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Mr John Pierce AO
Chairman
Australian Energy Market Commission

Dear Mr Pierce

AEMC's Electricity network economic regulatory framework (ENERF) 2020 review – Approach paper

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the AEMC's Approach paper - Electricity Network Economic Regulatory Framework 2020 review. The AER supports the AEMC's on-going monitoring and reporting on the effectiveness of the network regulatory framework in the light of the significant changes that are occurring within the energy sector.

We endorse the AEMC's intention to focus on identifying emerging themes and potential challenges in the near to medium term as part of the 2020 ENERF review. This submission focuses on what we consider are priority issues for advancing the National Energy Objective (NEO) and National Energy Retail Objective (NERO), informed by the AER's experience in administering the economic regulatory framework.

As a general point, we would encourage the AEMC to prioritize issues for the 2020 ENERF review on the basis of clearly identified needs and benefits, having regard also to the timeliness of potential reforms. We believe this is particularly important at this time given the scope of the current reform agenda and the impact that COVID-19 is having on the energy sector.

The approach paper notes the AEMC is interested in identifying priority issues other than Distributed Energy Resources (DER) integration for the 2020 ENERF review given the significant focus on DER in the 2019 review and the work program already under way. We believe this is a reasonable approach. Nevertheless, we would reinforce the need to progress the DER integration work program, through the Distributed Energy Integration Program (DEIP) and other industry processes, given the significant impact this will have on the long term interests of consumers in the energy transition. This should remain a high priority.

Outlined below are our comments on potential priority issues for the 2020 ENERF review.

Transmission investment

The AER considers that transmission investment is a relevant and important issue that should be a priority area for the 2020 ENERF review. Given the significant scale and imminent timing of new transmission investment, we consider this should be a high priority.

The National Electricity Market (NEM) is undergoing a significant transition from centralised large scale thermal generation to a system where demand is expected to be met by a combination of decentralised variable generation, flexible generation and distributed energy resources. This has highlighted the need for:

a more coordinated ‘whole of system’ planning to efficiently facilitate this transition, which has led to a reform of the transmission planning framework to make AEMO’s Integrated System Plan (ISP) actionable—this commences on 1 July 2020.

a number of large transmission projects (predominantly new or upgraded interconnectors) that will need to be assessed by the AER in upcoming transmission determination processes—these have been identified in AEMO’s 2018 and/or Draft 2020 ISPs.

Within this context, the AER is currently considering what challenges may arise in the assessment of large discrete transmission investment projects under the current transmission determination process set out in Chapter 6A of the National Electricity Rules (NER). We are considering two key issues:

- whether the existing incentive-based revenue determination framework can deliver efficient outcomes for consumers when applied to these large-scale discrete transmission investment projects, or whether amendments to the existing framework or an alternative regulatory approach might deliver better outcomes. We are considering whether our existing tools and assessment approaches are fit-for-purpose in supporting prudent and efficient investment decisions for large transmission projects, and how risks can be effectively managed and efficiently allocated to ensure efficient network investment.
- whether, in light of the above considerations, there are opportunities to streamline the transmission planning and regulatory processes for actionable ISP projects (for example, by removing duplication in assessments).

We intend to consult with stakeholders once our thinking is further developed—especially in the case where we identify potential changes to our assessment approach or the regulatory framework. We intend to continue sharing our work with the AEMC, including as part of the 2020 ENERF review. In addition, we welcome the opportunity to consider the submissions received to the 2020 ENERF review approach paper on this topic to further inform and develop our thinking. This will include the identification of opportunities to improve the current regulatory framework.

Enhanced consumer engagement

The AER considers the need for enhanced consumer engagement as part of revenue determination processes is a relevant and important issue that should be a priority area for the 2020 ENERF review.

The AER’s approach to consumer engagement as part of revenue determinations has evolved over time. We have implemented a number of processes aimed at better

incorporating consumer perspectives and preferences into the AER's regulatory decision-making.

The Consumer Challenge Panel (CCP) was established as part of the Better Regulation reforms in 2013 to assist the AER to make better regulatory determinations by providing input on issues of importance to consumers. The purpose of the CCP is to advise the AER on whether the network businesses' proposals are in the long term interests of consumers, and on the effectiveness of network businesses' engagement activities with their customers and how this is reflected in their proposals. More recently we have also established Consumer Reference Groups (CRGs) as part of the Rate of Return Instrument and Inflation review processes. The CRGs are intended to represent the perspectives and interests of consumers in these reviews.

The AER has also sought to encourage early customer engagement as part of the revenue determination processes. After the removal of limited merits review, we have observed a greater focus on early engagement between network businesses and their customers. Early engagement is intended to help network businesses to formulate regulatory proposals that better reflect their customers' needs and preferences. A number of network businesses have the stated goal of achieving a proposal that stakeholders support as capable of being accepted by the AER. To this end, many businesses now produce a draft plan for their regulatory proposal before lodging the proposal with the AER. They use this draft plan to consult with consumers when formulating their proposal.

In 2017, the AER, in partnership with Energy Networks Australia (ENA) and Energy Consumers Australia (ECA), launched a joint initiative to explore ways to improve sector engagement, and identify opportunities for regulatory innovation. The goal of the 'New Reg' initiative is to ensure customer preferences drive network business proposals and regulatory outcomes. As part of the New Reg initiative, AusNet Services trialled a new form of customer engagement in the development of its regulatory proposal for the 2021-26 period. Coming out of this trial, the ENA/ECA/AER intends to develop agreed joint principles and directions for reform that can be inputted into rule and policy development processes. The ENA/ECA/AER will provide a joint submission on some of the learnings from the AusNet Services trial to the AEMC in response to the approach paper.

Despite these initiatives, there remains scope for the revenue determination process to better meet the needs of consumers. While meaningful consumer engagement involves at its core a cultural change, there are potential framework amendments we believe would better meet the needs of consumers, now and into the future.

In particular, we consider there are potential benefits in moving away from a prescriptive, input-based, "one-size fits all" revenue determination process to a more flexible framework that better incentivises regulatory proposals that reflect consumers' needs and preferences. While enhanced early engagement and the AusNet Services New Reg Trial have occurred under the current rules, these processes have highlighted the limitations on the AER to fully take account of the specific consumer engagement and consumer preferences of individual businesses. For example, irrespective of the quality of early consumer engagement and support of consumers for a regulatory proposal, the rules include a prescribed process and set of discrete constituent decisions that applies to all businesses. This arguably blunts the incentive for networks to invest in enhancing their current consumer engagement processes. Furthermore, even if a network business and its customers agree to an incentive scheme or arrangement that reflects the specific outputs that customers value, there may not be scope to implement it under the current rules.

In the context of a rapidly evolving market, we believe a flexible framework that can readily accommodate the learnings from processes such as the AusNet Services New Reg Trial and other examples of enhanced consumer engagement would advance the NEO.

Risk allocation between distribution networks and consumers

The approach paper identifies risk allocation between consumers and distribution networks as a potential priority for the 2020 ENERF review. The risk of under-investment and over-investment in forecasting capex is identified in the approach paper.

While we acknowledge that risk allocation is an important issue, it is not apparent what reforms are required at this time. The approach paper does not provide clear guidance on the potential risk allocation problems that the AEMC is concerned about. If there are potential problems or issues related to risk allocation the AEMC has identified, it would be useful to articulate this to stakeholders to help guide further consideration as part of the 2020 ENERF review. This is particularly important given that risk allocation is a complex issue and is a function of (and interaction of) a number of components under the regulatory framework. Risk allocation between distribution networks and consumers is affected by ex-ante forecasts, the incentive schemes, the type of depreciation and RAB roll forward, as well as within period mechanisms such as contingent projects and pass throughs.

If the AEMC is interested in considering risk allocation under the ex-ante regulatory framework more generally we believe this should be assessed holistically as part of a review of the overarching framework for revenue determinations.

Other matters

Flexibility in the regulatory framework

As noted above, we consider a flexible regulatory framework can help to facilitate enhanced consumer engagement processes. Moreover, we believe there are broader benefits from increased flexibility in the regulatory framework.

The current regulatory framework was developed for a technologically-static electricity system premised on transporting energy from centralised large scale sources of generation to consumers. The framework is also input-based, prescriptive and complex.

The energy transition however is rapidly affecting how energy networks are utilised. Increasing penetration of DER is challenging the traditional model of generation, distribution and retail. Technological developments and consumer preferences are leading us away from a supply side oriented system to one that needs to support two way flows of electricity, as well reliance by consumers on DER as an alternative to grid based consumption. As the AEMC has noted in its most recent ENERF review, the changing patterns of usage in the system have key implications for access, pricing and network investment, and therefore regulation. In addition, as the 2020 ENERF review highlights, there are significant high cost and non-recurrent investments that will occur at the transmission level which will be considered by the AER through the current ex-ante incentive framework.

The changing patterns of network investment and usage in the context of the energy transition, changing technology and consumer behaviour raise legitimate questions about how fit-for-purpose the current regulatory framework is for dealing with such developments, and how quickly the framework can adapt to address emerging issues.

A flexible regulatory framework that can accommodate ongoing technological innovation in the electricity system will be important in advancing the NEO and NERO.

Interaction of two-sided markets with DER access and pricing

As noted above, the AER considers the current DER integration work program, through the DEIP and other industry processes, should remain a high priority. One issue we would like to highlight is the need for the Energy Security Board's (ESB) NEM 2025 market design work on two-sided markets to consider the DEIP work on DER access and pricing. If a two-sided market is implemented, there needs to be strong links to changes in the Distribution Network Service Provider (DNSP) access and pricing arrangements.

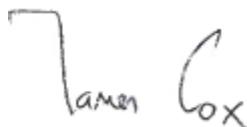
As large scale thermal generation is retired, and the volume of variable renewable grid based generation increases, it will become increasingly important for the market to be able to access flexible capacity including flexible generation and demand side capacity. DER represents a potential source of flexible capacity that can also support a reliable electricity system through two-sided markets and which can provide an important source of competition.

However, any initiatives on two-sided markets will need to align with efficient DNSP access and pricing arrangements to ensure customers (through their energy retailer or service provider) are able to access the distribution network to sell electricity into the wholesale market at times when it is valued the most.

The AER therefore considers it is important that DER access and pricing is integrated with the two-sided markets work stream so that investment in networks is efficient, deployment of DER is optimised, and customers can realise the benefits of DER. More generally, we consider the market design process should also be informed by insights into consumer behaviour.

We look forward to further engaging with the AEMC as part of the 2020 ENERF review. We would be happy to discuss any of the issues raised in this submission. If you have any questions on this submission, please contact Mark Feather, General Manager, Policy and Performance on (03) 9290 6958 in the first instance.

Yours sincerely

A handwritten signature in blue ink that reads "Jim Cox". The signature is written in a cursive style with a large initial 'J'.

Jim Cox,
Deputy Chair, Australian Energy Regulator

Sent by email on: 02.07.2020