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15 February 2017

Ben Davis
Senior Adviser
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Submitted electronically

Dear Mr Davis,

Re: Contestability of energy services

Red Energy (Red) and Lumo Energy (Lumo) welcome the opportunity to respond to the Australian Energy Market Commission (the Commission) contestability of energy services consultation paper developed in response to the rule changes submitted by the COAG Energy Council and the Australian Energy Council (AEC) respectively.

The rule changes focus on the regulation of services enabled by new and emerging technologies, particularly those located behind the meter (BTM). More specifically, they focus on the regulation of services that are delivered by assets BTM that provide value streams in both contestable and regulated markets (shared assets), for example battery storage technologies located BTM.

The COAG Energy Council rule change proposes to change the processes, definitions and principles regarding distribution service classification.

The AEC rule change argues DNSPs have an incentive to favour capital expenditure to grow their Regulated Asset Base (RAB) and provide shared assets to meet their regulatory obligations, in particular BTM. This has the potential to distort competition in the BTM contestable energy services market. To mitigate this problem, the AEC argues the market should supply these services.

This submission provides our overarching positions on each rule change, along with a more detailed response to the COAG Energy Council rule change in Appendix A and the AEC rule change in Appendix B.

COAG Energy Council rule change

Red and Lumo broadly support COAG Energy Council's proposed changes to the process, the definition and the principles relating to the distribution service classification. We consider that the changes will deliver clear, engaging and predictable distribution service classification decisions in the future.

AEC Rule Change

Red and Lumo agree that DNSPs must be excluded from investing directly in contestable energy services located BTM through a capital expenditure allowance. This is because DNSP investment BTM creates value streams in both the contestable and regulated markets with the potential to distort competition.

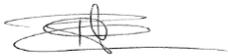
As such, the market for contestable energy services located BTM must be supplied through the contestable market. In this model, DNSPs would be permitted to supply these services through an independent affiliate at an arm's length (their ring fenced entity).

About Red and Lumo

Red and Lumo are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria and New South Wales and electricity in South Australia and Queensland to approximately 1 million customers.

We thank Commission for the opportunity to respond to this consultation. Should you have any further enquiries regarding this submission, please call Con Noutso, Regulatory Manager on 03 9976 5701.

Yours sincerely

A handwritten signature in black ink, appearing to be "Ramy Soussou", written over a horizontal line.

Ramy Soussou

General Manager Regulatory Affairs & Stakeholder Relations

Red Energy Pty Ltd

Lumo Energy Australia Pty Ltd

Att.

Appendix A: COAG Energy Council Rule Change

Red and Lumo generally support the proposed changes by COAG Energy Council to the process, definitions and principles that apply to the distribution service classification framework. The proposed changes will ensure that the distribution service classification process delivers clear, consultative, engaging and predictable distribution service classification decisions in the future.

As the market evolves and more technologically advanced assets are introduced into the market that are capable of providing services to both regulated and non-regulated markets, it will be important that the distribution services classification framework is capable of clarifying the specific nature of those distribution services.

The specific changes to the distribution services classification framework proposed by COAG Energy Council that we support include:

1. Process

1.1 Framework and approach

Red and Lumo agree with COAG Energy Council that the framework and approach process for classifying distribution services attracts little engagement from consumers and stakeholders more generally.

In general, stakeholders do not participate in this process because it is so embedded in the DNSP rate review process. Given the lack of participation by consumers in this process, an alternative approach to service classification would be warranted. This change should encourage consumers and other interested parties to get more involved in this process.

1.2 Guideline

Red and Lumo support the introduction of a service classification guideline, which allows the Australian Energy Regulator (AER) to make clear, consultative and predictable classification of distribution services decisions in the future.

Distribution service classification decisions would be made by the AER in accordance with the guideline itself. The guideline would include the specific criteria that can be developed by the AER to classify distribution services.

Even though we support the introduction of a guideline, we acknowledge that there are significant challenges associated with reclassifying a distribution service during a regulatory period.

For example, if a DNSP was allowed to reclassify services within a regulatory period it may result in changes to the price path. On this basis, if a service was reclassified from a standard control to alternative control within a regulatory period it would require that the asset base be recalculated to determine the revised price for standard control services. It may also require retrospective adjustments to a DNSP's total revenue for the regulatory period. Where this results in higher total revenue this outcome may not be in the best interests of consumers.

However, we consider that the AER requires the flexibility to reclassify distribution services during a regulatory period should it deem it necessary. This is especially true given the broader range of services that could potentially be enabled by new and emerging technologies as we move forward.

As such, we consider that it would be appropriate for the Commission to consider the balancing consumer outcome and AER flexibility when making the draft rule (should one be made).

2. Definitions

2.1 Distribution service definition

Red and Lumo agree with COAG Energy Council that the definition of a distribution service in the National Electricity Rules (NER) is unclear.

Under the current NER definition, a *distribution service* is “a service provided by means of, or in connection with a distribution system”.¹ And a *distribution system* is defined as “a distribution network together with the connection assets associated with the distribution network, which is connected to another transmission or distribution system”.²

Red and Lumo consider that it is important for the Commission to determine whether the terms “in connection with” a distribution system in the definition actually means there must be a physical connection to the distribution system for a service to be classified as a distribution service. We understand that the Commission intends to consider this specific issue in the context of the rule change as submitted by Western Power.³ We consider that these rule changes are linked and consider that clarity on this issue will assist in this rule change.

3. Principles

3.1 Classifying distribution services

Red and Lumo support a review of the form of regulation factors that the AER needs to have regard to when classifying distribution services. Form of regulation factors are an important part of the service classification process because they guide the AER in deciding whether a service should be regulated.

The AER’s approach to applying the form of regulation factors to service classification has been to classify services with a greater degree of competition or potential for the development of competition as negotiated or unclassified distribution services. Those with limited competition are classified as direct control service therefore subject to economic regulation.

With the broader range of services that could potentially be enabled by new and emerging technologies, we would support some changes to the form of regulation criteria that is applied by the AER when deciding on a distribution service classification.

In addition to a review of the form of regulation factors applied by the AER, to ensure that the service classification is fit for purpose and relevant in the current and future environments, we would also support the removal of the requirement on the AER to not change service classification unless a new classification is clearly more important. This clause was included in the NER as part of the process of transferring economic regulation from jurisdictional regulators to the AER. Given the level of technological change in the energy market, the AER now needs more discretion to reclassify distribution services.

¹ Glossary, NER version 89, as accessed: <http://www.aemc.gov.au/getattachment/7e9eef5b-f664-4918-826b-e86cd18f866d/National-Electricity-Rules-Version-89.aspx>

² *ibid*

³ Pending rule change, ERC0215, as accessed: <http://www.aemc.gov.au/Rule-Changes/Alternatives-to-grid-supplied-network-services>

Appendix B: AEC rule change

Red and Lumo support the AEC rule change.

1. The problem

With DNSPs having discretion on how they spend their revenue to meet their regulatory obligations, the AEC rule change suggests the current regulatory framework incentivises DNSPs to favour capital expenditure, compared with other options, to grow their asset bases to meet their regulatory obligations.

As a result DNSPs are incentivised to build assets that provide value streams in both contestable and regulated markets, for example to mitigate a constraint in a particular distribution feeder by investing in battery storage technologies located BTM. This allows them to cross-subsidise their non-regulated activities through their regulated businesses, distorting competition in the emerging BTM contestable energy services markets.

The AEC rule change argues that DNSPs should not be permitted to invest directly in BTM contestable energy services through a capital expenditure allowance to mitigate this risk. It proposes that DNSPs be required to procure network support, demand management and inputs provided by assets located BTM from the competitive market to service these needs. Under the rule change, DNSPs would be permitted to supply BTM contestable energy services through an independent affiliate company at an arm's length in the competitive market.

The AEC rule change further suggests that to encourage the market to supply these services, the current RIT-D investment threshold should be adjusted down from \$5 million to \$50,000. Also, the AEC has proposed changes to the planning framework that would help third parties to make investment decisions related to generation, transmission or distribution capacity to service a DNSPs needs.

2. Cost Allocation Methodology

The Cost Allocation Methodology (CAM) of a DNSP is best used to illustrate how a DNSP investment BTM funded by capital expenditure would create a cross-subsidy in the contestable energy services market.

Consider the example of a DNSP exploring the most efficient investment option under the RIT-D to meet its regulatory obligations. If we accept the AEC's view that a DNSP will favour capital expenditure to meet its regulatory obligations, it could be that a DNSP may favour a battery configuration that supplied network support BTM to meet its regulatory obligations. This investment would allow them to maximise the return to their shareholders by earning a regulated revenue stream (by rolling in a portion of the asset into the RAB) and combine this with an unregulated revenue stream by offering contestable energy services BTM.

When the AER assessed the efficiency of the investment it would be required to make an assessment of the portion of the asset that earned regulated revenue and the part that earned unregulated revenue.

Under the CAM developed by the DNSP and approved by the AER both the directly attributable costs and the allocated shared costs of the relevant asset would be assigned to the regulated and the unregulated shared of the asset accordingly based on its future use.

If the CAM was applied in these circumstances as it was originally intended then the cost allocations between the regulated and unregulated services provided by the relevant asset would be efficient. However, DNSPs have an incentive and the flexibility to allocate both their directly attributable costs and their allocated shared costs for capital investments in a manner that will maximise the shareholder value to their organisation. The cost allocation principles and the CAMs provide too much flexibility to allocate their costs as they so desire.

The result of this means DNSPs end up over allocating both the directly attributable costs and the shared allocated costs of an investment to the regulated side of an asset, in effect cross subsidising their unregulated business. The effect of this would be to give their unregulated business a competitive advantage.

Expanding on our battery example further, a DNSP could potentially over apportion both the directly attributable costs and indirect allocated costs of a battery configuration located BTM to the regulated business. It would then be able to lease a part of the battery configuration to their independent affiliate that operates in the contestable services market BTM at a discount to the market rate. This would have the effect of cross subsidising the unregulated business.

It is true that the incentive regulation regime applied to DNSPs is not intended to deliver these outcomes. However, in practice if DNSPs have an incentive and the flexibility to allocate their costs between regulated and unregulated services for an asset in a manner that gives them a competitive advantage in their unregulated business then they will do so.

While the AER's Ring-Fencing Guideline is intended to prevent DNSP affiliates from receiving more favourable treatment by a DNSP, we are not convinced that they will prevent this behaviour from occurring. On the surface, the AER Ring-Fencing Guideline prevents a DNSP receiving more favourable terms of a service i.e. leasing an asset from its unregulated business than it would normally receive from the market. However, it does not appear to deal with the problem that has been identified here.

With the market for the supply of BTM services in energy including solar PV and storage expected to grow dramatically in the next 20 years, market participants will all be vying for a share of the BTM contestable energy services market. The size of the market in Distributed Energy Resources (DER) alone was highlighted in a recent study by the Energy Networks Association (ENA) and the CSIRO titled the Electricity Network Transformation Roadmap (Roadmap). The Roadmap indicated that between \$225 billion to \$340 billion dollars of capital would need to be invested in DER between now and 2050 to satisfy the demand in two of the four forecasts included in the study.

As potential participants in these emerging markets it is important that the framework supports competitive neutrality and does not create barriers to entry or participation. A more competitive market in the BTM contestable energy services will guarantee that resources are allocated to these markets efficiently. And should the market operate efficient and effectively, it will provide a suitable outcome for consumers.

Given these problems, we consider that it is inappropriate for a DNSP to be allowed to invest directly in BTM services through capital expenditure. They should be required to procure these services through the market. This approach will ensure that resources that service these markets are allocated in the most efficient manner.

3. Shared Asset Guideline

The Shared Asset Guideline specifically deals with the issue of where a shared asset earns both regulated and unregulated revenue.

If 100% of the costs of an asset were allocated to direct control services when it was approved by the AER and it subsequently earned a material level of revenue (>1% of the Maximum Average Revenue - MAR) in the un-regulated market over the later part of its economic life, then Shared Asset Guideline dictates that it would only be required to return 10% of that unregulated revenue to customers to reduce the costs of supplying direct control services.

This would allow the relevant DNSP to keep the remaining 90% of the unregulated revenue that it earned from the shared asset to cross-subsidise its un-regulated contestable energy services BTM.

Given that the size of some DNSPs' MARs exceed \$1 billion dollars every year, where a DNSP was entitled to keep the un-regulated revenue that it earned from a shared asset (which would need to be >1% of the MAR) then the corresponding cross subsidy could potentially be significant. We implore the Commission to consider this when contemplating the next stage of the rule change process.