

13 February 2020



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

Dear Mr Pierce,

**DRAFT REPORT: UPDATING THE REGULATORY FRAMEWORKS FOR DISTRIBUTOR LED STAND-ALONE POWER SYSTEMS (SAPS), 19 DECEMBER 2019**

Endeavour Energy appreciates the opportunity to provide this response to the AEMC's *Updating the regulatory framework for distributor led SAPS* draft report (the draft report). This response also applies to the AER's *Ring-fencing interaction with distributor-led SAPS* explanatory note which was released in conjunction with the draft report.

Overall, the draft report provides additional clarity and a framework that will allow networks to transition customers to a SAPS in order to reduce existing cross-subsidies. However, in our view the proposed arrangements do not take full advantage of the opportunity presented by SAPS. The model seeks to maintain NEM equivalent settlement and retail arrangements while promoting competition in the SAPS generation service provider market. This has introduced a complexity and administrative burden to the framework that will inhibit the ability of DNSPs to deploy SAPS and reduce the potential benefits to SAPS customers. Our key concerns can be summarised as follows:

The service classification restrictions will limit our ability to deploy SAPS

The draft report maintains the Commission's Priority 1 position that the generation component of a SAPS is distinct and separate to a distribution service. In practice the vast majority of the assets that make up a SAPS will be generation assets. In our view this restriction is unnecessary, and the existing regulatory framework should be relied upon to incentivise networks to select the most efficient SAPS solution (and financing arrangements).

The restriction on networks owning such assets could result in higher cost, riskier third-party suppliers being relied upon or inhibit a networks ability to deploy SAPS quickly in emergency situations (like the recent bushfires).

We consider competition concerns are also overstated. There are strong prospects for a SAPS generation manufacturing market rather than one for SAPS installation and maintenance services. Developing a framework that requires and promotes the latter is likely to slow down or impede SAPS deployment and increase costs disproportionate to the expected benefits given the likely small scale and remoteness of candidate SAPS sites in the short to medium term.

The ring-fencing process will not alleviate these concerns

A framework that relies on ring-fencing waivers, or the financial ring-fencing of generation assets through a networks unregulated business, is sub-optimal. As aforementioned, it is likely that networks will not be able to source externally provided SAPS generation services on an ongoing basis. Networks may therefore be frequently required to seek ring-fencing waivers which is an administratively costly and uncertain process given these are temporary by nature.

Secondly, the scenarios provided by the AER clarify that where a third-party provider is available that a ring-fencing waiver will not be attainable. This fails to acknowledge instances where a network has legitimate concerns about the viability (financial, safety or otherwise) of a third-party provider. A third-party SAPS generator may not always provide a more cost effective and efficient solution. A network,

who has the overall responsibility for the safety and reliability of the SAPS customers supply, should be subject to scrutiny but not restricted in the exercise of discretion.

Further clarification is also required as to the scenario where a network requires a ring-fencing waiver for SAPS ownership and installation rather than just the ongoing maintenance services. Under such a scenario the cost-recovery should also be clarified. As currently presented the scenarios seem to imply that the intent is to prohibit networks from owning the SAPS generation assets under any circumstances. This would mean that a network would need to financially ring-fence these assets via its unregulated business. If this is not the intention, further scenarios and clarification of the treatment of ownership scenarios are required to allow participants to more fully engage with the breadth of likely and possible scenarios.

#### A more flexible, proportionate framework would enhance customer outcomes

Overall, SAPS provide an opportunity to improve network resilience and safety while reducing existing cross subsidies. We appreciate the opportunity to utilise SAPS and wish to maximise the benefits available to all customers and the experience of DNSP-led SAPS customers.

In adopting SAPS, we are likely to focus on small, individual level systems in fringe-of-grid locations (particular in bushfire prone areas). We will be committed to working closely with the effected customer(s) and, whilst not mandatory, obtaining their support. It is reasonable to expect that these customers would prefer a single and complete SAPS service provided by their DNSP, particularly with respect to ongoing maintenance and fault response and for comfort around safety and reliability.

For this reason, a model that relies on the emergence of an active and effective market for the provision and ongoing management of SAPS generation assets is theoretically sound but practically limited. The pricing arrangements and service classification restrictions required to support this model risk being sub-optimal and disproportionate. We consider that a more flexible framework, particularly with respect to smaller scale SAPS, would better promote the achievement of the National Electricity Objective. Under an integrated model similar to that envisaged in the Priority 2 report, both the pricing arrangements and ongoing customer experience will be enhanced.

Our submission on more detailed issues identified in the consultation paper is attached below. If you have any queries or wish to discuss our submission further please contact Jon Hocking, Manager Network Regulation at Endeavour Energy on (02) 9853 4386 or via email at [jon.hocking@endeavourenergy.com.au](mailto:jon.hocking@endeavourenergy.com.au)

Yours sincerely



**Rod Howard**  
**Deputy Chief Executive Officer**

# Endeavour Energy submission to AEMC draft report on updating the regulatory frameworks for distributor-led SAPS

## General comments

### Overview of the draft SAPS framework

The draft report follows the AEMC's *Review of the regulatory frameworks for SAPS - Priority 1* which focussed on developing a national framework for customers moving from grid-connected supply to a SAPS provided by DNSPs. The draft report is accompanied by draft rules that will give effect to the recommendations made in the Priority 1 final report. Some of key recommendations include:

- amending the NEL and NER to enable DNSPs to use SAPS to provide distribution services;
- requiring DNSPs to develop a SAPS customer engagement strategy and undertake formal consultation with all affected customers prior to a SAPS transfer;
- reporting SAPS opportunities and completed transfers in annual planning reports (i.e. DAPR);
- prohibiting DNSPs from making a connection offer to a new SAPS (new connections can be made to an existing SAPS);
- utilising existing market arrangements to accommodate DNSP-led SAPS with energy charges based on an administered SAPS settlement price rather than the market spot price; and
- extending the NECF and jurisdictional consumer protections to transitioned SAPS customers.

The draft DNSP-led SAPS framework reflects the 'NEM consistency' service delivery model which preserves many of the financial and service arrangements in the NEM. The AEMC considered a key advantage of this model over the alternative 'integrated' model was that it allows customers to maintain their relationship with their existing retailer. This would support a seamless transition and ensure SAPS customers would be no worse in regard to price and consumer protections.<sup>1</sup>

In contrast, the proposed framework for third-party SAPS (Priority 2) allows a more flexible approach in the way SAPS supply is provided to customers from parties other than DNSPs. Notably, the review recognised that services would likely be provided on a vertically integrated basis for medium (Category 2) and small (Category 3) SAPS where the potential for effective competition to emerge in retail and generation markets is limited.<sup>2</sup> To ensure requirements on service providers are proportionate, third-party SAPS will be regulated through a tiered framework with a light-handed approach for small microgrids and IPS.

### The focus of our feedback provided to date

During the previous consultation we supported the AEMC focus on promoting competition, appropriate consumer protections and proportionate regulations but considered these should be applied consistently across each framework.<sup>3</sup> We were therefore concerned by the inconsistency between the SAPS and embedded network frameworks, which could incentivise forum shopping by third-parties and potentially lead to inefficient investment and higher prices for customers.

The main reason given by the AEMC for the discrepancy in the SAPS frameworks relates to differences in consent and consumer choice. In broad terms, consistency with standard supply arrangements was considered unnecessary as customers transitioning to third-party SAPS (with terms and service offerings that differ from standard supply) would be doing so by choice.<sup>4</sup>

We accept that the absence of consent requirements in the DNSP-led SAPS framework supports differences between the frameworks. However, we maintain our view that customer outcomes could be optimised if DNSPs were also permitted to provide a SAPS as an integrated and streamlined service

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<sup>1</sup> AEMC, *Review of the regulatory frameworks for SAPS - priority 1*, Final report, May 2019, p.46

<sup>2</sup> AEMC, *Review of the regulatory frameworks for SAPS - priority 2*, Final report, October 2019, p.51

<sup>3</sup> Endeavour Energy, Response to the regulatory frameworks for SAPS priority 2 draft report, August 2019, p.1

<sup>4</sup> AEMC, *Review of the regulatory frameworks for SAPS - priority 2*, Final report, October 2019, p.iv

that does not reflect NEM arrangements where this is efficient and explicit informed customer consent has been obtained and/or for smaller scale systems.

#### Areas clarified in the draft report

The draft report is largely consistent with the Priority 1 final report and expands on the following key elements of the proposed framework.

- SAPS settlement price. The draft report outlines the formula and rationale underpinning the SAPS settlement price which removes the risk of NEM spot price volatility to retailers and avoids costs associated with hedging SAPS loads with NEM generation. As a result, the SAPS settlement price will be lower than the (previous year regional average) wholesale price and will incentivise retail competition for SAPS customers.
- Service classification. The draft report reinforces the AEMC's view that SAPS has distinct generation and network components with DNSPs prohibited from owning SAPS generation assets and providing generation services. These services would need to be procured from a third-party provider (including the DNSP's unregulated business) with costs attributed to regulated opex.
- Ring-fencing waiver process. In situations where there are no competitive SAPS generation providers, excluding temporary supply measures in an emergency response, a DNSP will need to obtain a ring-fencing waiver to provide generation services. The AER's explanatory note provides some guidance on when a SAPS waiver may be required and how applications will be assessed.

Overall, we consider the draft rules will remove existing regulatory barriers and allow DNSPs to utilise SAPS where it is more efficient than maintaining a grid connection. Network customers will benefit from reductions in cross-subsidies in network tariffs that support higher cost edge-of-grid customers. Transferred customers could also benefit from improved reliability outcomes and reduced exposure to bushfire risk. The current bushfire season demonstrates that SAPS supply would also be an important option in avoiding sustained outages during disaster events.

#### Complexity introduced in the draft report

However, from a network perspective the draft SAPS framework is sub-optimal and does not take full advantage of the opportunity provided by SAPS. The draft framework is complex relative to the planning process for conventional network investment. The additional administrative requirements involving; stakeholder engagement, market tendering for generation services, uncertainty from partnering with third-party generators and the ring-fencing process will reduce the competitiveness of SAPS options and may deter networks from deploying SAPS.

This is especially the case for small sized SAPS which are likely to constitute the vast majority of transfers in the short-to-medium term. The requirements and restrictions the framework imposes on DNSPs apply irrespective of the size of the SAPS and do not reflect a proportionate regulatory response for transfers to IPS and small microgrids.

In our view the remoteness of candidate SAPS sites is likely to reduce prospects for competition and the framework will therefore be heavily dependent on ring-fencing waivers or networks relying on their unregulated businesses.

Much of the framework complexities stem from the decision to distinguish generation from network services and treat them consistent with standard supply arrangements. However, in a SAPS it is often difficult to discern between these services and for smaller systems (i.e. IPS and small microgrids) there might not be any readily identifiable network component.

This creates a situation where the framework makes the DNSP accountable for transferring customers to a predominantly generation-based SAPS as a solution to a network-based constraint to which it is restricted from providing directly.

## Specific comments on the draft framework

### Restricting DNSPs from owing a SAPS

Under the framework DNSPs can only include assets related to the distribution component of a SAPS in the RAB. This is reinforced in the AER's explanatory note which explains that where a network procures only the initial construction of a SAPS generation system from a third party, this is then transferred to the DNSP to conduct ongoing operations and maintenance (subject to a ring-fencing waiver) but it is not added to the RAB.<sup>5</sup>

#### The restriction is disproportionate

In our view, codifying such a restriction is not necessary and may lead to sub-optimal outcomes. The existing classification framework provides the AER suitable discretion and flexibility to classify services in consideration of a DNSP's individual circumstances. Relying on the existing framework would allow the AER to classify a SAPS service (potentially including generation) as a distribution service in specific circumstances. This could significantly reduce the reliance on ring-fencing waivers and better accommodate any jurisdictional specific arrangements.

Principally, it is also unclear why a SAPS can only be considered an efficient distribution service if funded via opex rather than capex. The delineation created by the proposed framework may incentivise and/or necessitate financing arrangements designed simply to work within the rules rather than what is the most cost-effective approach.

In our view the existing regulatory framework incentivises networks to pursue the most efficient option in addressing network constraints. If there is a bias in the framework this should be addressed directly rather than imposing asset or service specific classification restrictions in the rules that, in this instance, constrain a network to opex only solutions.

#### The restriction could result in inefficient solutions

The model and AER ring-fencing waiver guidance presume that a third-party SAPS provider will be both available and the most efficient and cost-effective solution. There will be circumstances where this is not the case and it should be acknowledged and accounted for.

Given the challenges of servicing SAPS customers in remote locations, there will not always be a willing provider of SAPS establishment (design and installation) services. The draft report recognises that some flexibility in the framework is required to cater for these situations:

*"The recommended NEL changes, when made, will allow DNSPs to purchase SAPS services from the competitive market (or to install SAPS themselves if so allowed by the AER), in order to supply electricity to customers where SAPS supply provides an efficient alternative to grid-supply."<sup>6</sup> (Emphasis added).*

We acknowledge the restrictions in the draft report are aimed to facilitate growth in competition in the SAPS generation service market. Noting the feedback from the COAG Energy Council relating to service delivery and classification, we consider further review is required of the scenario in which a third-party SAPS generation service provider cannot be obtained.

*"The Council agrees in principle with these recommendations, however, notes that the regulatory frameworks need to ensure that there are efficient processes in circumstances where there isn't competitive supply."<sup>7</sup>*

In promoting competition, it is important to note that the DNSP will ultimately be responsible for the service outcomes that a customer experiences and is likely to be the first contact point for any reliability or safety issues. It is therefore important that a network can apply discretion in selecting a SAPS

<sup>5</sup> AER, *Ring-fencing interaction with distributor-led SAPS*, Explanatory note, December 2019, p.8

<sup>6</sup> AEMC, *Updating the regulatory frameworks for distributor-led SAPS*, Draft report, December 2019, p.40

<sup>7</sup> COAG Energy Council, *Response to the regulatory frameworks for SAPS priority 1 final report*, December 2019, p.3

generation provider including the option to self-supply. The counter-veiling power of a self-supply option may also provide competitive tension that improves the service and pricing outcomes offered by the market.

It is also important that a DNSP is not be compelled to select a third-party provider where there are legitimate concerns around their financial viability and technical (i.e. safety and reliability) performance or where circumstances dictate an alternative supply (e.g. emergency bushfire response). It is appropriate that a network be subject to regulatory scrutiny when making investment decisions, but this should not extend to unnecessary limits on discretion.

Overall, we believe DNSP ownership of a SAPS (where this is the efficient solution) would not be detrimental to competition. In our view, it would be simpler to classify DNSP-led SAPS generation assets as distribution services and rely on the incentives under the existing framework to ensure networks select the most efficient solution.

At a minimum, we also consider the final explanatory note should provide clearer guidance on how a ring-fencing waiver can be obtained when the only option to deploy a SAPS solution is by purchasing the SAPS directly. Preferably, to confirm that in these situations DNSPs can recover the costs of procuring a SAPS generation system by including it in the RAB or at least clarifying the financially ring-fenced approach involving a network's unregulated business especially as the AER has stated an intention to seek civil penalties for breaches of the ring-fencing guideline.

### **Pricing arrangements for SAPS generation**

#### *The proposed pricing arrangements will not reduce complexity*

The SAPS settlement price is a core element of the SAPS delivery model and is used in the financial settlement of energy provided by SAPS generation providers. This pricing approach maintains the settlement and retail structures of the NEM. A presumed benefit of this compared to the integrated model is that this consistency will reduce the complexity and disruption involved in transitioning a customer to a SAPS.

In our view it will not promote this objective as from a customer's perspective there is already significant disruption when transitioning to a SAPS given the network consultation requirements and physical work required at the customers' premises. We support a principle of ensuring the customer is no-worse off but we question whether the complexity introduced by administering a SAPS settlement price is actually beneficial to the effected customer.

#### *It will not promote cost-reflective price signals*

We previously raised concerns with the ongoing value a retailer would provide a SAPS customer and that a NEM consistency model would not provide a cost-reflective price signal. The draft framework has sought to address these issues through the introduction of the SAPS settlement price. Whilst the framework is more technically complete our concerns remain.

It is not clear how the wholesale price will provide a cost-reflective price signal to SAPS customers to efficiently utilise their SAPS. The wholesale market is designed for large-scale demand and supply of generation to a wide variety of customers. DNSP-led SAPS will most likely be small-scale and better suited to a site-specific pricing arrangement. It is therefore not clear why the wholesale market, and to a lesser extent retail services, are relevant or valuable to SAPS customers.

We would encourage further consideration of this issue given the importance of ensuring the pricing arrangements facilitate the effective management of the SAPS to ensure there is not inefficient outcomes (like over-sized SAPS).

#### *Risk should be borne by the party best placed to manage it*

The Commission notes a benefit of the SAPS settlement price is that it obviates the need for retailers to incur additional hedging costs in managing price risk. We question whether hedging for a small volume of SAPS sites would materially impact the hedging costs of retailers.

Setting this aside, the proposed pricing arrangements do not eliminate pricing risk but instead transfer it to networks. The model presumes that networks will enter into agreements with SAPS generators that provide a 'make-whole' style payment (the SAPS generator business case will rely on such payments). This means that under the envisaged arrangements networks will be exposed to price risk as the payments they will make to SAPS generators will vary with movements in the average wholesale price from the previous year. We question whether this is an appropriate allocation of risk and consistent with the 'consistency model'.

#### The model requires an ongoing SAPS generation service provider

The model presumes that a generation service provider (i.e. owner of the SAPS generation system) maintains a presence in a customer's SAPS supply arrangements and receives a flow of revenue based on the energy consumed by the customer.

As discussed above, there may be instances where there are no SAPS generation providers willing to provide an ongoing service to either the customer or network beyond the sale of a SAPS system. In this case, the only way a cost-effective SAPS could be deployed is if the network (or its unregulated business) was allowed to purchase, install and operate the complete SAPS system.

In this instance it is not clear who would then receive the AEMO energy payment and any contracted network payment. Clarification is required as to whether the customer would receive these payments directly and how (the latter in the case of the AEMO energy payment) and/or whether a network with a generation service ring-fencing waiver would receive or administer the energy payment.

#### A more flexible pricing approach would enhance customer outcomes

These issues arise because the framework maintains consistency with the structures and arrangements in the NEM. If the framework instead allowed DNSPs to provide SAPS customers with an integrated SAPS service (consistent with the proposed third-party SAPS framework) these issues could be avoided through innovative and tailored service offerings at a lower cost to customers.

In our view, these issues are best managed if DNSPs (or their unregulated business) are able to own a SAPS and provide generation services. Granting exemptions to DNSPs would at a minimum be more effective than applying the ring-fencing framework to SAPS, noting the AEMC's comments:

*".. the integrated nature of smaller systems in particular means the extent to which the ring-fencing of SAPS generation services would represent the most efficient approach is unclear".<sup>8</sup>*

As these issues are likely to be most prevalent in small SAPS we believe it would be prudent to limit exemptions to IPS installations.

#### **Assessing SAPS ring-fencing waiver applications**

When assessing a ring-fencing application, the AER explain they will consider the extent to which the DNSP has demonstrated that third-party providers are unable to provide the SAPS generation service and will have regard to evidence such as the outcomes of market tenders and responses to expressions of interest.

The explanatory note indicates where a DNSP does not tender for generation services they will have failed to provide sufficient evidence to support the waiver and the AER will subsequently consult publicly on the application before deciding whether to grant a waiver. Where a tender is conducted but no interested providers are willing to provide the generation services, the AER will grant a waiver.

We have two main concerns with this approach. Firstly, it may force DNSPs to undertake formal public tenders for all SAPS transfers, including when it can be reasonably established beforehand (through recent, comparable experience and informal interactions with prospective providers) that no SAPS providers will offer an acceptable tender response.

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<sup>8</sup> AEMC, *Updating the regulatory frameworks for distributor-led SAPS*, Draft report, December 2019, p.46

Secondly, it presumes where a DNSP receives a quoted response, a waiver is not required on the basis a willing third-party SAPS generation service provider has been identified. However, it may be in the customers' interest for a waiver to be granted particularly if the willing provider cannot satisfactorily demonstrate the capabilities needed to satisfy the terms of the contract or has a history of breaching their contractual obligations.

Also, DNSPs will remain responsible for ensuring compliance with all relevant distribution obligations including jurisdictional reliability performance and safety standards following a SAPS transition. As the quality of customers' supply service will be impacted by the performance of the SAPS generation service (an input to the distribution service), we believe it is important for DNSPs to access waivers where they exercise discretion to not contract with willing generator providers where there are legitimate doubts over their ability to fulfil their obligations. Accessing waivers in these cases is important to promote confidence in SAPS as an alternative to grid supply and gain consumer support for future SPS deployments.