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Dear Daniela

Electricity network economic regulatory framework review, Approach Paper, June 2020

AGL Energy (**AGL**) welcomes the opportunity to respond to the Australian Energy Market Commission's (**AEMC**) Approach Paper for the 2020 Electricity network economic regulatory framework review (**ENERF Review**).

AGL supports the AEMC's continued interest in the implementation of recent reforms with respect to distributed energy resources (**DER**) integration. We agree that some progress has been made with respect to the actions proposed in the AEMC's 2019 ENERF Review, as detailed in the Approach Paper. Nevertheless, we consider that further reform is required to develop a market-based framework to allow customers to engage and share in DER value. We believe that further work is required to test a market-based framework that:

- Enables DER to bid as scheduled resources for wholesale and ancillary services;
- Opens the network value pool to the competitive market through enhanced transparency and opportunities for non-network solutions for the benefit of all consumers; and
- Provides greater accountability for network constraints management to support improved investment certainty for DER customers.

AGL also notes the AEMC's proposal to consider other emerging issues beyond DER integration that may also impact upon the electricity sector's transformation.

We support the AEMC's proposal to review the implications of changes to transmission planning and cost recovery associated with the existing economic regulatory framework, arising as a result of the newly enforceable Actionable Integrated System Plan (**ISP**) rules. In addition, AGL encourages the AEMC to also review the broader coordination of transmission reforms and their interactions with transmission ringfencing arrangements.

However, we do not believe the other issues selected in the Approach Paper are of high priority and suggest the AEMC consider alternative topics for review.



Instead, we would recommend the ENERF Review consider the following matters:

- Review the regulatory framework for front-of-the-meter (**FTM**) distribution connected energy storage assets to ensure that the framework supports efficient investment in these assets for the benefit of all consumers.
- Review the network tariff reform program to ensure it remains fit-for-purpose in supporting efficient network expenditure outcomes and DER integration, including opportunities associated with alternative models such as the bulk wholesale network tariff model and the appropriateness of the current consumption-based network tariff paradigm.
- Consider if the framework for network investment is appropriate given the transition of the energy industry. The current level of regulated asset bases is already creating underlying cost pressures and consideration of remedial actions such as network asset write downs. It would seem appropriate for the AEMC to consider whether the regulated framework should continue to guarantee returns on investments in these long-lived network assets. With the increasing uptake of DER which tends to entail shorter-lived assets, there may be value in assessing whether the framework is appropriate.

We elaborate our feedback in the **Attachment**.

AGL also supports the AEMC's monitoring and reporting on key metrics as part of this process. We note the AEMC is planning to include data on the uptake of new technologies and networks' use of non-network solutions in the 2020 Review. AGL believes it may also be useful if any data on non-network solutions could be disaggregated according to whether the non-network solutions were provided by third party providers or by related parties to the networks.

Should you have any questions in relation to this submission, please contact Patrick Whish-Wilson, Senior Manager, Regulatory Strategy on 02 9921 2207 or PWhish-Wilson@agl.com.au.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Elizabeth Molyneux'.

Elizabeth Molyneux

GM Policy and Energy Regulation



ATTACHMENT

1. Access to transmission contingent project revenue and the adequacy of ring-fencing arrangements

While ISP transmission projects are required to pass a streamlined Regulatory Investment Test (RIT-T), the flexibilities afforded by the ISP Rules may offer an attractive approach for TNSPs to access contingent project revenues for expanded transmission projects that may have been otherwise more difficult to access under the existing economic regulatory framework (i.e. ISP priority project in addition to other related non-ISP priority projects).

This in turn could increase the risk of inefficient non-ISP projects being built and funded by consumers, especially where their investment case is dependant on (or strengthened by) an ISP-priority project. AGL therefore encourages the AEMC, working with the AER, to review the operations of the existing economic framework to ensure that it remains suitable for ongoing transmission investment outside of the ISP Rules, including ensuring that its RIT-T remains suitably rigorous, testing projects on their own merits, to limit consumer risks of over investment and cost inefficiency.

In addition, AGL holds some concerns regarding cross subsidisation of new unregulated activities by TNSPs using their regulated asset base and monopoly status, specifically to procure, own, operate or provide energy storage, demand management and new network services. There is an inherent risk that provision of these unregulated services are deemed justified because TNSPs use the same infrastructure to provide regulated (prescribed or negotiated) transmission services. Should these activities continue without review, this could impact on wholesale market competition, particularly noting NEM rules governing the installation, use and control of energy storage systems do not yet exist.

However, AGL acknowledges that regulatory projects are currently pending or underway to assess these risks. For example, the AER has commenced a review to examine whether existing transmission ring-fencing in the NEM remains fit for purpose, although this has now been delayed due to the Covid-19 pandemic. Similarly, the AEMC has a pending rule change on the integration of energy storage¹, has recently finalised a rule on TNSP access to a demand management innovation allowance² and has just commenced a combined rule change consultation on system services.³

Noting the links between these processes and the Energy Security Board's Post 2025 Market Review initiatives, AGL encourages the AEMC and other market bodies to closely coordinate its workstreams to ensure a considered approach is taken to avoid unintended market consequences.

2. Risk allocation between distribution networks and consumers

The AEMC appears to have identified this issue as a concern over the correct allocation of risk to minimise under or over capital investment by distribution networks. AGL does not consider that the allocation of risk between distribution networks and consumers, as currently articulated in the Approach Paper, requires further reform to the current regulatory framework.

AGL acknowledges that this may be a concern when considering the timing of large capital investment projects but expects these would predominantly occur in the context of transmission planning and should be considered in the previous topic.

¹ <https://www.aemc.gov.au/rule-changes/integrating-energy-storage-systems-nem>

² <https://www.aemc.gov.au/rule-changes/demand-management-incentive-scheme-and-innovation-allowance-tnsps>

³ <https://www.aemc.gov.au/sites/default/files/2020-07/System%20services%20rule%20changes%20-%20Information%20Sheet%20-%202%20July%202020.pdf>



Regarding distribution networks, we believe the AEMC is conflating forecast error with under and over investment in capital expenditure. The AER locks in a network's maximum allowed revenue prior to each regulatory period based on forecasts of cost allowances, including efficient levels of capital expenditure. These forecasts will always be inaccurate to a degree. However, this should not lead to under and over capital investment as:

- forecast capital expenditure is a large cost allowance that is made up of a multitude of different sized capital projects over the five-year period. The network can vary from its original capital plan and defer or add projects as needed. This ability to manage its expenditure as circumstances changes ensures the network can meet its projected spend as required. In fact, AGL would highlight that in recent regulatory periods, almost all distribution networks have managed to spend below the allowance for capital expenditure provided by the AER; and
- the risk of underspend and failing to meet legislated service standards is highly unlikely. Firstly, any change in service standards has historically been used by the networks to justify large increases in capital expenditure during any period. Second, even if service standards did change intra-period, additional investment in capital expenditure in the short term is unlikely to result in a material change in reliability so there is little consequence of under spend. The network also can manage its operational expenditure to mitigate any issues. Finally, if additional capital expenditure was critical to avoid penalties under the Service Target Performance Incentive Scheme (STPIS) then the network would invest accordingly. The only financial impact on the network would be that it relinquishes the annual return on capital for any expenditure in excess of its allowance.

AGL believe there is little risk of under or over investment by networks under the current regulatory framework and that this is not a persuasive reason to review the risk allocation between networks and customers.

Indeed, AGL suggest that the risk allocation could be considered biased towards the distribution network given:

- the current framework provides networks with a rate of return that is "notionally" guaranteed. The network receives full depreciation for any prudent expenditures in excess of the forecast as well as the rate of return on these assets from the next regulatory period. The network would only be relinquishing the rate of return on excess expenditure for a small part of the assets long-life;
- networks can manage their expenditure and mitigate their risks while still benefitting from a framework that reward them as although the risks were uncontrollable; and
- customers bear the cost of forecast error as well any under and over investment and have no control over this risk.

Any examination of the risk allocation should therefore start with the premise on how to reduce the risk being borne by consumers.

3. Need for enhanced consumer engagement

As the AEMC has noted, the network revenue determination process has seen improved positive engagement by the networks with consumers.

Recent determination processes have also included early engagement by networks with both consumers and industry stakeholders prior to submitting their regulatory proposals to the AER.

AGL has appreciated this level of consumer engagement but has doubts whether any further benefits can be derived from any additional engagement and whether such activities can replace the industry knowledge



and balance of the Regulator. We recognise the AER has been exploring negotiated-settlement approaches between consumer representatives and the network businesses but believe the added complexity and high cost of these approaches raise doubts on their effectiveness as a central part of the regulated framework.

4. Front-of-the-meter distribution connected energy storage assets

Against the backdrop of technology advancements, such as battery storage which can provide multiple services, and the increased choices it offers consumers, recent regulatory reform has focused on supporting a competitive market in 'behind the meter' (**BTM**) products and services. This was advanced most notably through the contestability rule change that limits distribution network businesses' ability to own and control these assets⁴.

We have observed a similar issue emerging in the context of FTM distribution connected energy storage assets. Recent industry conferences convened by the Energy Security Board (**ESB**) have suggested that while there may be economic and equity advantages in the deployment of FTM technologies, there are a range of financial, regulatory and consumer matters that need to be resolved to ensure their efficient uptake across the NEM. As with BTM products and services, FTM assets may also present a range of value streams for the benefit of customer if they are regulated through an appropriate ownership and control framework that supports innovation and customer-centric outcomes.

While FTM technologies have sometimes been characterised as 'community' batteries, we have observed a diversity of views on the appropriate ownership and control framework to deliver optimal economic outcomes for consumers. Although discussions have contemplated network ownership as well as recognition of new market participants categories to enable direct community ownership, there has been limited discourse on the potential benefits associated with contestability in supporting the uptake of FTM technologies.

Accordingly, we would recommend a broader review of the regulatory framework for FTM distribution connected energy storage assets to ensure that the framework supports efficient investment in these assets for the benefit of all consumers. Among other things, the review should consider:

- Whether distribution networks are appropriately incentivised to provide clear price signals to the market for the provision of services from distribution connected FTM assets; and
- Whether contestability should extend to distribution connected FTM assets to enable efficient deployment as well as co-optimisation of value streams for the benefit of all consumers through orchestration.

5. Cost reflective network pricing

In the context of the network tariff reform program, we note the policy intent to create economic value through retailers solving the dichotomy between network tariff complexity and simplicity in customer offers by bundling products (aided by technology) that are appealing and will respond on behalf of customers. While in theory this may be possible, we consider that it has been slow to progress due to, among other things:

- the cost of product development (including technology);
- customer trust; and
- the current incentive structure in the electricity supply chain.

⁴ AEMC 2017, Contestability of energy services, Rule Determination, 12 December 2017, Available at <https://www.aemc.gov.au/sites/default/files/content/b0fcc4f6-7bcd-4351-ad8c-4d53e5306dc3/Final-determination.PDF>.



While AGL already provides some cost-reflective retail prices, we consider that all retailers face challenges in delivering a persuasive business case for new product types that utilise cost reflective tariffs given customers preference for simplicity. We would therefore encourage exploration of options that could allow network cost reflectivity to progress while also delivering on simplicity in retail offerings.

Through our engagement with the Distributed Energy Integration Program (**DEIP**) Access and Pricing work program, we have observed a range of potential alternative approaches to network pricing that may warrant a broader review of the network tariff reform program.

We would therefore recommend that the ENERF Review consider whether the network tariff reform program remains fit-for-purpose in supporting the continued growth in DER uptake. Among other things, the review should consider:

- Whether charging cost reflective network tariffs to retailers based on an aggregated load profile of the retailers' customers (the bulk wholesale network tariff model) could better incentivise retailers to manage the risks associated with network costs thereby promoting greater innovation in the development of products and service and investment; and
- Whether the consumption-based network tariff paradigm remains fit-for-purpose in supporting DER integration, given the range of services DER could provide to distribution networks, wholesale and ancillary service markets.

6. Framework for regulating distribution networks

A significant issue over the last 10 years has been the level of networks' regulated asset bases and the impact they have on network costs. Return from these assets is the largest cost driver in network determinations making up around 50 per cent of network revenue and lower network utilisation of these asset has exacerbated the problem.

Admittedly, decreasing rates of returns in recent years has resulted in large reductions in network charges however this is largely driven by external movements in the risk-free rate. If rates started to increase then we will see network charges increasing significantly, irrespective of the efficiency of the networks in question.

Remedial actions, such as network asset write downs, have been publicly discussed by Governments and regulatory bodies such as the ACCC. Furthermore, because these assets are very long lived, depreciation of the asset base will not rectify the issue.

Given these concerns and the transition occurring in the energy industry, AGL believes that it is inappropriate that networks continue to make long-term capital investments on assets that may or may not be utilised in 20 years, let alone at the end of their life in over 50 years, noting that consumers will pay for these investments for the entire time.

Accordingly, AGL believes the AEMC should consider reviewing the current framework regarding capital expenditure, depreciation and life of network assets and whether future investments in long-lived network assets should continue to be guaranteed or whether networks should share some of the risk with consumers.