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Australian Energy Market Commission

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Dear Mr Davis,

Contestability of Energy Services – Consultation Paper

AGL welcomes the opportunity to respond to the *Contestability of Energy Services, Consultation Paper* (**Consultation Paper**), December 2016. This Consultation Paper canvasses issues raised in two separate rule change proposals – one lodged by the COAG Energy Council (**COAG EC**) and the other by the Australian Energy Council (**AEC**) – together referred to in this submission as the 'contestability of energy services' rule change proposals.

AGL is one of Australia's largest integrated energy companies and the largest ASX listed owner, operator and developer of renewable generation. Our diverse power generation portfolio includes base, peaking and intermediate generation plants, spread across traditional thermal generation as well as renewable sources. AGL is also a significant retailer of energy, providing energy solutions to over 3.7 million customer accounts throughout eastern Australia. In 2015, AGL established a New Energy Services division, with a dedicated focus on distributed energy services and solutions.

AGL firmly supports the objective of the contestability of energy services rule change proposals. Underlying the proposals is the principle that, where feasible, contestability and the competitive delivery of services will promote choice and lead to better price and service outcomes for consumers. The greater the proportion of network services and network spending that can be subjected to the rigour of the competitive market, the less work that the regulatory determination process has to do in terms of simulating efficient outcomes and overcoming information asymmetry issues. It is this principle which underpinned the reorganisation of electricity industry following the seminal Hilmer Report.

A key focus of the rule change proposals is on Distributed Energy Resources (**DER**) that can be installed behind-the-meter and have the potential to offer value in a number of realms – for example, customer comfort and bill optimisation, network support services (e.g. peak load shaving, voltage and frequency regulation), wholesale energy and ancillary services. 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.

However, the current regulatory framework does not require network businesses to draw on competitive markets to deliver network support and demand management solutions. Instead network monopolies can (and are sometimes encouraged to) directly invest in technologies installed behind-the-meter provided this is ostensibly to assist in the management of the network. An emerging market (such as for DER-related products and services) would seem to be particularly sensitive to a regulatory framework that enables a monopsony purchaser of demand management services (which also has certain funding and information advantages) to directly deploy DER. It creates a barrier to the development of well-functioning markets in DER-related products and services, including demand management programs. Without effective competition in the delivery of such services, the efficiency of network spending, customer choice and innovation will all be negatively impacted.

Accordingly, the two rule change proposals raise important issues to be resolved if the deployment and use of DER, and the investment and management of network infrastructure with increasing deployment and advancing capabilities of DER, is to occur in an efficient manner and in a way which maintains the primacy of customer choice. We note that this is not the only review considering issues relevant to the success of the transformation to a more decentralised electricity grid. The local generation network credits rule change, the replacement expenditure rule change, the review of the effectiveness of the electricity network economic regulatory framework and the distribution market model project are all addressing parts of this challenge.

It is important that the Commission coordinates and properly sequences these complementary work-streams to promote a measured and predictable transition to a more decentralised electricity grid. A program vision will highlight the interdependencies and logical sequencing of different pieces of work. For this reason, AGL cautions against the Commission's decision to extend the timetable for making a decision on these contestability of energy services rule change proposals. An assessment of the issues raised in these rule changes, will offer an important indication of whether incremental changes to current frameworks can accommodate the evolution to a more distributed energy system, or whether more fundamental changes are required. This will therefore influence the appropriate direction of the Distribution Market Model project.

Classification and the development of efficient markets in DER products and services

AGL appreciates the distinction between distribution services provided to customers by network businesses and the various inputs procured by network business in the efficient delivery of those distribution services. However, as the Commission notes, this distinction is not always a clear one and this ambiguity can at time have notable impacts on the scope for the development of competitive markets in those services.

Load control is a useful example. Some network businesses offer a controlled load tariff to customers who are prepared to have either a hot water, air conditioning system or pool pump controlled by the network business. If taken-up, the customer pays one tariff for the majority of its household load and a different, lower tariff for the controlled load element. Thus the controlled load tariff is properly viewed as a unique product that is offered to and selected by the customer, rather than a uniform service provided to the majority of electricity customers. Despite this, both tariffs are described by the network business as a standard control service.

In reality, this load control is actually a demand management service procured by the network as a way of reducing the cost of its standard control service. Customers are compensated for providing the network the ability to control their load through a network support payment which manifests as a discount to the normal network charge for electricity supply. Correctly characterising this service as an in-put to the standard control service and allowing it to be competitively provided would open up provision by third parties. This would increase the options available to customers, benefiting both the network and participating customers.

Alternatively if, rather than offering a controlled-load tariff, the network business implemented cost-reflective network tariffs which offered all customers a financial benefit for shifting load to off-peak periods, then any competitive service provider could offer the customer a behind-the-meter load management service to optimise for that tariff. (AGL has noted in other forums that pricing of access to the network will likely to need to evolve further if it is to more effectively accommodate the evolution to a decentralised electricity system.)

As the above illustrates, structuring the load control as a standard control service effectively precludes competitive delivery of alternative load management services. Legacy load control programs reflect the state of technology and industry development at the time they were designed and implemented. However, the regulatory framework requires updating to reflect the fact that there are now far more advanced demand management solutions available and potential for a vibrant competitive market in load management services.

As well as promoting the efficiency and effectiveness of load management services, opening these services to contestable provision will enable providers to craft service offerings which optimise for additional values (e.g. customer comfort, wholesale energy value, ancillary services). This is likely to maximise the overall efficiency of investments in DER and promote customer choice and innovation, while also providing networks with valuable and measurable demand response.

It may be that the definition of distribution services is technically appropriate, however the interpretation of the classification requires further rigour. Properly identifying inputs to distribution services and non-standard services and treating them as such, rather than allowing them to be cloaked as distribution services (and standard control services more specifically), will increase the potential for their competitive provision.

A straightforward way to promote the emergence of competitive markets for DER related products and services, and ensure (legacy and current) classification decisions do not create a barrier to this occurring, is to preclude regulated network monopolies from offering products and services that operate 'behind-the-meter'. Behind-the-meter products and services do not exhibit natural monopoly characteristics and lend themselves to competitive provision. As such, AGL firmly supports this aspect of the AEC rule change proposal.

Reclassification framework

AGL shares the COAG EC's concern that the infrequent opportunities that exist to reclassify services risks impeding the emergence of contestable markets in energy services. Combined with an F&A process that commences some 18 months – 2 years before regulatory proposals are submitted, service classification is effectively locked in for some 7 or 8 years. Technology can evolve substantially in the same timeframe.

While it may be impractical to permit the reclassification of services within a regulatory control period, the Australian Energy Regulator (**AER**) should be encouraged to be more aggressive in moving services into the contestable sphere (i.e. as alternative control, negotiated or unclassified services). This would involve anticipating the potential for competitive markets to develop in areas where new technologies and market developments are showing promising indications that a once regulated service is now amenable to contestable provision.

The current requirement to not change service classification unless a new classification is clearly more appropriate is an impediment to appropriate and swift reclassification decisions and should be removed from all service classification decision frameworks. AGL understands that this provision was originally included in the rules to prevent disruptive reclassification decisions on the transfer of economic regulatory responsibility from jurisdictional regulators to the AER. However, it is unnecessary in the current environment and leads to an unjustified bias towards maintaining the *status quo*. Given the long-standing nature of classification decisions (6—7 years including the F&A process), the AER should be encouraged to do the opposite and take a more aggressive approach to reclassification decisions under the guidance of the form of regulation factors.

AGL agrees with the COAG EC that the form of regulation factors should also be reviewed and updated. The likely impact of a classification decision on the emergence and development of a contestable market in a particular service should be included as a factor in the decision to classify a service as direct control or otherwise. Although this is already a factor in the decision to classify a direct control service as either standard control or alternative control, it is also relevant to and should be included in this primary classification decision.

Including such a factor would, by default, require consideration of the interoperation of the electricity distribution ring-fencing guideline, cost allocation and shared asset rules in light of the classification decision. However, given the direct impact of service classification on obligations under the ring-fencing guideline, in AGL's view it would be worthwhile making the requirement to consider the interaction of these rules and instruments explicit.

AGL agrees with the COAG EC that, whether a service exhibits natural monopoly characteristics, is a primary factor in a classification decision and should be included as either an objective of classification or in the form of regulation factors, as appropriate. However, as noted by the Commission, there may be other circumstances which mean that a service that could in theory be contestably provided practically cannot be – for example, due to a jurisdictional instrument which gives a network business an exclusive mandate or responsibility for accrediting other service providers (i.e. regulating its own potential competitors). If such services were not economically regulated by the AER then network businesses could charge monopoly rents. There is a clear tension here between legacy jurisdictional arrangements and a national economic regulatory framework that allows efficient service reclassification in the customer interest.

Shared assets and cost allocation

The cost allocation guideline and the shared asset guideline were implemented at a time when the primary focus was on assuring the efficiency of revenue for the provision of standard control services. With the advent of new distributed energy technologies and declining utilisation of network services, network businesses are seeking to diversify their revenue streams by establishing related businesses operating in competitive markets and sharing costs and assets with the economically regulated entity. This could provide an incentive for network businesses to allocate more costs to the provision of standard control services than is efficient. Therefore, the two guidelines now have a more pronounced dual focus on assuring the efficiency of revenue for the provision of standard control services and minimising distortions to the competitive markets in which related businesses are operating.

In AGL's view, the greater the level of transparency associated with cost and asset sharing between regulated businesses and their unregulated related parties, the more likely is the achievement of these two objectives. Accordingly, to the extent a cost or asset is capable of being offered more broadly to (unrelated) entities operating in contestable markets (e.g. in-field services such as trucks, warehouses, field staff), it may be appropriate for the network business to be required to set out an explicit transfer price for that asset or service when shared with a related entity. The price would be visible in the internal accounting produced pursuant to the ring-fencing guidelines to demonstrate the nature and extent of transactions between the regulated entity and its unregulated related business. This may also create the opportunity for unrelated competitive service providers to pay to share network assets, with broader efficiency benefits for consumers.

Other means to strengthen the cost allocation framework include:

- requiring network businesses to provide the AER a reconciliation between regulatory accounts and group statutory accounts;
- requiring reconciliation between the expected allocation of costs as set out in 5-year regulatory determinations with allocations reported in annual regulatory information notices, and requiring consistency in allocator/allocation methodology applied in these documents to assist comparability;
- requiring network businesses to clearly allocate costs between different categories of regulated services, as well as unregulated services, to provide a complete picture;
- requiring the annual provision of audited financial statements to the AER, to the extent this is not already required by the revised electricity distribution ring-fencing guideline; and
- offering interested stakeholders the ability to challenge a proposed allocator.

We note that the shared asset guideline only applies where unregulated revenues earned from shared assets are expected to exceed 1 per cent of regulated revenues from standard control services. Given the strength of regulated revenues from standard control services, this means substantial asset sharing can occur without any reduction to regulated revenues recouped from customers. It further provides the corollary benefit that a related party can operate in contestable markets with a lower cost base than if it contracted the use of the asset at a competitive market rate. Given that the revised ring-fencing guidelines require network businesses to properly account for transactions between a regulated network business and any unregulated related party, the materiality threshold should be removed where assets are shared between two such businesses.

Incentive framework for regulated services

The regulatory framework currently allows networks broad discretion as to how distribution services are provided. They can elect to use: network or non-network options; operating or capital expenditure; a wide variety of technologies; assets behind or in-front of the meter; and services provided in-house or procured from third parties or related entities.

AGL agrees with the AEC premise that, to date, networks have been naturally biased towards:

- the use of capital expenditure over operating expenditure;
- the use of network solutions rather than non-network solutions;
- procuring services from in-house rather than outsourcing; and
- utlising their own related entities rather than third party providers when they do go to the market.

This is not surprising given a regulatory framework which encourages a commercial bias towards these activities. For example, under a form of control which guarantees revenue recovery up to a cap, a commercial enterprise will naturally favour expenditure which increases the regulated asset base (**RAB**). Intra-group transactions are also likely to be favoured as revenue remains within the corporate group. The distribution networks' actual activities over the last 10 years clearly reinforce this understanding of outcomes.

The AEC has proposed several rule amendments to mitigate these issues including:

- prohibiting networks from using capital expenditure on 'behind the meter' services, for example network support and demand management;
- providing that expenditure on network support and demand management may only be added to capex and opex allowances after those proposed expenditures have been subject to a truncated RIT test;
- authorising the AER to remove investments in the RAB which have not been subject to a RIT above a new $50,000 threshold; and
- creating a prohibition on including costs in the RAB in excess of those revealed through a truncated RIT processes.

AGL supports these as a necessary, albeit, incomplete first step. 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.

Further, although AGL strongly supports the principle of incentivising networks to provide standard control services as efficiently as possible, it believes the economic regulation of the networks as it stands is overly complicated and distorted by the multi-layered incentive schemes that are currently applied. In our experience, these schemes have not encouraged more efficient capital and operating expenditure by networks but have simply resulted in questionable annual accounting practices, highly variable reported expenditures during regulatory periods, followed by tenuous expenditure proposals by networks in the subsequent period that the regulator cannot easily judge to be efficient.

AGL is very supportive of the benchmarking processes used by the AER in its recent determinations that reward highly efficient networks whilst forcing those that are not to improve their productivity. The benchmarking framework effectively creates a form of competition *between* network businesses. With this benchmarking framework in place, providing additional incentives for network performance compared to its current performance (for example, under the Capital Expenditure Sharing Scheme and the Efficiency Benefit Sharing Scheme) is redundant.

Under the benchmarking framework, a network that is more efficient than its peers will accrue additional revenue in the current period due to this performance and should continue to do so for so long as it outperforms its peers. It does not require a separate formulaic ‘bonus’ that is highly gamed and impossible for the regulator to critically assess. Similarly, a network that is not performing should not be able to engineer its spending and accounts to mitigate this inefficiency into the future.

AGL would therefore contend that these additional incentive schemes are currently redundant, inefficient and costly for consumers and this situation will only worsen as customers access DER. AGL considers that the AEC proposals will serve customers better than these existing incentive schemes by ensuring that non-network solutions are considered for the widest practicable range of investment decisions and that these solutions are procured from contestable markets where possible. The proposal to bind networks’ capital expenditure to the outcome of the truncated RIT will also minimise the impact of the incentive to increase the RAB.

Although AGL supports the objective of the Demand Management Incentive Scheme and Demand Management Innovation Allowance (**DMIS/DMIA**) to encourage efficient expenditure on relevant non-network options, if it does not require network businesses to involve competitive providers in design and delivery, it is unlikely to promote efficient, effective and innovative programs. Rather, it would constitute yet another barrier to the development of contestable markets for such services, and another opaque layer of incentive payments. A truncated RIT for a broader pool of planned network expenditure would allow alternative providers of non-network solutions to compete in the design and delivery of network support and demand management proposals. This competitive process would promote the efficiency and effectiveness of DER-related programs and create the right conditions for genuine innovation.

Conclusion

The contestability of energy services rule change proposals raise important issues to be addressed if deployment of DER is to occur efficiently in a manner benefitting both individual customers investing in DER and grid customers as a whole. AGL expects the Commission to consider the issues holistically in light of related reviews and developments, and that addressing them will likely involve a number of incremental changes to the existing framework, rather than a broad scale redesign.

Should you have any questions in relation to this submission, please contact Eleanor McCracken-Hewson, Manager Policy and Research, on 03 8633 7252 or myself on 03 8633 6836. AGL is also keen to engage in direct discussion with the Commission to outline our experiences to date engaging in DER-related markets.

Yours sincerely,

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