitted under a regulatory proposal. When a trigger event occurs the DNSP then makes an application to the AER for an allowance for the additional expenditure to be included in the determination.²⁰⁰

In the context of the draft rule, contingent projects raise issues about whether DNSPs should be able to make exemption applications when making contingent project applications and how the restriction applies to capital expenditure for contingent projects. The Commission's position on these issues is set out below.

Commission's analysis

The draft rule does not allow DNSPs to make exemption applications within regulatory periods for contingent projects. Contingent projects are, by their nature, foreseeable at the time of the distribution determination – otherwise they would not be able to be included as contingent projects in the distribution determination. The Commission therefore considers that DNSPs will be able to apply for exemptions from the restriction within the determination process and do not need to be able to make exemption applications with the regulatory control period.

In regard to how the restriction will apply to capital expenditure proposed in contingent project applications, the draft rule specifies that:

- DNSPs may not include proposed contingent project capital expenditure on restricted assets in their regulatory proposal, unless the DNSP has sought an exemption in respect of that expenditure²⁰¹
- the AER may not approve proposed contingent project capital expenditure on restricted assets, or include such expenditure when amending a distribution

²⁰⁰ See NER Chapter 10, definition of 'trigger event' for a DNSP.

²⁰¹ See clause 6.6A.2(a1) of the draft rule.

determination under 6.6A.2, unless they have granted an exemption in respect of such expenditure²⁰²

- A DNSP must not include in their regulatory proposal, and the AER must not accept, unspent capital expenditure for a contingent project, unless the AER has granted an exemption in respect of such expenditure.²⁰³

6.2 Transitional arrangements

The Commission sets out below proposed transitional arrangements for the package of provisions related to restricted assets contained in the draft rule. However, the draft rule does not contain draft transitional provisions. A consultation paper outlining a complete transitional proposal, along with draft transitional provisions, will be published for comment by 19 September 2017.²⁰⁴

The Commission considers that with the rate of development in contestable energy services it is important that the restrictions apply to the next round of regulatory control periods for all DNSPs. The Commission therefore proposes that in jurisdictions where the implementation process set out in section 6.1 above cannot occur due to timing within the regulatory process, transitional arrangements should apply. These proposed arrangements are set out for each jurisdiction below.

6.2.1 New South Wales, Australian Capital Territory, Northern Territory and Tasmania

Context

The process for application of the asset restriction described in section 6.1 is not practically able to be applied to the New South Wales, Australian Capital Territory, Northern Territory and Tasmanian DNSPs for the 2019-24 regulatory control period. The respective DNSP's regulatory proposals are required to be submitted by 31 January 2018, which is less than two months after the final rule is scheduled to be published. This means that there will not be sufficient time for the AER to make the Asset Exemption Guideline and it is unlikely DNSPs will be able to comply with the final rule for the purposes of making their regulatory proposals. These timelines are set out in Table 6.1.

²⁰² See clause 6.6A.2(e1) under the draft rule.

²⁰³ See clauses 6.5.7(b)(5)(i) and (c)(2) under the draft rule.

²⁰⁴ This timeframe will mean that stakeholders will have at least 6 weeks to make submissions on the draft transitional provisions.

Table 6.1 New South Wales, Australian Capital Territory, Northern Territory and Tasmanian revenue determination key dates

Milestone	Date	
Proposed date for publication of Contestability of energy services final rule	12 December 2017	
DNSP regulatory proposals	By 31 January 2018	Revenue proposal due on and a half months after the final rule is scheduled to be published
AER draft determination	By 30 September 2018	
AER asset exemption guideline	By 30 September 2018	Guideline published after DNSP revenue proposal and AER draft determination
Revised revenue proposal	By 31 December 2018	
AER final determination	By 30 April 2019	
Commencement of regulatory control period	1 July 2019	

Commission's analysis

To allow the restriction to apply to the 2019-24 regulatory control period the Commission proposes to require the DNSPs to submit exemption applications for any exemption being sought to the AER by 31 March 2018. The general implementation process set out above will then apply - with minor alterations to adjust the process for the 31 March applications and the lack of a published exemptions guideline. This transitional process is set out in Table 6.2 below.

Table 6.2 New South Wales, Australian Capital Territory, Northern Territory and Tasmanian transitional implementation schedule

Milestone	Date	Explanation
Contestability of energy services final rule	12 December 2017	
DNSP regulatory proposals	By 31 January 2018	The requirements in the draft rule will not apply. The DNSPs will not be required to make exemption applications alongside the regulatory proposal.
DNSP exemption applications	By 31 March 2018	The transitional provisions will require DNSPs to submit exemption applications to the AER by 31 March 2018 if they are seeking exemptions within the regulatory control period. If a DNSP has proposed capital expenditure on restricted assets in its regulatory proposal that it is not seeking an exemption for, it will be required to set out information regarding this capital expenditure in the exemption application. It will also be required to provide the AER with information regarding expenditure allowances it may require.
AER draft determination	By 30 September 2018	The AER will be required to make draft exemption decisions regarding the exemption applications submitted on 31 March 2018.
Revised revenue proposal	By 31 December 2018	The revised revenue proposals will be made under the general implementation process set out in section 6.1.
AER final determination	By 30 April 2019	The final determination will be made under the general implementation process set out in section 6.1.

In this transitional process both DNSPs and the AER will not be required to take into account the Asset Exemption Guideline in their exemption applications and exemption decision. However, by requiring exemption applications in March 2018, DNSPs and the AER will still be able to go through the two rounds of propose respond which the Commission considers will allow for adequate consultation.

6.2.2 Queensland, South Australia and Victoria

The Commission does not consider any transitional implementation measures are required for DNSPs in Queensland, South Australia or Victoria. The AER will complete its exemption guideline by September 2018. This will give Queensland and South Australian DNSPs four months to take it into account in submitting their regulatory proposals and ten months for the Victorian DNSPs to take it into account.

7 Service classification process and principles

COAG Energy Council has recommended that specific amendments be made to service classification processes and principles in order to allow for greater clarity, transparency and regulatory predictability for stakeholders, and to allow for the timely reclassification of services. This chapter sets out the Commission's findings in relation to COAG Energy Council's proposed solutions.

7.1 Service classification processes

7.1.1 Classification guidelines

Background

Service classification is the first step in the economic regulatory framework for DNSPs under the NER because it determines which services will be economically regulated and in what form. This is a key input into DNSPs' regulatory proposals and the AER's distribution determinations.

Distribution services may be assigned a specific service classification in the NER or may otherwise be classified by the AER.²⁰⁵ Typically, the NER have not classified distribution services and therefore the AER has had to consider the classification that applies to the distribution services provided by DNSPs.

The AER commences the distribution service classification process during the F & A stage of each DNSP's distribution determination. The AER typically publishes a draft F & A paper for consultation, in which it sets out its draft approach to service classification, and then issues a final F & A paper.

The AER determines distribution determinations on a DNSP by DNSP basis, and as such, distribution determinations occur on different timelines in different jurisdictions.²⁰⁶ As a result of these arrangements, stakeholders may need to make submissions in relation to the proposed approach to service classification set out in the F & A papers of each DNSP in each state, even where their submissions may relate to the same service.

The AER typically publishes final F & A papers for distribution determinations approximately two years before the commencement of a new regulatory control period.

The factors that the AER must have regard to in classifying distribution services are set out in clauses 6.2.1(c) and 6.2.2 (c) of the NER, and are discussed in detail in section 7.1.1. of this chapter.

²⁰⁵ NER, clause 6.2.1(a).

²⁰⁶ The timetable for the current round of regulatory determinations can be found at: https://www.aer.gov.au/networks/pipelines/determinations_access_arrangements.

COAG Energy Council's views

Issues the rule change seeks to address

COAG Energy Council considered that current service classification arrangements have resulted in a business by business approach to service classification and a lack of transparency and certainty around the AER's approach to service classification.²⁰⁷ Furthermore, COAG Energy Council considered that the current F & A process attracts little engagement from stakeholders, as it is conducted very early in the distribution process where stakeholders are ill-prepared to participate,²⁰⁸ and that there is a lack of understanding amongst stakeholders that the F & A process underpins service classification.²⁰⁹

Proposed solution

To address the lack of transparency and certainty in relation to the AER's approach to service classification, COAG Energy Council proposed that the AER be required to develop and maintain a service classification guideline (classification guideline).²¹⁰ COAG Energy Council proposed that the classification guideline set out the AER's standard approach to applying the service classification framework.²¹¹ COAG Energy Council has proposed that the development of, and any amendment to, the classification guideline be subject to the distribution consultation procedure already provided for in the NER.²¹² COAG Energy Council also proposed that the classification guideline be binding unless the AER considers an alternative approach is clearly more appropriate.²¹³

COAG Energy Council considered that a single dedicated process that is subject to proper consultation would promote a robust dialogue on service classification issues and ultimately enhance transparency and promote consistency in regulatory treatment. COAG Energy Council, nonetheless, considered that service classification should still be conducted as part of each DNSP's distribution determination, with the focus of deliberations being the application of the guideline to the network business.²¹⁴

Stakeholders' views

There was strong support for the introduction of a classification guideline amongst stakeholders. Retailers including Red & Lumo, the AEC, and Origin Energy supported the introduction of a classification guideline.²¹⁵ Distributors, including Endeavour Energy, United Energy and Ausnet Services were also supportive of the introduction of a classification guideline.²¹⁶ The AER too indicated its support for the guideline, and has

207 COAG Energy Council, Rule change request Contestability of energy services, p. 15.

208 *ibid.*

209 *ibid.*

210 *ibid.*

211 *ibid.*

212 *ibid.* The distribution consultation procedures are set out in clause 6.16 of the NER.

213 *ibid.*

214 *ibid.*

215 Submissions to the Consultation paper: Red & Lumo, p. 3; AEC, p. 4; Origin, p. 2.

216 Submissions to the Consultation paper: Endeavour Energy, p. 6; United Energy, p. 3; AusNet Services, p. 3.

indicated that it has already commenced preparatory work in that regard.²¹⁷

A number of stakeholders expressed views about the clarity that a classification guideline could provide to stakeholders.

- Endeavour Energy and Origin Energy stated that a classification guideline could provide clarity about how the AER is applying the service classification factors in practice.²¹⁸ Energy Queensland and United Energy stated that the AER should use the classification guidelines to explain the weight it accords to various factors when classifying distribution services as standard control services, alternative control services or negotiated distribution services.²¹⁹ Origin Energy and Energy Queensland further supported the introduction of a classification guideline to provide clarity on how the AER classifies direct control services as standard or alternative control services.²²⁰ Energy Queensland stated that a classification guideline would be useful in setting out the weight the AER accords to the different form of regulation factors.²²¹ Origin Energy stated that the AER should use the classification guidelines to set out its approach in applying its discretion in relation to barriers of entry and interdependencies in the form of regulation factors.²²²
- Energy Queensland stated that the AER should set out the other relevant factors the AER may consider in making classification decisions.²²³
- Endeavour Energy noted that the distinction between an input and a service is a difficult one, and that a classification guideline may assist in providing clarity to stakeholders about the distinction.²²⁴

Stakeholders noted that the jurisdiction by jurisdiction and DNSP by DNSP determination process makes service classification process difficult for stakeholders to engage with. Endeavour Energy noted that service classification is a complex issue, exacerbated by service classification occurring on a jurisdiction by jurisdiction basis.²²⁵ The CEC and the AEC stated that DNSP by DNSP determinations have made stakeholder engagement unnecessarily complicated, unclear and difficult to predict.²²⁶

Nonetheless, other stakeholders noted that there would be difficulties in deviating away from such an approach. Energy Queensland, South Australian Power Networks (SAPN), and CitiPower and Powercor, for example, stated that a classification guideline should not pre-empt a certain outcome for service classification as there is a need to take into account

²¹⁷ AER, submission to the Consultation paper, p. 4.

²¹⁸ Submissions to the Consultation paper: Endeavour Energy, p. 7; Origin Energy, p. 4.

²¹⁹ Submissions to the Consultation paper: Energy Queensland, p. 11; United Energy, p. 3.

²²⁰ Submissions to the Consultation paper: Origin Energy, p. 5; Energy Queensland, table of detailed comments, p. 2.

²²¹ Energy Queensland, submission to the Consultation paper, table of detailed comments, p. 2.

²²² Origin Energy, submission to the Consultation paper, p. 4.

²²³ Energy Queensland, submission to the Consultation paper table of detailed comments, p. 2.

²²⁴ Endeavour Energy, submission to the Consultation paper, p. 9.

²²⁵ *ibid*, p. 1.

²²⁶ Submissions to the Consultation paper: AEC, p. 3; CEC, p. 2.

jurisdictional differences, specific characteristics of each service, and local market conditions in respect of a particular service.²²⁷ Accordingly, they stated that service classification should still be conducted on a DNSP by DNSP basis.

Whilst COAG Energy Council did not submit a proposal in relation to changing the timing of the F & A process, the Commission received a number of submissions from stakeholders supporting the early timing of the F & A process. Energy Queensland stated that there were many benefits to conducting the F & A process early as it had implications for other processes, including decisions on building blocks, forecast capital expenditure, forecast operating expenditure, depreciation and the regulatory asset base.²²⁸ Jemena stated that the timing of the process is unproblematic as it more easily allows the AER to change service classifications from the F & A stage.²²⁹ Endeavour Energy, however, stated that the early timing of the F & A process made it difficult for stakeholders to engage with the process.²³⁰

The Commission did not receive any submissions from stakeholders supporting COAG Energy Council's assertion that the F & A process was difficult to engage with due to stakeholders' lack of understanding that it underpinned service classification.

Analysis and conclusions

The draft rule requires the AER to develop, publish and maintain a distribution service classification guideline.²³¹ The Commission acknowledges stakeholders' concerns that there is a lack of clarity and transparency in relation to the AER's approach to service classification, and that this impedes stakeholders' ability to engage with the F & A process. This is not a criticism of the AER's past approach to service classification. Instead, it is a recognition that service classification now plays a more important role in the regulatory framework than it did in the past due to a range of factors including an evolving market with greater use of new technologies, increased potential for competition in the provision of some network services, and the importance of service classification to the AER's recently introduced distribution ring-fencing guidelines.

Accordingly, the draft rule requires the AER to set out in the classification guideline the approach it proposes to take when classifying distribution services. This includes the AER's approach to:

- Applying the factors set out in clause 6.2.1 (c) of the NER when classifying a distribution service as either a direct control service or a negotiated distribution service.²³² In practice, the Commission expects that this would include the AER setting out which factors it gives primacy to in determining whether a distribution service should be classified as a direct control service or a negotiated distribution service.

²²⁷ Submissions to the Consultation paper: Energy Queensland, p. 3; SAPN, Citipower and Powercor, p. 7.

²²⁸ Energy Queensland, Submission to the Consultation paper – table of detailed comments, p. 1.

²²⁹ Jemena, submission to the Consultation paper, p. 2.

²³⁰ Endeavour Energy, submission to the Consultation paper, p. 6.

²³¹ See clause 6.2.3A (a) under the draft rule.

²³² See clause 6.2.3A (2)(i) under the draft rule.

- Applying the factors set out in clause 6.2.2 (c) of the NER when classifying a direct control service as either a standard control service or an alternative control service.²³³ In practice, the Commission expects that this would include the AER setting out which factors it gives primacy to in determining whether a direct control service should be classified as a standard control service or an alternative control service.
- Determining whether a distribution service should not be classified.²³⁴ In practice, the Commission expects that this would include the AER setting out the factors it gives primacy to in determining whether a distribution service is an unclassified distribution service.
- Distinguishing between a distribution service itself and the inputs that are used to provide distribution services.²³⁵ As highlighted in Chapter 4, the Commission notes that there is a lack of clarity amongst stakeholders as to the distinction between a distribution service itself and an input to a distribution service. Furthermore, the Commission notes that the distinction is not always a clear one. Setting out this distinction is also important as it will provide clarity to DNSPs as to the inputs in respect of which they have service discretion and in relation to which they can receive regulated revenue insofar as concerns direct control services.

The Commission considers that final decisions on service classifications will still need to be made on a DNSP by DNSP basis. As noted by stakeholders such as Energy Queensland, SAPN, and CitiPower and Powercor, there may be differences in the markets in which DNSPs operate – albeit rarely – and jurisdictional legislation which applies in each state which may require that service classifications may need to differ from DNSP to DNSP, even in respect of the same service. Notwithstanding this, the Commission considers that a classification guideline outlining the AER’s approach to service classification will provide clarity and transparency to stakeholders, and therefore facilitate better engagement by stakeholders during the F & A stage of each DNSP’s distribution determination process.

COAG Energy Council did not submit a proposal in relation to changing the timing of the F & A process. However, the Commission notes stakeholder comments that the current timing of the F & A process is desirable given its implications for other processes. The draft rule does not therefore propose any changes to the current timing of the F & A process.

Additional topics for inclusion in the classification guideline

The Commission encourages the AER to include additional topics in the classification guideline if it considers it appropriate, and the draft rule provides the AER with sufficient discretion in that regard, provided the minimum requirements are met.

²³³ See clause 6.2.3A(2)(ii) under the draft rule.

²³⁴ See clause 6.2.3A (b)(1) under the draft rule.

²³⁵ See clause 6.2.3A(3) under the draft rule.

Implementation

Under the draft rule, the classification guideline is not binding on the AER. This approach is consistent with the approach taken for many of the other guidelines in Chapter 6 of the NER, including the Rate of Return Guidelines. Whilst the Commission considers that the AER should be following the approach set out in the classification guideline in the vast majority of circumstances, the Commission acknowledges that there may be certain circumstances in which the AER may need to depart from the approach set out in the classification guideline. Nonetheless, the draft rule requires the AER to provide reasons for any departure in its approach from the guideline to provide transparency to stakeholders in circumstances where the approach differs from that in the classification guideline.²³⁶

The draft rule requires the classification guideline to be developed in accordance with the distribution consultation procedures set out in the NER.²³⁷

The Commission sets out below proposed transitional arrangements for the package of provisions related to the classification guidelines contained in the draft rule. However, the Commission notes that the draft rule does not contain draft transitional provisions. A consultation paper outlining a complete transitional proposal, along with draft transitional provisions, will be published for comment by 19 September 2017.²³⁸

To that end, the Commission will require that the AER develop and publish its first set of classification guidelines by 30 September 2018, which the Commission considers is an appropriate amount of time for the AER to develop the guideline, including sufficient time to consult with stakeholders. The Commission will require the AER to apply the approach set out in its classification guideline to the current Victorian, Queensland and South Australian distribution determination processes. The Commission will not, however, require the AER to apply the approach set out in its classification guideline to current Northern Territory, New South Wales, Australian Capital Territory and Tasmanian distribution determinations. This is as the AER will not have sufficient time to consider and apply its final guidelines to the draft determinations for these states, which are also due to be published in September 2018.

7.1.2 Reclassification of services

Background

The service classification framework does not currently allow for reclassification of services within a regulatory control period.

²³⁶ See clause 6.2.8(3) under the draft rule.

²³⁷ See clause 6.2.3A (a) under the draft rule.

²³⁸ This timeframe will mean that stakeholders will have at least 6 weeks to make submissions on the draft transitional provisions.

The service classification framework does, however, allow for service classifications to be changed during the distribution determination process. Clause 6.12.3(b) of the NER provides that the classification of distribution services set out in a relevant F & A paper can be changed in a distribution determination if there are “unforeseen circumstances” justifying a departure from a relevant classification.

COAG Energy Council’s views

Issues the rule change seeks to address

COAG Energy Council states that service classifications are determined as part of the F & A process approximately two years before the commencement of a regulatory control period. As services cannot currently be reclassified within a regulatory period, they are then locked in for the duration of the regulatory control period, which is a minimum of five years. This means that service classifications can be set for a period of up to seven years. Given the duration of this period and the pace of technology change in the market, COAG Energy Council considers that service classifications may not reflect market conditions and the emergence or potential for competition in relation to the service towards the end of a regulatory period.²³⁹

As noted by COAG Energy Council in its rule change request, in its 2015 stress test of the economic framework, it identified ‘the timing of regulatory recognition’ as a potential barrier to the development of competition in the alternative services markets,²⁴⁰ and a regulatory lag in the opportunity to reclassify services as potentially negatively impacting the development of competition.²⁴¹

Proposed solution

COAG Energy Council proposes that the NER be amended to specify the circumstances in which within-period classification decisions may be appropriate and the process involved, including the parties that could initiate a within period process to consider reclassification.²⁴² COAG Energy Council states that within period reclassification may be appropriate for both new services and for existing services where market conditions indicate a change of classification would provide benefits.²⁴³

The AER’s related proposal

In order to deal with the regulatory lag issue identified by COAG Energy Council, during consultation, the AER suggested a related proposal that the threshold in clause 6.12.3(b) of the NER be amended. The AER proposes that it is foreseeable that there may be technology changes inbetween the F & A stage and determination stages of distribution determinations which may necessitate a change in service classification. Accordingly, the AER believes that it would be difficult to consider these changes as “unforeseen circumstances” justifying a

²³⁹ COAG Energy Council, Rule change request Contestability of energy services, p. 16.

²⁴⁰ *ibid.*

²⁴¹ *ibid.*

²⁴² *ibid.*

²⁴³ *ibid.*

departure from the classification set out in the F & A paper. As a result, the AER proposes that the “unforeseen circumstances” threshold in the clause be amended to a threshold requiring that there be “good reasons” justifying a departure from the classification proposed in the paper.

Stakeholders’ views

Distributors such as Ausgrid, Jemena and the ENA were not supportive of reclassification within a regulatory control period.²⁴⁴ Furthermore, AGL notes that reclassification within a regulatory period may be impractical.²⁴⁵

Energy Queensland and Jemena stated that allowing for within period services classification would require reopening a revenue determination, and would have the effect of almost remaking a determination.²⁴⁶ Energy Queensland noted that the costs of doing this would be significant. It notes that the time, effort, resources and planning required to develop a regulatory submission are significant, and this cannot be overlooked while reconciling the positives/negatives associated with service reclassification within a regulatory control period.²⁴⁷

Furthermore, Endeavour Energy and Jemena noted that amending service classification decisions would require a reassessment of a number of other AER decisions.²⁴⁸ This would include changes to building block proposals, the RAB, capital expenditure forecasts, operating expenditure forecasts, corporate income tax, depreciation schedules, and incentive regulation targets such as the Efficiency Benefits Sharing Scheme (EBSS) and the Capital Expenditure Sharing Scheme (CESS).

Ausgrid also noted that it would undermine investment decisions.²⁴⁹ Ausgrid noted that 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 a five-year regulatory period. If service classifications can change within a regulatory period, this would create uncertainty regarding the treatment of expenditure and increase the risk of under-utilised or stranded assets.²⁵⁰

²⁴⁴ Submissions to the Consultation paper: Ausgrid, p. 2; Jemena, p. 2; ENA, p. 12.

²⁴⁵ AGL, submission to the Consultation paper, p. 3.

²⁴⁶ Submissions to the Consultation paper: Energy Queensland, table of detailed comments, p. 3; Jemena, p. 2.

²⁴⁷ Energy Queensland, submission to the Consultation paper, table of detailed comments, p. 3.

²⁴⁸ Submissions to the Consultation paper: Endeavour Energy, p. 6; Jemena, p. 2; Energy Queensland, table of detailed comments, p. 3.

²⁴⁹ Ausgrid, submission to the Consultation paper, p. 6.

²⁵⁰ Ausgrid, submission to the Consultation paper, p. 8.

Certain stakeholders supported classification in certain circumstances. Red & Lumo stated that the AER should have the flexibility to reclassify services during a regulatory period.²⁵¹ Furthermore, Origin Energy stated that 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, they would expect that a reclassification would be an exceptional event and not open to manipulation.²⁵²

Analysis and conclusions

Reclassification within a regulatory control period

The Commission has not made a draft rule in relation to the reclassification of services within a regulatory control period.

The Commission acknowledges that the changing energy market has seen the emergence of new technologies, which can lead to a need to reclassify services more frequently. The regulatory framework must thus be sufficiently responsive so as to allow for the timely reclassification of services.

However, the Commission considers that the costs of allowing for reclassification within a regulatory control period would significantly outweigh the benefits. As noted by stakeholders, allowing for within period reclassification would effectively mean reopening a distribution determination, a process which would be lengthy and involve a significant investment of resources by DNSPs and the AER. As noted by the AER in its submission, this cost would ultimately be borne by consumers.²⁵³

Furthermore, if a service was to be reclassified, it could have significant flow-on effects to other aspects of the regulatory framework. For example, it could require recalculation of:

- the total revenue requirement
- the RAB
- operating expenditure targets
- capital expenditure targets
- corporate income tax calculations
- depreciation amounts
- incentive regulation targets such as the CESS and EBSS

As noted by stakeholders, there would also be significant implications for DNSPs' planning and business decisions and the risks that they face. With respect to standard control

²⁵¹ Red & Lumo, submission to the Consultation paper, p. 3–4.

²⁵² Origin Energy, submission to the Consultation paper, p. 2.

²⁵³ AER, submission to the Consultation paper, p. 5.

services, for example, DNSPs are currently able to make investments with confidence on the basis of being to provide these services on a regulated basis over the entire regulatory control period. If the NER allowed for reclassification within a regulatory control period, DNSPs would not have the confidence to make these very significant investment decisions, and therefore may not make the most appropriate investment decisions in the long-term interests of consumers.

Reclassification during the distribution determination process

The Commission has made a draft rule in relation to the AER's recommendation that the threshold in clause 6.12.3 (b) be changed from an 'unforeseen circumstances' threshold.

As acknowledged above, changes in technology can lead to a need to reconsider service classifications. Whilst the costs of changing service classifications within a regulatory control period would outweigh the benefits and therefore cannot be justified, the implications of changing service classifications prior to the commencement of a regulatory control period are less significant.

The Commission considers that it is foreseeable that technologies could change between the F & A stage of service classification and the stage where distribution determinations are determined, and therefore lead to a need to reassess a service classification. This has happened in the past, for example, in relation to metering services in several distribution determinations in 2015 due to new rules facilitating the roll-out of advanced meters.

The Commission considers that it would not necessarily be true that a technology change in relation to the provision of a service could be considered an "unforeseeable circumstance" justifying a change in classification.

Accordingly, the draft rule lowers the threshold used in Clause 6.12.3 of the NER. In order to be consistent with wording adopted in Chapter 6 of the NER, the draft rule lowers the threshold in the clause from "unforeseen circumstances" required to justify a departure from a classification set out in a relevant F & A paper to "a material change in circumstances" required to justify a departure from the classification set out in a relevant F & A paper.²⁵⁴ This would capture technology changes and furthermore, other important changes such as changes in jurisdictional laws or NEM regulatory arrangements, and changes in submissions as a result of errors.

As a result of a change to this clause, a subsequent change is necessary to the threshold contained in clause 6.12.3(c) of the NER. This provision states that the formulae that gives effect to the control mechanism relevant to a service and set out in the relevant F & A paper, must be as set out in that paper unless there are "unforeseen circumstances" justifying a departure. As the Commission considers that technology changes may not necessarily be captured within an "unforeseen circumstances" threshold in relation to a change in classification, the same reasoning would prevail in relation to a change in the formulae which gives effect to the control mechanism relevant to that classification and set out in the

²⁵⁴ See clause 6.12.3(b) under the draft rule.

F & A paper. Accordingly, the draft rule change changes the threshold in clause 6.12.3(cl) from an “unforeseen circumstances” threshold to a “material change in circumstances” threshold.²⁵⁵

7.2 Service classification principles

7.2.1 Factors applied in classifying services

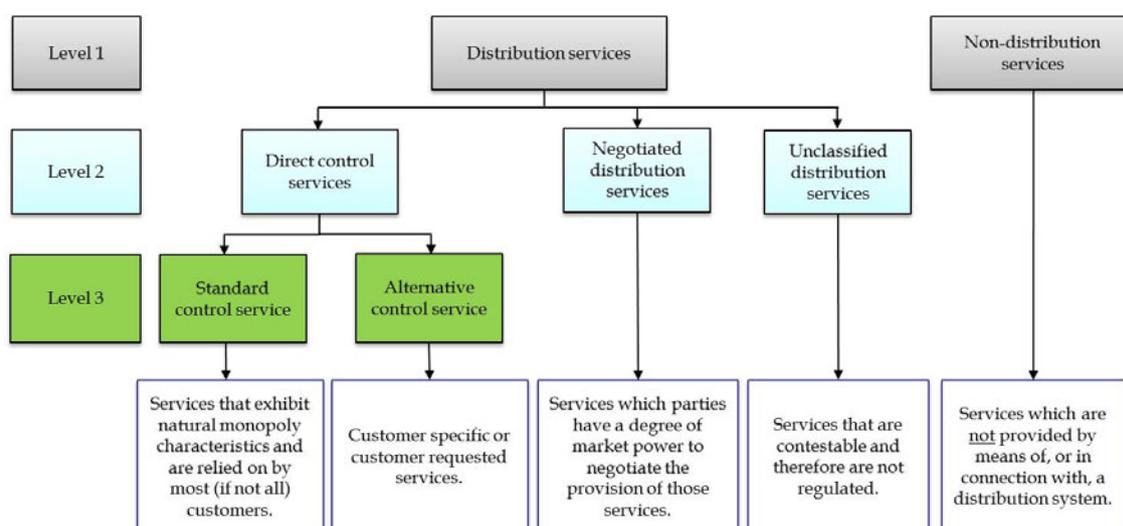
COAG Energy Council’s request

In its rule change request, COAG Energy Council requested that the Commission investigate whether the form of regulation factors in section 2F of the NEL remain appropriate in the context of a changing energy market and in relation to the Commission’s deliberations on the issues raised in the rule change request.²⁵⁶ This section sets out the Commission’s findings in relation to this request.

Background

Service classification occurs over a number of different stages. Figure 7.1 sets out the three levels of service classification, the service classifications within each level, core characteristics of services within each classification and examples of which services the AER has typically classified within each classification.

Figure 7.1 Steps in distribution service classification



²⁵⁵ See clause 6.12.3(cl) under the draft rule.

²⁵⁶ COAG Energy Council, Rule change request – Contestability of energy services, p. 13

At the first stage, in order to be able to be classified, services must be a “distribution service” within the meaning contained in the NER.²⁵⁷

At the second stage, the AER classifies distribution services as either direct control services or negotiated distribution services, or leaves the service unclassified.²⁵⁸ Clause 6.2.1(c) of the NER specifies that the AER must have regard to the following factors when classifying distribution services at this stage:

- the form of regulation factors (as set out in section 2F of the NEL)
- the form of regulation (if any) previously applicable to the relevant service or services and, in particular, any previous classification under the present system of classification or under the previous regulatory system
- the desirability of consistency in the form of regulation for similar services (both within and beyond the relevant jurisdiction)
- any other relevant factor

The form of regulation factors set out in section 2F of the NEL are:

- the presence and extent of any barriers to entry in a market for electricity network services
- the presence and extent of any network externalities (that is, interdependencies) between an electricity network service provided by a network service provider and any other electricity network service provided by the network service provider
- the presence and extent of any network externalities (that is, interdependencies) between an electricity network service provided by a network service provider and any other service provided by the network service provider in any other market
- the extent to which any market power possessed by a network service provider is, or is likely to be, mitigated by any countervailing market power possessed by a network service user or prospective network service user
- the presence and extent of any substitute, and the elasticity of demand, in a market for an electricity network service in which a network service provider provides that service
- the presence and extent of any substitute for, and the elasticity of demand in a market for, electricity or gas (as the case may be)
- the extent to which there is information available to a prospective network service user or network service user, and whether that information is adequate, to enable the

²⁵⁷ NER, chapter 10, glossary.

²⁵⁸ NER, Clause 6.2.1.

prospective network service user or network service user to negotiate on an informed basis with a network service provider for the provision of an electricity network service to them by the network service provider

At the third stage, the AER further classifies direct control services as either standard control services or alternative control services. Clause 6.2.2(c) of the NER sets out that the AER must have regard to the following factors when classifying direct control services at this stage:

- 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 for the AER, the DNSP and users or potential users
- the regulatory approach (if any) applicable to the relevant service immediately before the commencement of the distribution determination for which the classification is made
- the desirability of a consistent regulatory approach to similar services (both within and beyond the relevant jurisdiction)
- the extent the costs of providing the relevant service are directly attributable to the person to whom the service is provided
- any other relevant factor.

In arriving at a service classification decision, the AER will consider jurisdictional laws which may restrict the scope of competition for the provision of a service notwithstanding the underlying economic scope for competition in relation to the market for the service.

Stakeholders' views

Ausgrid was the only stakeholder to comment on the specific policy question raised by COAG Energy Council in its rule change request, that is, whether the form of regulation factors remain fit for purpose in the context of technology change. Ausgrid stated that COAG Energy Council's concern that the classification process is not keeping pace with technological changes is misguided. They state that 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.²⁵⁹

Some stakeholders commented on the broader appropriateness of the form of regulation factors and the service classification framework.

²⁵⁹ Ausgrid, submission to the Consultation paper, p. 12.

Jemena and the AEC stated that the form of regulation factors remain appropriate.²⁶⁰ Ausgrid further stated that the underlying intent of the form of regulation factors is appropriate, as is the AER's approach to applying the factors.²⁶¹

Other stakeholders proposed amendments to the factors applied in classifying services/form of regulation factors. The AEC stated that the emergence of potentially competitive markets should be a priority consideration amongst the form of regulation factors.²⁶² Furthermore, AGL stated that the likely impact of a classification decision on the emergence and development of a contestable market for a particular service should be included as a factor in the decision to classify a service as a direct control service or otherwise.²⁶³

The AER further submitted that the terminology used in the form of regulation factors may be made more accessible to stakeholders.²⁶⁴

Endeavour Energy stated that the service classification framework in the NEL remains appropriate with minor scope for improvement in relation to service classification processes (discussed in section 7.1 of this chapter).²⁶⁵ Furthermore, it stated that the AER's application of the framework remains appropriate.²⁶⁶

Analysis and conclusions

The Commission notes at the outset that the form of regulation factors are set out in the NEL, and the Commission cannot make changes to the NEL. Nonetheless, the Commission can make recommendations that changes be made to the NEL if it deems it to be necessary, and can make changes to the factors set out in clauses 6.2.1(c) and 6.2.2(c) of the NEL.

Appropriateness of the form of regulation factors in the context of a changing energy market

The Commission agrees with the views expressed by Ausgrid that the form of regulation factors applied in classifying services are sufficiently flexible to adapt to changes in technology. The form of regulation factors are based on classic economic regulatory principles designed to make an assessment of the potential need for regulation and/or the potential scope for competition in the market for a service. These factors do not need to change in light of technology change; technology change may simply lead to a need to reconsider the application of the factors when determining the classification of a service.

Appropriateness of the service classification regime beyond technology change

Notwithstanding this, the Commission decided to conduct an analysis of whether the current approach to service classification, including the factors applied in classifying

²⁶⁰ Submissions to the Consultation paper: Jemena, p. 2; AEC, p. 7.

²⁶¹ Ausgrid, submissions to the Consultation paper, p. 12.

²⁶² AEC, submission to the Consultation paper, p. 7.

²⁶³ AGL, submission to the Consultation paper, p. 3.

²⁶⁴ AER, submission to the Consultation paper, p. 6.

²⁶⁵ Endeavour Energy, submission to the Consultation paper, p. 6.

²⁶⁶ *ibid*, p. 8.

services/form of regulation factors, remains appropriate beyond the scope of technology change.

In order to make this assessment, the Commission conducted a “blank page” analysis of the factors that should be considered in determining whether a service should be regulated or provided by contestable markets.

The Commission’s analysis led to a framework containing four principles:

- **Principle 1:** That the service is distinct and separable. This principle sets out an approach to distinguishing between an input and a service, and is primarily intended to apply in the context of determining whether part of an existing regulated service can be provided on a contestable basis as a stand-alone service.
- **Principle 2:** That scope for competition for the service exists or can exist. This means that the opportunity for a customer to switch to an alternative provider of the service is credible and provides an effective constraint on the behaviour of an incumbent supplier.
- **Principle 3:** That sector-specific economic regulation is not required to address any identified barriers for competition for the service to develop. This principle considers whether any identified barriers to competition can be sufficiently addressed through the application of broader competition law (as provided for in the *Competition and Consumer Act 2010*), rather than sector-specific economic regulation. Principle 3 also provides for consideration of whether sector-specific regulation might be required to further other objectives, notably consumer protections.
- **Principle 4:** If there is scope for competition in the absence of sector-specific regulation, is contestability likely to provide a net benefit to end-users, compared to regulation. If there is limited scope for contestability, Principle 4 considers which form of regulation would be most appropriate.

Principle 2 of the Commission’s framework provides a useful comparison point in analysing the appropriateness of the form of regulation factors, as it also sets out the factors that should be considered in making an assessment of the scope for competition in relation to a particular service. Under this principle, the Commission has concluded that the following factors should be considered:

- Whether economic factors mean that the service has natural monopoly characteristics, or that one or more service providers are likely to have significant market power. Relevant considerations in this regard include economies of scale and scope, contract and coordination costs, network effects, costs of entry and expansion, and the extent of vertical integration.

- Countervailing buyer power, which looks at the extent of customers' capacity to constrain supplier behaviour. Relevant considerations in this regard include the availability of substitutes, information asymmetry, the negotiation capacity of customers and search and switching costs.

Furthermore, under this principle, the Commission considers it appropriate to assess whether there are regulatory, legislative or policy barriers that maintain the position of a monopoly service provider or otherwise restrict competition for the provision of services, notwithstanding the underlying economic conditions in a market for a particular service,

The Commission notes that this approach is similar to the approach currently adopted by the AER. The form of regulation factors are very similar to the factors considered under Principle 2 of the Commission's framework, and include barriers to entry (which may include a range of factors such as contract and coordination costs, costs of entry and expansion, the extent of vertical integration, and economies of scale and scope), the availability of substitutes, information asymmetry, the negotiation capacity of customers, and the extent to which market power is or is likely to be mitigated by countervailing buying power. Furthermore, the AER's approach to assessing jurisdictional laws which may effectively restrict the scope for competition in relation to a market for a service notwithstanding the underlying economic factors present in the market, is very similar to the Commission's approach under principle 2, of assessing regulatory, legislative or policy barriers that maintain the position of a monopoly service provider in similar circumstances.

The Commission also considered stakeholder submissions and informal consultation with the AER in assessing the appropriateness of the factors applied in classifying services/the form of regulation factors. Having taken these comments into consideration, the Commission does not believe that further changes should be made to these factors. Stakeholder submissions and informal consultation with the AER have generally indicated that these factors are appropriate and are being applied effectively. The Commission notes that certain stakeholders have suggested that the emergence of potentially competitive markets or the likely impact of a classification decision on the emergence and development of a contestable market should be introduced into the factors applied in classifying services or form of regulation factors at the second stage of classification. Informal consultation with the AER, however, has indicated that if an assessment of the scope for competition in a particular regulatory period indicates that a distribution service should be classified as either a direct control service or an alternative control service at the second stage of classification, it is almost impossible that the potential scope for competition in relation to that service would lead to a different classification.

Whilst the Commission acknowledges the AER's comments that the terminology in relation to the form of regulation factors could be made more accessible to stakeholders, it recommends that the AER use the classification guidelines to clarify any ambiguities in that regard.

Accordingly, having had regard to the independent consultant's report, stakeholder comments and informal consultation with the AER, the the Commission does not recommend making changes to the factors applied in classifying services/the form of regulation factors.

7.2.2 Consideration of service classifications/regulatory approaches taken in previous regulatory periods

Background

Clauses 6.2.1(d) and 6.2.2(c)(3) and 6.2.2(d) of the NER set out obligations on the AER to consider service classifications and/or regulatory approaches taken in previous regulatory periods when classifying distribution services.

Clause 6.2.2 (c) (3) of the NER states that in classifying a direct control service as a standard or alternative control service, the AER must have regard to the regulatory approach (if any) applicable to the relevant service immediately before the commencement of the distribution determination for which the classification is made.

Clause 6.2.1(d) of the NER states that in classifying distribution services that have previously been subject to regulation under the present or earlier legislation, the AER must act on the basis that, unless a different classification is clearly more appropriate:

- there should be no departure from the previous classification (if the services had been previously classified)
- if there had been no previous classification – the classification should be consistent with the previously applicable regulatory approach.

Similarly, clause 6.2.2(d) of the NER states that in classifying direct control services that have previously been subject to regulation under the present or earlier legislation, the AER must act on the basis that, unless a different classification is clearly more appropriate:

- there should be no departure from a previous classification (if the services have been previously classified)
- if there has been no previous classification - the classification should be consistent with the previous applicable regulatory approach

COAG Energy Council's views

COAG Energy Council proposed that the wording of clauses 6.2.1(d) and 6.2.2(c)(3) and (d) of the NER be changed to remove prescription around the AER's consideration of services that had been previously regulated which COAG Energy Council believes favours the status quo.²⁶⁷ Nonetheless, COAG Energy Council did not specify what this exact wording should be. COAG Energy Council stated that the wording in these rules provides

²⁶⁷ COAG Energy Council, Rule change request – Contestability of energy services, p. 14.

the AER with limited discretion to reclassify services and is framed contrary to the policy aim of promoting the development of effective competition. In a less dynamic market, a more static or conservative approach to the classification of services may have been appropriate. However, in the context of a changing (more dynamic) energy market, allowing the AER to have more discretion to re-classify services would allow a more proactive approach to be applied to moving services out of economic regulation, and would also likely stimulate greater debate in the market in relation to the potential contestability of services.²⁶⁸

COAG Energy Council also noted that the limitations on the AER's discretion to reclassify services reflects the context for their development and are no longer warranted. COAG Energy Council stated that the clause was included in the NER as part of the process of avoiding disruptive service classifications when transferring economic regulation from jurisdictional regulators to the AER. With that period past, and a period of technological change occurring in the market, COAG Energy Council considered the AER now needs more discretion to reclassify services.²⁶⁹

Stakeholders' views

Retailers such as AGL and Origin Energy, as well as the AEC and the AER supported the removal of the presumptions (clauses 6.2.1(d) and 6.2.2(d) of the NER). AGL and the AEC state that the presumptions were originally included in the rules to prevent disruptive reclassification decisions on the transfer of economic regulatory responsibility from jurisdictional regulators to the AER.²⁷⁰ The presumptions are therefore unnecessary in the current environment and lead to an unjustified bias towards maintaining the *status quo*.²⁷¹

The AEC stated that the presumptions are unnecessary if the AER is operating appropriately. Where a regulator is doing the most careful job it can in the normal course of its activities, there is no need to retain these requirements.²⁷²

Origin Energy stated that in each regulatory period, the AER should simply be able to classify distribution services according to their potential contestability at the time.²⁷³

The AER stated that the presumptions have resulted in the maintenance of direct control service classifications originally determined by jurisdictional economic regulators prior to the AER assuming its responsibility. While the current approach has promoted regulatory consistency over time within jurisdictions, it has resulted in the retention of unnecessary differences in classifications across jurisdictions.²⁷⁴

²⁶⁸ *ibid.*

²⁶⁹ *ibid.*

²⁷⁰ Submission to the Consultation paper: AGL, p. 3; AEC, p. 8.

²⁷¹ AGL, submission to the Consultation paper, p. 3.

²⁷² AEC, submission to the Consultation paper, p. 8.

²⁷³ Origin, submission to the Consultation paper, p. 4.

²⁷⁴ AER, submission to the Consultation paper, p. 3.

AGL and the AER further stated that the presumptions are an impediment to appropriate and swift reclassification decisions. Given the long-standing nature of classification decisions, AGL believed that the AER should be encouraged take a more proactive approach to reclassification decisions.²⁷⁵

Distributors were generally in favour of retaining the presumptions. Ausgrid, Energy Queensland and Endeavour Energy argued that the presumptions should not be removed as any changes to service classification should be justified. Endeavour Energy stated that it is common sense that a service classification should only be changed if that change is to a more appropriate service classification.²⁷⁶ Ausgrid stated that regardless of the genesis of the 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.²⁷⁷

Ausgrid, Energy Queensland and Jemena further noted that reclassifying services can have a significant impact on both DNSPs and customers, so it is appropriate that changes be justified.²⁷⁸

However, Endeavour Energy also stated that it does not consider the removal of the presumptions provision would be problematic should the Commission form an alternate view.²⁷⁹

There were limited comments from stakeholders in relation to the amendment of clauses 6.2.2(c)(3) of the NER.

Analysis and conclusions

The draft rule removes clauses 6.2.1(d) and 6.2.2(d) from the NER.

The Commission acknowledges and agrees with stakeholder comments that the presumptions were introduced as part of the transfer of economic regulatory responsibility from jurisdictional regulators to the AER to prevent disruptive reclassification decisions. Accordingly, the reasons for its introduction no longer hold true.

Furthermore, the Commission believes that the regulatory framework should provide the AER with the discretion to make decisions that are suitable for a changing environment. The Commission notes that the discretion provided to the AER in applying the factors set out in Clauses 6.2.1(c) and 6.2.2 (c) of the NER in classifying services is consistent with this principle. The presumptions clauses are inconsistent with this principle.

Additionally, as noted by Origin Energy, there should be no need for the presumptions as it should be open to the AER to classify distribution services according to their scope for

²⁷⁵ AGL, submission to the Consultation paper, p. 3.

²⁷⁶ Endeavour Energy, submission to the Consultation paper, p. 7.

²⁷⁷ Ausgrid, submission to the Consultation paper, p. 12.

²⁷⁸ Submissions to the Consultation paper: ENA, p. 2; Jemena, p. 2; Ausgrid, p. 12.

²⁷⁹ Endeavour Energy, submission to the Consultation paper, p. 8.

competition at the commencement of each regulatory control period by simply applying the factors in classifying services. The maintenance of the presumptions does not allow the AER to act in this way, and as noted by stakeholders, leads to a bias towards maintaining the *status quo* and an approach that favours regulation over competition.

Whilst the Commission acknowledges that changes in service classification can have an impact on distributors, service classification decisions are made following extensive consultation. In addition, the service classification framework operates on the basis that classification decisions are made for one regulatory period only. Therefore, if circumstances in relation to market for a service change in a subsequent period, it should be open to the AER to reclassify the service; there should be no need to justify any change.

The Commission notes that the classification guidelines introduced by the draft rule and discussed in Chapter 5 of this draft determination will provide distributors with clarity, transparency and regulatory predictability in relation to the AER's approach to service classification. Accordingly, in understanding the AER's approach to service classification, distributors should be able to foresee the likely classification of services in any given period. This is likely to allow distributors to prepare for the impact of any change.

The draft rule does not make any amendments to clause 6.2.2(c)(3) of the NER. The clause simply requires the AER to consider, amongst other factors in clause 6.2.2(c), the previous regulatory approach when determining whether a service should be classified as a direct control service or alternative control service. The Commission therefore concludes that there is no need to amend this clause as, unlike clauses 6.2.1(d) and 6.2.2(d), it does not limit the AER's discretion to reclassify services.

Abbreviations

AEC	Australian Energy Council
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
CEC	Clean Energy Council
Commisison	See AEMC
Council of Australian Governments	COAG
DER	Distributed Energy Resources
DNSP	Distribution network service provider
MCE	Ministerial Council on Energy
NEL	National Electricity Law
NEM	National electricity market
NEO	National electricity objective
RAB	Regulatory asset base

A Summary of other issues raised in submissions

This appendix sets out the issues raised in the first round of consultation on this rule change request and the AEMC's response to each issue. If an issue raised in a submission has been discussed in the main body of this document, it has not been included in this table.

Table A.1 Summary of other issues raised in submissions

Stakeholder	Issue	Commission response
DER and the contestable procurement of inputs		
TEC, p. 3	Can find no support in the NER for the assertion that "It is the services provided by DNSPs to customers that are classified within distribution service classification."	As set out in Chapter 4 of this draft determination, the service classification framework under Chapter 6 of the NER and the relevant defined terms in Chapter 10 of the NER dictate that it is services provided by distributors to customers which can be classified within distribution service classification.
AGL, p. 1	Although DER can be used to support the management of the network, they do not exhibit natural monopoly characteristics. Instead they lend themselves to contestable provision by a service provider who can craft service offerings which optimise for the various potential values available.	As set out in Chapter 4, inputs provided to DNSPs cannot be classified within distribution service classification. Only the services provided by DNSPs to customers can be classified. Given that inputs cannot be classified, the impact of whether they display natural monopoly characteristics for service classification will only be through their effect on the economic characteristics of the end service.
PIAC, p. 2; TEC, p. 4	Rule change could be changed to distinguish between assets and services essential to the operation of the network to provide a safe and reliable power supply, which is not amenable to competition, and which should be the subject of a revenue or a price cap as periodically determined by the AER; and all other assets and services, which should be procured as operational expenditure only and open to competition.	The Commission is satisfied with the current position in the NER that only services should be classified. As set out in Chapter 4 of this determination, the inputs that DER provide, cannot be classified. The introduction of contestable frameworks inputs to standard control services provided by restricted assets is dealt with through the form of regulation - the building block methodology in Chapter 6 of the NER. These issues are addressed in Chapters 5 and 6 of the draft determination.
TEC, p.4	Concur with the Consultation Paper that the distinction between an input and a service is not always clear. Believe that energy storage could fall into the same category and therefore	Energy storage devices are assets that can provide multiple services. As set out in Chapter 4, assets are not classifiable within distribution service classification.

Stakeholder	Issue	Commission response
	should be capable of being separately classified.	Where energy storage devices provide inputs, these inputs are also not classifiable, but some of the services provided by energy storage may be classifiable.
SAPN and CitiPower, p. 7	The AER suggests that when a DNSP uses DER, it is providing a non-network service, and therefore a service that DNSPs are disallowed from providing under ring-fencing. The AEMC is invited to comment.	This is a matter for the AER.
Service classification processes		
Jemena, p. 2	The issue of insufficient time to prepare submissions (in relation to an F & A) can be addressed by providing more time for stakeholders to prepare a submission.	The Commission understands that in practice, stakeholders are generally provided with at least six weeks to respond to the draft F & A paper. The Commission considers that this is sufficient time in which to prepare relevant submissions. Furthermore, stakeholders have not generally considered that they have insufficient time to prepare submissions to the draft F & A paper.
Red & Lumo, p. 3	In general, stakeholders do not participate in the F & A process because it is so embedded in the DNSP rate review process.	The Service Classification Guideline will provide an opportunity for stakeholders to participate in the overall approach to service classification NEM wide.
Origin Energy, p. 2	<p>Agree with COAC EC that the gap between the F & A process and the lodgement of the regulatory proposals is longer than preferable; in many instances there is a gap of six months.</p> <p>Recognise that a 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. Nonetheless, consider that this gap should be compressed and that a guideline would provide certainty to support a shorter window.</p>	The preparation of a revenue proposal is complex and time-consuming. The Commission considers that a six-month gap inbetween the F & A process and the time that a DNSP is required to submit a revenue proposal is therefore appropriate.
Reclassification		
United Energy, p. 3	Supports being able to propose changes to the AER's service classification within the regulatory period for alternative control or negotiated services only. For instance, consider that should be able to propose new alternative control or negotiated services throughout the period. Considers the	Changes to classify services as alternative or negotiated distribution services would still be administratively complex, and require the reopening of a revenue determination. For example, if a new service was classified as an alternative control service within a regulatory period, the AER would

Stakeholder	Issue	Commission response
	cost associated with offering additional alternative control or negotiated services within the period would be low and largely administrative.	need to determine (amongst other things) the price or revenue that a DNSP can charge (or earn) for provision of the service.
Factors applied in classifying services		
AGL, p. 3	AGL agrees with COAG Energy Council that whether a service exhibits natural monopoly characteristics is a primary factor in making service classification decisions, and should be included in the form of regulation factors.	Whether a service displays natural monopoly characteristics already plays a significant role in determining how the service is classified because the form of regulation factors, which guide the AER's service classification decisions, include factors such as barriers to entry and the presence of substitutes for the service.
TEC, p. 4	The AER currently applies s 2F of the NEL in light of Clause 6.8.1(b)(2)(i) of the NEL. However, clause 6.8.1 of the NEL does not specify how the the AER should classify these services.	Clause 6.8.1(b)(2)(i) of the NEL specifies that the AER must have regard to the factors set out in that clause - which also include consideration of the form of regulation factors set out in s 2F of the NEL - when classifying services. The clause does not specify how the services are to be specifically classified as the AER has the discretion to decide how the different combinations of the factors may lead to different service classification decisions. Nonetheless, as set out in Chapter 7 of this determination, the AER will be able to provide clarity and transparency to stakeholders in regards to likely service classification decisions by introducing the Service Classification Guidelines, which will assist stakeholders in understanding which factors are important when arriving at particular service classification decision outcomes.
ENA, p. 11	<p>The AEMC should consider the interlinkages between the form of regulation factors and the declaration criteria contained in Part IIIA of the Competition Act and the Coverage criteria in the Gas regime.</p> <p>The form of regulation factors appear in contrast to the declaration and coverage criteria, to be:</p> <ul style="list-style-type: none"> - complex and multi-layered, adding uncertainty to their interpretation; - based on distinct economic concepts to the declaration criteria, without it being clear whether such 	The Commission considers that the AER has been applying the form of regulation factors without material problems and the factors remain appropriate in the context of a changing energy market.

Stakeholder	Issue	Commission response
	<p>difference is intended to bring about different outcomes or assessment approaches;</p> <ul style="list-style-type: none"> - rarely practically used as the basis for in-depth market or competitive analyses by the AER, which generally appears to adopt high-level qualitative based assessments; - unbalanced and inconsistent with the declaration criteria in lacking a requirement for the decision-maker to be affirmatively satisfied of a range of factors before regulation of a service can be introduced; - missing a wider 'public interest' test allowing consideration of wider impacts (such as indirect investment impacts, and broader public welfare considerations). 	
ENA, p. 12	<p>Service classification decisions should be primarily driven by market-based considerations of the state of competition in the market, barriers to entry, countervailing market power, availability of information and substitutes. That is, classification decisions under the Rules should not be driven by the current content of subsidiary guidelines and other instruments (which can and do change more frequently, and with fewer procedural consultation safeguards than the rule change process).</p> <p>This would invert the intended governance framework of the NEL, NER and subsidiary guidelines and instruments. Rather, the AER's obligation is to ensure that its ring-fencing guideline, cost allocation obligations, and shared asset approaches are workable and responsive to the policy determinations made by the AEMC on the different types of classifications and when each should be applied.</p>	<p>Service classification decisions will still be determined by applying the factors set out in Clauses 6.1.2(c) and 6.2.2(c) of the NER. Where other guidelines influence the market-based assessments the AER will continue to have regard to these issues.</p>
AER, p. 6	<p>Consider that the negotiated service classification requires reconsideration, with a view to potentially removing this category from the range of service classification options or better specifying its purpose.</p>	<p>The removal of the negotiated distribution service classification goes beyond the scope of this rule change request, and would require detailed consideration which would be more appropriately dealt with under a separate rule change</p>

Stakeholder	Issue	Commission response
	<p>It is unclear exactly what utility a negotiated service classification currently provides. Existing examples of services classified as negotiated services, such as in South Australia, are legacy approaches inherited from jurisdictional economic regulators.</p> <p>It is also possible that this category could be used as an intermediate step for services which are transitioning between alternative control and unregulated categories. It has not really been used in this way, nor can we think of any examples of this. In either case, however, it is likely it will be used sparingly at all.</p>	request.
AER, p. 7	<p>The alternative control service classification should be split in order to deal with two different types of services. The first relates to monopoly services which can be separately charged to customers. The second relates to services which are potentially contestable, and therefore, a standard control service classification would prevent the emergence of a competitive market.</p> <p>Splitting the two alternative control services in this way would improve the operation of the Ring-Fencing Guidelines. At present, the NER has established that alternative control services are not treated differently to standard control services by the Ring-Fencing Guidelines. However, arguably, potentially contestable services should be ring-fenced because the service is being offered (or may be offered) in a contestable or potentially contestable market.</p>	The splitting of the alternative control classification goes beyond the scope of this rule change request. It would require detailed consideration which would be more appropriately dealt with under a separate rule change request.
PIAC, p. 2; TEC, p. 5	<p>There should two classifications: regulated and contestable services.</p> <p>Regulated services would comprise what are currently standard control services including planning, designing, constructing, operating and maintaining the network.</p> <p>Contestable services would comprise what are currently alternative control services (such as ancillary network services, public lighting, metering and possibly connections) as well as</p>	The Commission does not consider that there should only be two possible service classifications. For example, the removal of alternative control services would restrict the ability for the AER to provide a transitional mechanism for services moving from regulated to contestable.

Stakeholder	Issue	Commission response
	<p>negotiated and unclassified services. Network services would be subject to a revenue cap, while contestable services would be free of revenue or price caps.</p>	
Definitions		
AER, p.5	<p>The definition gives rise to uncertainty, as it may be arguable that a specific service is, or is not, consistent with the definition. Furthermore, the phrase 'in conjunction with' may be interpreted very broadly. Potentially almost any service provided with resources otherwise used to provide distribution services may also be considered to be a distribution service. In an evolving market and technological environment, this does not promote regulatory certainty or efficient market outcomes.</p>	<p>There is likely to be some degree of uncertainty as to whether a service will fall within any definition of a 'distribution service'. As explained in Chapter 4, the level of ambiguity in the current definition will not prevent DNSPs from being able to deploy new and emerging technologies in order to provide already existing distribution services.</p>
AER, p. 5	<p>Distribution services do not need to be defined separately. Rather, distribution services may be considered in more general terms so that their physical characteristics are not specified, with emphasis instead on provision of a service by a distributor to a customer. The definition could instead be determined through the service classification process. Alternatively, less importance may be placed on the definition of distribution services and the focus instead placed directly on the services we classify as direct control services and negotiated services. That is, avoid the step of identifying what is a distribution service before the classification of services.</p>	<p>There will need to be some set criteria that a service will need to meet in order for it to be considered a 'distribution service', irrespective of whether there is a specific definition in the NER, or the service is classified through the Guidelines. The benefit of a definition is that it sets out this criteria clearly and transparently to stakeholders.</p>
AER, pp. 6, 8	<p>An improved definition of services may help address the issues raised by the AEMC Consultation Paper about the distinction between inputs and services.</p> <p>Aside from the definition of a distribution service, other NER and NEL definitions that could be reconsidered include network service, transmission service and shared distribution service to make these clearer and made consistent with any changes made under these rule changes.</p>	<p>As set out in Chapter 4 of the determination, the the draft rule does not make changes to the definition of a 'distribution service'. As a result, there is no need to consider changes to related definitions in the NER.</p> <p>Furthermore, the Commission cannot make changes to the NEL, and any changes made to NER definitions would need to be consistent with definitions contained in the NEL. Therefore, if any changes were to be made to these definitions, COAG Energy Council would be best-placed</p>

Stakeholder	Issue	Commission response
		to make these changes as part of a package of reforms.
Origin, p. 2	Notes that the definition of a distribution service is unclear, notably around those services that can provide both network support and other contestable services.	The definition of a distribution service solely relates to services provided by a distributor to a customer. Inputs to the provision of standard control services that are provided to DNSPs, such as network support, do not fall within the definition.
Regulation of standard control services		
AGL, p. 5.	AGL also suggests the Commission reconsider the regulatory framework with regard to the form of control (price or revenue) and the incentives provided to network businesses given the changing nature of energy provision. The prevalence of revenue cap regulation is counter intuitive in an environment where under-utilisation of networks is becoming a significant issue. Disassociating usage and throughput from networks' capital expenditure decisions is nonsensical.	Control mechanisms decisions for DNSPs are made by the AER under clause 6.2.5 of the NER and are not within scope of the rule change requests.
Dr. Martin Gill, p. 2.	Efficiency of demand response programs: The AER reviews DNSP regulatory proposals to ensure network augmentation only occurs in areas where peak demand is approaching the network capacity. This is intended to prevent DNSPs receiving a regulated income for unnecessary network augmentation. The AER is unable to apply the same checks to DNSP demand response programs. This is largely because the AER is unable to validate the achieved demand reduction.	The validation of results of demand response programs by the AER is not within scope of this rule change.
ENA, p. 3	Primacy should be given to the efficient delivery of network services to customers	The NEO refers to "efficient investment in, and efficient operation and use of <i>electricity services</i> [emphasis added]" which relates to the entire electricity supply chain, not just network services.
Energy Queensland, p. 17	Where DNSPs are forced to procure battery storage as network support, if the battery storage fails as a network support service, then DNSPs are essentially paying twice, once for the behind the meter service and then for the upgrade of the network. DNSPs should not be required to adopt more expensive solutions to placate an	The performance of the service delivery methods that DNSPs employ in delivering standard control services is an issue for all service delivery methods and is taken into account by DNSPs for all inputs to standard control services. For example, when selecting whether and how to obtain any input to

Stakeholder	Issue	Commission response
	under-developed third party market at greater cost and risk to customers.	<p>standard control services DNSPs will take into account the likelihood of non-performance of each input and consider the likelihood of the provider of that input not delivering.</p> <p>The restricted asset definition will not change this onus on DNSPs. It will (in certain circumstances) remove the option of sourcing the inputs through capital expenditure on restricted assets - which will narrow the range of options available to the DNSP.</p>
Other issues		
Southern City of Regional Councils (SSROC), p. 1	<p>This submission relates specifically to public lighting and urges the AEMC to consider:</p> <ul style="list-style-type: none"> • measures the AEMC can take to facilitate the introduction of both comprehensive public lighting service-level regulation and expanded contestability of public lighting • developing an access framework to facilitate future contestability of public lighting services; and • allowing customers to fund replacement lighting across the NEM. <p>Direct council control of public lighting is the norm in much of the developed world and, in some other overseas jurisdictions where this is not the case, steps towards transferring control of lighting from utilities to local councils is underway in an effort to speed up LED and smart controls deployments. It is in this context that SSROC is asking the question about whether steps should be taken in the National Electricity Market to facilitate enhanced contestability of public lighting services.</p>	<p>The Commission considers that SSROC has raised a number of significant issues with the regulation of public lighting in the NEM. However, as SSROC notes, its main goal is to achieve direct council control over the supply of public lighting. The distribution service classification is capable of facilitating council control through AER classification of public lighting services as non-direct control services. However, as SSROC notes, there are two main barriers to this being achieved:</p> <ul style="list-style-type: none"> (a) DNSP ownership of existing public lighting assets, and (b) access to network assets (for example, poles) to facilitate supply of public lighting. <p>Neither of these issues is within the scope of this rule change. The first would require the sale of public lighting assets from DNSPs to councils and the second would require a third party access arrangement.</p>

B Legal requirements under the NEL

This appendix sets out the relevant legal requirements under the National Electricity Law (NEL) for the Commission to make this draft rule determination.

B.1 Draft rule determination

In accordance with section 99 of the NEL, the Commission has made this draft rule determination in relation to the rule proposed by COAG Energy Council and the AEC.

The Commission's reasons for making this draft rule determination are set out in section 2.4 of this draft determination.

A copy of the more preferable draft rule is published with this draft rule determination. Its key features are described in section 2.4.1 of this draft determination.

B.2 Power to make the rule

The Commission is satisfied that the more preferable draft rule falls within the subject matter about which the Commission may make rules. The more preferable draft rule falls within section 34 of the NEL as it relates to the operation of the national electricity market,²⁸⁰ and to the activities of persons participating in the national electricity market.²⁸¹

B.3 Additional rule-making test - Northern Territory

The National Electricity (Northern Territory) (National Uniform Legislation) Act 2015 provides the Commission with the ability to make a differential rule that varies in its terms between the national electricity system and the Northern Territory's local electricity system. The Commission may make a differential rule if, having regard to any relevant MCE statement of policy principles, it determines that a differential rule will, or is likely to, better contribute to the achievement of the NEO than a uniform rule.

The Commission has considered whether a differential rule is required for the Northern Territory electricity service providers and concluded that it is not required in this instance. This is because the Commission considers that the draft rule will be able to operate in the Northern Territory without special arrangements.

B.4 Revenue and pricing principles

In addition to having regard to the NEO, the Commission must take into account the revenue and pricing principles in making a rule with respect to (among other things) the regulation of revenue earned, or that may be earned, by DNSPs from provision of services

²⁸⁰ NER, clause 34(1)(a)(i).

²⁸¹ NER, clause 34(1)(a)(iii).

that are the subject of a distribution determination.²⁸²

The Commission has taken into account the revenue and pricing principles. The Commission considers the following revenue and pricing principle the most relevant to the draft rule:

- A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing direct control network services.²⁸³
- A regulated network service provider should be provided with effective incentives in order to promote economic efficiency with respect to direct control network services the operator provides. The economic efficiency that should be promoted includes:
 - efficient investment in a distribution system or transmission system with which the operator provides direct control network services; and
 - the efficient provision of electricity network services; and
 - the efficient use of the distribution system or transmission system with which the operator provides direct control services.²⁸⁴
- Regard should be had to the regulatory asset base with respect to a distribution system or transmission system adopted:²⁸⁵
 - in any previous:
 - as the case requires, distribution determination or transmission determination; or
 - determination or decision under the National Electricity Code or jurisdictional electricity legislation regulating the revenue earned, or prices charged, by a person providing services by means of that distribution system or transmission system; or
 - in the NER.

The draft rule changes the processes and principles within the NER regarding the AER undertaking distribution service classification. These changes will provide greater clarity to DNSPs about the AER's likely approach to classifying services as direct control services, which will promote DNSPs having a reasonable opportunity to recover the efficient costs of providing direct control network services.

²⁸² Refer to section 88B and Items 25 26J of Schedule 1 of the NEL. The revenue and pricing principles are set out in section 7A of the NEL.

²⁸³ NEL, section 7A(2)(a).

²⁸⁴ NEL, section 7A(3).

²⁸⁵ NEL, section 7A(4).

The Commission has taken into account the incentives provided to DNSPs in providing direct control services and whether the draft rule promotes economic efficiency with respect to direct control network services that DNSPs provide. The Commission notes that while the draft rule may have a minor impact on the ability of DNSPs to provide direct control services efficiently with respect to investment in restricted assets, this will not effect the overarching incentive regulatory framework for the provision of direct control services. Furthermore, to the extent that the draft rule limits efficient incentives for the provision of direct control services, the Commission considers that any detriment will be outweighed by benefits through efficiency gains in the provision of non-direct control (contestable) electricity services and that the draft rule will therefore contribute to the achievement of the NEO.

The Commission has had regard to the RAB in developing the restricted asset provisions of the draft rule. Importantly, the restrictions do not affect any past investments by DNSPs or investments made in the current regulatory control period.

B.5 Commission's considerations

In assessing the rule change request the Commission considered:

- its powers under the NEL to make the rule;
- the rule change request;
- submissions received in response to the consultation paper; and
- the Commission's analysis as to the ways in which the proposed rule will or is likely to, contribute to the national electricity objective and the revenue and pricing principles.

There is no relevant Ministerial Council on Energy statement of policy principles for this rule change request.²⁸⁶

The Commission may only make a rule that has effect with respect to an adoptive jurisdiction if satisfied that the proposed rule is compatible with the proper performance of Australian Energy Market Operator (AEMO)'s declared network and system functions.²⁸⁷ The more preferable draft rule is compatible with AEMO's declared network and system functions because it is unrelated to them and therefore does not affect the performance of those functions.

²⁸⁶ Under section 33 of the NEL, the Commission must have regard to any relevant MCE statement of policy principles in making a rule. The MCE is referenced in the Commission's governing legislation and is a legally enduring body comprising the Federal, State and Territory Ministers responsible for Energy. On 1 July 2011, the MCE was amalgamated with the Ministerial Council on Mineral and Petroleum Resources. The amalgamated council is now called the COAG Energy Council.

²⁸⁷ Refer to section 91(8) of the NEL.

B.6 More preferable rule

Under section 91A of the NEL, the Commission may make a rule that is different (including materially different) to a proposed rule if the Commission is satisfied that, having regard to the issue or issues that were raised by the proposed rule (to which the more preferable rule relates), the more preferable rule will, or is likely to better contribute to the achievement of the NEO. As discussed in Chapter 2 of this draft determination, the Commission has determined to make a more preferable rule. The reasons for the Commission's decision are set out in section 2.4 of this draft determination.

B.7 Civil penalties

Given the importance of a robust planning framework to efficient provision of network services and an efficient competitive energy services market, the Commission considers that any breaches of the RIT-D and RIT-T processes should be subject to civil penalty provisions. The Commission therefore considers that clauses 5.16.3(a) and 5.17.3(a) of the NER should be classified as civil penalty provisions.

While the Commission cannot create new civil penalty provisions, it may recommend to COAG Energy Council that new or existing provisions of the NER be classified as civil penalty provisions. The new provisions that the Commission is recommending to COAG Energy Council as civil penalty provisions are clauses 5.16.3(a) and 5.17.3(a), which relate to the regulatory investment tests for transmission and distribution.