9 February 2017

Mr John Pierce
Chairman
Australian Energy Market AEMC
PO Box A2449
Sydney South NSW 1235

Dear John

RE: AEMC Consultation Paper – *National Electricity Amendment (Contestability of energy services) Rule 2016* (Reference ERC0206)

RE: AEMC Consultation Paper – *National Electricity Amendment (Contestability of energy services – demand response and network support) Rule 2016* (Reference ERC0218)

Endeavour Energy welcomes the opportunity to provide feedback on the AEMC's consultation paper – *National Electricity Amendment (Contestability of energy services) Rule 2016* and *National Electricity Amendment (Contestability of energy services – demand response and network support) Rule 2016*. The consultation papers follow from rule changes lodged by the Council of Australian Governments (COAG) and the Australian Energy Council (AEC) respectively.

The proponents consider the existing rules do not support the development of contestable markets for emergent technologies. Specifically, the proponents consider:

- The processes, definitions (in particular "distribution service") and National Electricity Rules (NER) provisions for distribution service classification are:
    - unclear resulting in inconsistent service classification across the National Electricity Market (NEM); and
    - inflexible and untimely in accommodating both within and between regulatory determination period changes to the nature of a service or new services;
- the framework is ill-suited for technologies that are capable of providing both regulated and unregulated services.
- it fails to protect against the service delivery bias Distribution Network Service Providers (DNSPs) have for in-sourcing (i.e. capital asset ownership) over out-sourcing.

The COAG rule change request is strictly focussed on the service classification framework. In order to facilitate competition in emergent markets such as generation and storage technologies COAG recommend that the service classification is amended to:

1. make services provided by technologies that provide both regulated and unregulated value unclassified by default; and
2. require the AER to produce a guideline, allow for reclassification within a period and providing for an easier path to changes in classification over time.

Endeavour Energy appreciates that service classification is a complex issue, exacerbated by service classification occurring on a jurisdictional basis well in advance of the remainder of a determination. As such, Endeavour Energy is of the view that a service classification guideline is worth consideration. The objective should be to establish a more transparent, consultative process that will improve the clarity and consistency of service classification outcomes.

The AEC rule change request is focussed on amending the service classification framework to resolve broader issues they perceive within the regulatory framework. The AEC considers that the mechanisms in Chapters 5, 6, 6A and 7 of the NER are inadequate and ineffective in facilitating competition in the services provided by generation and storage devices (i.e. the planning framework, building block determination process, incentive schemes, cost allocation, shared asset and ring-

fencing guidelines and metering provisions). The AEC recommend that the regulatory framework is modified to:

1. Prohibit DNSPs from capitalising (i.e. owning) assets capable of providing "contestable services", such as demand response and network support. These services could only be procured from third parties as operating expenditure;
2. Lower the RIT-D threshold to $50,000, shorten the process and prohibit any non-RIT-D approved capital expenditure from being rolled into the regulatory asset base (RAB); and
3. Require DNSPs to publish all information associated with a contestable service it is directly or indirectly involved with.

Endeavour Energy considers the broader issues raised by the AEC with the regulatory framework are unsubstantiated and the proposed amendments ill-considered. For instance, the AEC's proposed new, "contestable service" would undermine its stated objective as DNSPs would not be able to obtain regulatory funding to procure (with operating expenditure) network support and demand response services as they would no longer be distribution services. Collectively, the AEC recommendations seek to embed a service delivery bias in the NER and eliminate competition from DNSPs in emergent markets for the benefit of its members. These changes would result in a suboptimal market design and necessitate a departure from incentive based regulation to a prescriptive, cost plus form of regulation. We consider these outcomes would be to the detriment of the achievement of the National Electricity Objective (NEO).

We support the AEMC's focus on clarifying the service classification framework and seek to identify any genuine issues that exist with the regulatory framework in the consultation paper. Specifically, the AEMC may further investigate whether the regulatory framework provides DNSPs balanced incentives between network (capital expenditure) and non-network (operating expenditure) solutions. We consider the incentive based regulatory framework does provide an appropriate balance. If a network "bias" exists, it may be more attributable to the immaturity and high cost of alternative, non-network technologies or the intrinsic inefficiency of decentralised, distributed solutions compared to the scale and scope efficiencies achievable under a centralised distribution model. If a bias exists due to DNSPs preferences or imbalanced incentives in the regulatory framework then we consider solutions like "totex" warrant further consideration.

Overall, we consider the NEO is best achieved by an ex-ante, incentive based regulatory framework that is neutral to particular types of technology or service delivery options. The existing service classification framework provides an appropriate mechanism for assessing whether regulation is applied, how it applies and what protections are in place for DNSPs that wish to provide unregulated distribution or non-distribution services. For standard control services, DNSPs are provided a strong incentive by the ex-ante regulatory framework and various incentive schemes to implement least cost solutions and pursue dynamic efficiencies in delivering network services. For alternative control services (i.e. potentially competitive services with costs directly attributable to individual customers) the regulatory framework provides for price discovery to help facilitate the transition to competition. While scope for improvements exist, such as a service classification guideline, we do not consider the proponents have demonstrated that the regulatory framework is deficient or that the suggested amendments will better serve the long term interests of customers.

Our responses to the questions contained in the consultation paper are attached to this letter. We have also provided a brief overview a residential battery storage trial we are conducting. This case study provides evidence of Endeavour Energy pursuing dynamic efficiencies while positively contributing to the developing of a competitive storage market.

If you have any queries or wish to discuss this matter further please contact Jon Hocking, Manager of Network Regulation at Endeavour Energy on (02) 9583 4386 or via email at jon.hocking@endeavourenergy.com.au.

Yours sincerely

Rod Howard
Acting Chief Executive Officer
Endeavour Energy

Attachment A: Response to the consultation paper questions

Overview

Before responding to the individual questions contained in the consultation paper, we wanted to address an underlying concern of the rule change proponents. That is the belief that DNSPs are not capable of being dynamically efficient and will instead abuse their monopoly position to frustrate the development of markets for generation and storage technologies that may become substitutes to traditional network services.

Based on this assumption, several stakeholders have suggested that DNSPs should be prevented from participating in competitive markets, or face stringent ring-fencing obligations which effectively exclude them, to protect against the risk of 'crowding out'[1] i.e. the notion that DNSPs will monopolise these new markets through their ability to purchase and capitalise these assets in their regulated asset base en masse.

For clarity, "crowding out" refers to the scenario where government involvement in a market limits the ability of private industry to participate. It typically refers to interest rate adjustments following an increase in government spending (or reduction in revenues) but can also refer to the government provision of a service or good that could have otherwise been provided by private industry and therefore subject to the forces of voluntary exchange.

The reference is flawed for a number of reasons. Firstly, several DNSPs are privately owned and no government owned DNSPs are acting on the basis of government policy to acquire assets critical to unregulated markets (such as battery storage technology). Instead, DNSPs are making discretionary planning decisions regarding when, where and how they utilise storage technology subject to the efficiency, innovation and prudency expenditure requirements of the NER and/or DMIA requirements.

Secondly, the occurrence of "crowding out" is dependent on the state of the market in question. Specifically, crowding out impacts interest-sensitive spending when an economy is operating at full capacity or employment. The battery storage market in Australia (and internationally) is an emerging one. It is highly unlikely that the (voluntary) involvement of DNSPs in this market could restrict the ability of others to enter the market. If a DNSP is a first mover in the Australian market (hypothetically) it should not be prevented from enjoying the advantages associated with this as it is not anti-competitive to be a first-mover.

Thirdly, there is no evidence to suggest that the theoretical collective and coincidental involvement of DNSPs in a market is analogous with the impacts of government fiscal policies. As aforementioned, the supplier side for emerging markets such as battery storage are strongly developing with major international suppliers such as Tesla, Panasonic, Samsung, LG, Bosch, Sunverge etc. and Australian based suppliers such as Ecoult, ZEN Energy, AllGrid Energy, Redflow etc. DNSPs operate individually, are separate legal entities and operate in disparate geographic locations eliminating the capacity to collude on their involvement in such markets. The bargaining buyer power of each DNSP is most likely limited and not significantly different to the bargaining power of other potential entrants given the supply-side involvement of multinational conglomerates and electronics manufacturers.

It would be detrimental to the long term interests of customers to prohibit DNSPs from participating in competitive markets, or to significantly reduce their ability to do so. If a DNSP is not allowed to acquire or procure the network services provided by these assets it significantly restricts the value that customers can realise. If a DNSP must only procure these services from a third party it will not deliver an optimal outcome. This is because the third party providers will not face competition from DNSPs implementing "in-house" solutions. Further, DNSPs may be less likely to procure these services if they are unfamiliar with the capabilities, specifications and firmness of the devices. This is because DNSPs are obligated to comply with an array of service standards, obligations and licence conditions. A DNSP must therefore understand both the capabilities of these technologies and the impacts they may have on the network before than can be invested in or relied upon.

It is more likely that the participation of DNSPs in emerging markets will be beneficial to the development of the market. For example DNSPs can have a significant role in:

- developing procedures and protocols for the safe and efficient operation of emergent technologies;
- developing expertise both internally and externally through trialling technologies, sharing information and/or implementing training programs; and

[1] ECA, *Principles for the Integration of Energy Storage*, November 2015, p 3, Origin, Response to Integration of Storage: Regulatory Implications Discussion paper, November 2015, p. 2, PIAC, *PIAC response to AEMC's energy storage discussion paper*, November 2015, p. 3, AER, *Electricity Ring-Fencing Guideline – Preliminary Positions*, April 2016, p. 23

- making necessary changes to the non-contestable business (i.e. the network) to increase the capacity of the contestable market (e.g. managing issues associated with reverse power flows).

Rather than crowding out investment we consider these immature markets benefit from DNSP R&D activities and investment. As excess capacity exists, DNSP spending can help expand the market and act as an accelerator for private investment.

The current market for demand management services with energy storage is in very early stages of development. Studies suggest this market may take several years to fully develop and be widely viable for residential households.[2] Endeavour Energy is already seeking to; understand the impacts and potential uses of energy storage, develop a safe framework for the roll-out and operation of these technologies and promote growth in the potential market.

Specifically, Endeavour Energy has been involved in the Australian Standards development of AS/NZS 4755 – Demand response capabilities and supporting technologies for electrical products Part 3.5 – Interaction of demand response enabling devices and electrical productions – Operational instructions and connections for grid-connected Electrical Energy Storage Systems.

We consider the standardisation of technical requirements will benefit both DNSPs and customers as it:

1) has the potential to result in more streamlined connections of battery storage devices, as DNSPs will have confidence that the integration of the device on its network will not result in adverse safety and reliability impacts; and
2) provides opportunities for customers to more effectively manage their energy usage and reduce their network bill. This means that in addition to the safety and reliability matters the standard now provides standard control functionality that is mostly optional in nature and not limited to use by networks.

In addition to these activities Endeavour Energy is also conducting a residential energy storage trial in conjunction with various competitive market suppliers. An overview of our residential energy storage trial is provided below which demonstrates that, contrary to stakeholder concerns, Endeavour Energy's involvement will deliver dynamic efficiencies for its distribution business while enhancing the contestable market for energy storage.

Case Study: Energy Storage Residential Trial

Endeavour Energy is currently implementing a residential energy storage trial for demand management purposes and to understand how energy storage can be beneficial to the network and to customers. The objectives of this trial are:

- to quantify the network demand reduction potential from installing battery energy storage systems in residential premises;
- to demonstrate the power quality benefits offered by battery energy storage systems by investigating how batteries can assist in managing voltage fluctuations;
- to learn more about the use of battery energy storage technology in residential applications and how to optimise the system for network demand reduction; and
- to understand the willingness of residential customers to invest in a battery energy storage system to provide network support and demand reduction services.

This trial targets locations within our network prioritised in order of network capacity, availability of PV generators and the number of residential customers in the area. This is to ensure we are able to test both the demand reduction and power quality benefits of batteries.

The scope of the trial is to:

- recruit customers in targeted areas;
- engage a third party company to supply, install and commission battery energy storage systems at the customers' premise;
- engage a third party provider/aggregator to implement communications and signalling

[2] CSIRO, *Change and Choice: The Future Grid Forum's analysis of Australia's potential electricity pathways to 2050*, December 2013

technology to ensure battery utilisation at the required times;

- collect and analyse the customer' import and export consumption patterns;
- quantity the total demand reduction in the network area;
- demonstrate the power quality benefits offered by battery energy storage systems;
- confirm customer ride-through capability (if supported by the energy storage system) in the event of an outage;
- model the technical benefits by developing network models utilising the data collected from the trial; and
- enhance the demand response management system that manages the administration of customers and event signalling in the case of a large scale penetration of energy storage systems.

Under the trial, customers in the targeted areas will be incentivised to install energy storage. Endeavour Energy is not seeking to monopolise the ownership, control and use of energy storage devices in this trial. Instead, the energy storage system will be owned by the customer. Endeavour Energy will simply subsidise this purchase in recognition of the network support service that will be provided on a few peak demand days of the year. The customer (via the third party aggregator managing the device) will be able to utilise the battery for their own purposes at all other times to earn additional revenue streams.

A post-trial evaluation report will be completed following its conclusion and made publicly available to share the learnings and outcomes with interested parties.

Clearly, Endeavour Energy could become a large potential customer to a competitive market for these services if they prove to be viable. It is unlikely that DNSPs would procure these services without a thorough understanding of them.

We consider that over time, as the cost of these systems reduces, customers will commence installing battery energy storage systems at higher rates. It is envisaged that ultimately, the control and dispatch systems for DNSP purposes will be readily available at low cost reducing the need for Endeavour Energy to offer financial incentives to customers to procure a device. Instead, Endeavour Energy will simply be able to procure demand reduction, voltage control or support functions from third party aggregators.

It is evident that this trial is not being used as an opportunity to monopolise the potential storage market. Rather, Endeavour Energy is only procuring network support services (via a contribution to the battery purchase) from the customer by engaging third party service providers whilst seeking to give customers ownership and control of their device. Endeavour Energy is simply researching the capabilities of the storage market (so it can become a future customer of this market) and simultaneously developing the capabilities of the market and rate of customer ownership of energy storage devices.

Response to the AEMC's consultation questions

Question 1 Distribution service classification

a) Is there a problem with the current process for distribution service classification? For example:
   i. does the current determination by determination approach reduce clarity over likely service classification decisions?
   ii. does the timing of the framework and approach process (in advance of each distribution determination) inhibit stakeholder engagement on service classification decisions?

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

Overall we consider the existing service classification framework in the NER is appropriate with minor scope for improvement. We appreciate that the regulatory knowledge required to engage effectively in the service classification process can limit the participation of stakeholders.

This is exacerbated by the staggered nature of the framework and approach process and the fact that each framework and approach is conducted well in advance of the remainder of the determination. In addition to limiting the extent to which stakeholders can engage in the process it also contributes to inconsistent outcomes across jurisdictions, which further confuses stakeholders.
We consider that outside of specific state-based legislation or circumstances the classification of services across the NEM should be consistent.

We are supportive of a distribution service classification guideline being developed to address these issues. It will provide a more well-defined opportunity for stakeholders to engage in a single process, allow the AER to clearly explain the classification framework and assessment criteria and most likely result in more consistent service classifications across jurisdictions..

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

d) What other changes to the economic regulatory framework may be required to allow clear and properly informed decisions on reclassification of services within a regulatory control period?

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

We acknowledge that the existing classification framework is not flexible or responsive to changes post-determination. Currently, services are classified at the time of a framework and approach and confirmed at the time of the final AER determination. Under clause 6.13 of the NER the AER may (not must) revoke and substitute a distribution determination if it is affected by a material error or deficiency of the following kind(s):

- a clerical mistake or an accidental slip or omission;
- a miscalculation or misdescription;
- a defect in form; or
- a deficiency resulting from the provision of false or materially misleading information to the AER

These reasons do not appear to support a substitute determination to accommodate a new or amended service.

In our view, it would be a costly and timely exercise to make any modifications to any aspect of standard control services, as any amendment (i.e. services moving to or from standard control services) would require updated expenditure forecasts, revenues and prices. Additionally, it is highly unlikely that an alternative to network services (the standard control service) could arise within a period that would warrant a service reclassification. Such a reclassification would suggest that there is competition for network services and therefore no regulation of DNSPs activities in this market is required.

If a new alternative control service emerges or a reclassification is required we again fail to see the risks. For an alternative control service that has become truly contestable the DNSPs price has been set by the AER and only the DNSP would be disadvantaged by the longer than necessary price control.

For unregulated distribution services or non-distribution services we do not consider a reclassification would be required. A DNSP could not abuse its monopoly power for an emergent service in the absence of direct regulatory control as the AER's new ring-fencing guideline would apply. The AER state:

> *From time to time, a DNSP may commence providing a new service that was not considered at the time the classification of services was finalised. Our approach to service classification is to classify services in groupings rather than individually. This obviates the need to classify services one-by-one and instead defines a service cluster, that where a service is similar in nature it would require the same regulatory treatment. A new service might simply be added to the existing grouping and hence be treated in the same way for ring-fencing purposes. Alternatively, a distribution service that does not belong to any existing service classification is 'not classified' and would be treated as a contestable electricity service.*[3]

Overall, we cannot find any examples of services that were disadvantaged by the existing framework that would justify a re-determination mechanism. It is unlikely that the absence of a service classification for a maximum period of five years has prohibited the development of any new services or markets to date or will do so in the future.

Question 2 Distribution service definition

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

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

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

Overall, we consider the proponents have incorrectly identified the service classification framework as the means of addressing the issues they have raised. We note 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.

The remaining issues raised relate to broader matters such as incentive based regulation, service delivery discretion and competition policy. If the issues raised by the proponents are valid (we do not consider they are) this would require a more complex, thorough revision of the existing regulatory framework rather than attempting to give effect the desired outcomes by modifying the classification framework and associated definitions.

As such, we do not consider the definition of "distribution services" requires amendment. In our view the only aspect of the current definition that requires clarification is whether "in connection with" is figurative or literal (i.e. does it imply a physical connection to the distribution network is required). This clarification can readily be provided by the AER in the potential service classification guideline or the AEMC during consultation on the WesternPower rule change request regarding this very issue.

Question 3

a) Do the form of regulation factors provide clear guidance to the AER in determining whether distribution services should be classified as direct control services, negotiated services or be left unclassified?

The form of regulation factors contained in the NEL guide the AER to assess the level of, or prospect for, competition in assessing whether to classify a service. In our view this is appropriate for determining whether regulatory intervention/oversight is required. The AER's understanding of these factors and intended application of them can be explained and consulted on as part of any service classification guideline.

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

We consider this to be a reasonable requirement that is not restrictive or problematic. It is common sense that a service classification should only be changed if that change is to a more appropriate classification. We understand that some stakeholders may consider this requirement, or the inclusion of the word "clearly" may set a prohibitively high threshold for the AER to establish a positive case for

[3] AER, *Electricity distribution Ring-Fencing Guideline: Explanatory Statement*, 30 November 2016, p. 15

change. In practice, we do not consider there is evidence the AER has been restricted or hampered by this requirement.

We consider it should remain, but as a 'common sense' requirement that has been of immaterial consequence to date, we do not consider its removal would be problematic should the AEMC form an alternate view.

Question 4 NER classification framework

a) Are the NER clear regarding classifying direct control services as standard or alternative control services?

b) Do the NER provide effective guidance to the AER in classifying direct control services into standard and alternative control services?

Response to (a) and (b)

The criteria outlined in clause 6.2.2(c) are not deficient. The COAG rule change suggests that either the definitions and/or rules need to more clearly reflect the intent that services should only be classified as standard control if they have natural monopoly characteristics.

The NEL and NER, quite appropriately, provide the AER discretion to classify a service. The framework provides guidance to the AER, the focus of which is around understanding the level of competition both currently and prospectively. Services with natural monopoly characteristics should be readily identified using the existing criteria. In addition to competition related factors, the criterion also directs the AER to consider the consistency and proportionality of any potential classification.

In our view, both the framework and the AER's application of it to date are appropriate. The framework provides the AER sufficient clarity while providing discretion. The example provided in clause 6.2.2(5) and the AER's practical application in its Framework and Approach decisions provide sufficient guidance as to how the AER interprets and applies the NER. We consider additional measures to improve the transparency and robustness of the process should be investigated before more fundamental changes are considered.

We are concerned that the proponents are recommending a prescriptive service classification framework as a means of addressing their perceived issues with the current framework. The proponents are seeking to modify the framework to impose physical boundaries or service delivery preferences in service definitions. This would be a departure from the principles based, technologically neutral, incentive based regulatory framework currently in place.

This would increase regulatory costs, embed inefficiencies in distribution businesses and limit the flexibility afforded to the AER. We consider a framework that provides guidance through principles is preferable to one which seeks to engineer a particular outcome on the tenuous assumption it is preferable.

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

As per the response to question 3(b)

Question 5 Classification Objective

a) Is an objective for service classification in the NER necessary? For example, COAG Energy Council considers the NER should be more explicit in providing that only services which exhibit natural monopoly characteristics should be economically regulated.

We consider the purpose of service classification is to apply regulation where it is required in a proportionate manner to facilitate competition. The NEL provides the AER guidance in deciding whether a service should be regulated or not. If a service requires regulation (i.e. it exhibits monopoly characteristics) the NER guides the AER in deciding how to best regulate the service. If a service does not require regulation (i.e. a competitive market exists) the ring-fencing guideline and negotiated distribution framework govern the arrangements that must be in place for a DNSP to participate in that service.

In our view, this is an effective and appropriate framework that does not require a unifying objective separate to the NEO. Amending the NER to focus on services which "exhibit natural monopoly characteristics" as suggested by COAG is simply another way of expressing what already occurs.

b) Should the steps of service classification be informed by the same considerations? For example, should all service classification steps be based on market characteristics, rather than on the form of regulation that applies to the service?

As per the response above. The current steps already consider the market characteristics as part of the criteria as to what form of regulation and service classification should apply.

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

We appreciate the uncertainty around "inputs to network services". As identified by the AEMC, some of these input services, such as metering and connections, have been separately classified whilst others have not. This uncertainty may arise from differing interpretations of what constitutes a "distribution service" and "network service". We consider metering and connection services have been separated from network services as they can be directly attributed to a customer and/or provided on a competitive basis.

Metering and Connection services are therefore different to services like demand response or support. The latter services are often provided by an individual to the network and service classification is designed for services provided by the network to customers. Additionally, these services are difficult to attribute to an individual as they can contribute to the safe and reliable supply of energy through the distribution network to the benefit of all customers (or at least surrounding customers).

This is a complex distinction that a service classification guideline may further assist stakeholders in understanding.

We note that the AEC rule change request suggests a new classification should be added. Specifically, a "contestable service" classification that would apply to generation and storage technologies.

As noted by the AEMC

> *Both of the rule change requests seek to require DNSPs to procure certain inputs to standard control services from third parties or related entities, rather than investing in assets that provide such inputs. To achieve this aim, the requests focus on changes to the service classification framework to introduce new categories of classified services (e.g. a new "contestable service" classification) or otherwise clarifying what types of services can be classified as direct control services.*[4]

We consider the concerns of COAG, and many other stakeholders, can be addressed by improving the transparency and clarity of the existing service classification framework through a more accessible and coordinated consultation process.

We consider the AEC's position is an attempt to embed a service delivery bias in the NER to force DNSPs to procure certain services from the third parties it represents. The AEC's rationale is somewhat confusing and the suggested amendments appear to be impractical. The AEC state in their rule change request:

> *we propose that a new service classification called "energy-related", or "contestable", services be created. We do not think that this new term "energy-related" services is or should be captured by the current definition of unclassified services. The reason for this is that unclassified services appear to constitute what are residual services from the perspective of the Rules. This is because any service that is not otherwise classified as either a Direct Control Service or a Negotiated Service is deemed to be unclassified.*
>
> *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 AER would have a role in determining from time to time what services are to be included within this category of services, as well as determining whether a NSPs costs for procuring those services are prudent and efficient.*[5]

It is unclear what is meant by unclassified services being the "residual services from the perspective of the Rules". If a service is not classified it is because it is a distribution service for which sufficient competition exists or a non-distribution service meaning it does not require regulation by the AER. The AEC's suggested "contestable service" would therefore be duplicative and unnecessary.

---

[4] AEMC, *Consultation Paper: National Electricity Amendment (Contestability of energy services) Rule 2016*, 15 December 2016, p. 17

[5] AEC, *Rule change request: Amendments to Chapters 5, 6, 6A and 7 of the National Electricity Rules in the implementation of Demand Response and Network Support Services*, 13 October 2016, p. 5

Any service prohibited from being classified as a distribution service based on location or technology would be detrimental to customers and the interests of the proponents. It would limit the value of generation and storage technologies by restricting the distribution value streams from being unlocked. If these services are not distribution services than in addition to not being able to capitalise generation and storage assets, DNSPs would not be able to obtain an operating expenditure allowance to procure these services. This is because the AER cannot fund the contestable activities of a DNSP, only the costs of distribution services can be recovered through regulated revenues. This is why the service classification framework is not well suited to achieving the intended outcomes of the proponents.

More broadly, we do not consider the intended outcomes of the AEC rule change should be pursued through more appropriate parts of the regulatory framework. In our view, forcing DNSPs to procure any service that involves generation or storage technology from third parties is in the interests of those third parties rather than customers. The emergent market for generation and storage is immature and costly and unlikely to improve without further innovation and the competitive tension provided by traditional network solutions. Customers will benefit from a truly competitive market rather than a market design that acts to protect the interests of a subset of potential suppliers. Such a market will potentially prohibit consumer access to least cost options and will, in effect, subsidise higher cost suppliers through higher network chargers to consumers.

As opposed to creating additional services the AEMC should instead review whether there is in fact a bias for network based solutions that is limiting the development of these potential markets. We consider the regulatory framework appropriately incentivises least cost solutions. It is unlikely that any evidence exists demonstrating that DNSPs are willingly incurring financial penalties under the existing regulatory framework by systematically ignoring lower cost solutions.

Any "bias" that currently exists is most likely attributable to the lack of competitiveness of non-network solutions due to their higher cost, lack of firmness or the inherent inefficiency of decentralised solutions. However, if a bias exists due to imbalanced incentives in the regulatory framework or the frameworks failure to correct cultural bias within DNSPs then amendments to the NER may be required. For instance, a totex style approach to expenditure may neutralise a bias for network over non-network solutions.

d) The proponents of the rule change requests consider that service classification is no longer only determining which services are economically regulated and which are not. It is increasingly having significant effects on the application of the distribution ring-fencing, cost allocation and shared asset guidelines. Should the AER expressly be required to have regard to the interaction of service classification with these other forms of regulation?

Service classification is a key determinant in what ring-fencing obligations will apply. A principles based approach should guide the classification of services. However, we appreciate that the ring-fencing outcomes of the classification should be considered as a sense check or reasonableness test.

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

Yes the NER is clear.

Stakeholders would benefit from a clear and transparent process to improve their understanding of the service classification framework. The explanation provided by the AEMC in the consultation paper is a useful example of the kind of clarification an AER could provide in a guideline.

Question 6 DNSP service delivery discretion

a) Is there a problem with DNSPs having service delivery discretion in relation to demand response, network support and other inputs derived from assets located 'behind the meter'? If so:

- **i. What is the problem?**
- **ii. How material is it?**
- **iii. Provide examples of the problem?**

It is paramount that DNSPs have discretion as to how it acquires or deploys demand response and network support to deliver network services. DNSPs have the best knowledge and expertise to develop the most effective and efficient solutions. It would be imprudent to confer exclusivity to third party providers in an emergent market with the expectation it will develop further in the absence of any DNSP involvement.

As aforementioned, the service classification framework is not well suited to achieving the rule change proponents intended outcome. In our view the regulatory framework would be over-stepping its designed role if the service classification framework was amended to prescribe a preferred delivery model. This would essentially be a departure from incentive based regulation to a prescriptive cost plus form of regulation.

We consider the best outcomes for customers will be facilitated by a regulatory framework that incentivises DNSPs to implement the most effective, least cost option.

The building blocks determination framework in Chapter 6 of the NER provides the AER oversight to approve or substitute expenditure allowances. This means DNSPs must justify their practices and provide evidence as to the efficiency of their solutions. The RIT-D provides additional transparency around a DNSPs planning framework. In addition to this direct oversight, the current framework provides strong incentives for a DNSP to implement least cost solutions in order to obtain financial rewards from the various incentive schemes. It would be irrational and loss making for a DNSP to favour network solutions if lower cost non-network solutions or outsourcing options were available.

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

As above, we do not consider there is a problem.

Question 7 Incentive mechanisms

a) Does the regulatory framework provide balanced incentives for DNSPs to use the most efficient mix of:

- **i. network or non-network options?**
- **ii. capital and operating expenditure?**
- **iii. a range of technologies?**
- **iv. assets that are positioned behind or in front of the meter?**
- **v. providing the services "in-house" or procuring the services from other parties?**
- **vi. procuring the services from third parties or related entities?**

As aforementioned, we consider the existing framework provides DNSPs with strong and balanced incentives to implement least cost solutions and pursue dynamic efficiencies.

We consider it would be costly and risky to presume what the most efficient mix of options is in delivering network services and embedding this in the NER in an exhaustive and prescriptive manner. An incentive based regulatory framework is preferable as it can be principles based and neutral to particular technologies, physical locations or delivery models. Instead, DNSPs are incentivised to select the most efficient solutions irrespective of whether they are "in-house" or outsourced, network or non-network, in-front of or behind the meter etc.

Stakeholders, such as the AEC, allege that a bias exists in the NER due to imbalanced incentives and/or the failure to correct DNSP network investment preferences. Given the incentives DNSPs are currently faced with we consider it is unlikely DNSPs are actively ignoring least cost solutions to their own financial detriment. Instead, it is more likely the case that these network service substitutes or alternate technologies are not yet competitive with traditional network solutions. This could be due to their cost or the disadvantages associated with distributed, decentralised services compared to a coordinated, centralised network service.

This issue may be worth further consideration to understand whether any bias does exist and if so, the role of the regulatory framework in facilitating it. Any potential imbalance should be resolved through direct changes like adopting a "totex" model rather than trying to prescribe alternate outcomes through service classification.

Question 8 Planning framework

a) Is there a problem with the current planning framework in relation to network support and demand management? If so:

- **i. What is the problem (e.g. the detail or timeliness of relevant information; DNSPs being both the decision-maker of investment decisions and the asset owner)?**
- **ii. How material is it?**
- **iii. Provide examples?**

The planning framework provides third parties a plethora of information and opportunities through the DAPR and RIT-D respectively to identify and propose alternate solutions to networks. It may be worth considering whether these mechanisms may be improved through truncation or simplification. We note the continued work of the ENA on network opportunity mapping that DNSPs are voluntarily participating in. Ideally, a solution of this nature will arise and eliminate the need for prescriptive disclosure and options analysis requirements.

It would not be appropriate to lower the threshold of the RIT-D to $50,000 and mandate its outcomes for all capital projects. This would create an unworkable, costly and time consuming planning framework. The RIT-D is designed to provide additional transparency around a DNSPs options analysis. This complements the approval of capital plans via the building block determination process. An overly prescriptive RIT-D as suggested by the AEC is better suited to a cost plus, ex-post form of regulation. As previously explained, attempting to micro-manage and mandate the outcomes of every single DNSP decision is more costly and inferior compared to an incentive based regulatory framework.

Question 9 Cost Allocation

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

Yes.

A CAM is designed to protect against DNSPs cross-subsidising their unregulated activities via their regulated business. It provides for the efficient allocation of costs where the service classification is appropriate.

The COAG and AEC rule change requests would distort the efficient allocation of costs if an asset that provides multiple services is defaulted to unregulated/contestable in order to prescribe a preferred service delivery model.

We also note that the level of detail currently contained in the cost allocation principles and CAMs are appropriate. It would not be appropriate for the NER to act as a quasi-accounting standard with detailed instructions and prescription. The NER provides the AER discretion to review and assess each DNSPs CAM by reference to a set of criteria. The criteria is focussed on ensuring DNSPs do not cross-subsidise their unregulated activities and that costs are allocated efficiently and accurately.

It appears the AEC are trying to re-appropriate CAMs to be used for price discovery purposes rather than simply cost allocation. We do not consider this is appropriate as the costs of standard control services are disclosed via the plans and forecasts submitted to the AER during a determination process and in the Regulatory Information Notices (RINs) submitted annually. While the price of alternative control services are directly set by the AER. This level of disclosure is adequate.

Question 10 Shared Asset Guideline

a) Does the shared asset guideline provide efficient incentives for DNSPs to invest in assets that can provide both direct control services and other services? If not:
   - **i. What is the source of the issue?**
   - **ii. What is the extent of the issue?**
   - **iii. Provide examples?**

We consider the shared asset guideline provides appropriate protection against the CAM failing to respond to a dynamic environment. Where the nature of the services provided by an asset evolve and change over time the initial cost allocation of the underlying asset may no longer be appropriate. The shared asset guideline ensures that DNSPs do not opportunistically benefit from the rent-free, unregulated use of formerly "network only" assets by providing for a fair sharing of the unregulated revenue derived from the asset. This provides an efficient incentive for DNSPs rather than a perverse one. We do not consider the AEC have outlined any specific issues or provided evidence that this guideline is deficient.