



Designing the annual health check

Response to the AEMC's approach paper on the Electricity Network Economic Regulatory Framework Review

2 February 2017

Introduction

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit law and policy organisation that works for a fair, just and democratic society, empowering citizens, consumers and communities by taking strategic action on public interest issues.

PIAC welcomes the opportunity to comment on the AEMC's approach paper on the Electricity Network Economic Regulatory Framework Review.¹

The AEMC states the main issue to be considered in this review is whether the current economic regulatory framework is providing the right incentives for network businesses to choose the most economically efficient option while maintaining reliability, security and appropriate consumer protections.

In our submission PIAC considers the purpose and scope of the review and identifies the key issues that we ask the AEMC consider in its assessment.

The lead authors of this submission are Kristal Burry, Policy Officer, and Tina Jelenic, Senior Policy Officer.

Consideration of purpose and scope

Terms of reference

The Terms of reference for the review note that the most critical risk is the potential for an increased uptake of decentralised electricity supply options to lead to asset under-utilisation or stranding, which could lead to material increases in the price of electricity services and accelerate the issue. It notes that attempts to incrementally change the regulatory framework once the key features of the decentralised energy scenario are present will be too late to allow market participants and associated regulatory frameworks to adequately adapt.

The Energy Council tasked the AEMC to monitor and report annually on the status of market developments which may impact on the ability of the electricity network economic framework to continue to deliver the national electricity objective in the event of an increase in decentralised supply options.

In its approach paper the AEMC seems to downplay the urgency implicit in the terms of reference from the Energy Council. The scenario that the Energy Council identified as carrying the most critical risk has already started to play out. PIAC considers it vital that the AEMC focus on the gaps and the risks associated with the current framework, and the need to take immediate steps to make it more responsive and adaptable.

Defining the existing framework

PIAC recommends that the AEMC consider regulatory risks arising from a substantial increase in demand for network services, as well as risks arising from reduced demand or bypass.

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AEMC, 'Approach paper: Electricity network regulation framework review', 1 December 2016, available <http://www.aemc.gov.au/getattachment/0145c0d9-68d9-41d3-9c88-913fea8e548c/Approach-paper.aspx>

We note that the AEMC will mainly focus on chapter 6 and 6A of the national electricity law. We support this but suggest that parts of chapter 5, such as demand forecasting and tests for new capital expenditure, are also considered. These are central components of the existing regulatory framework. Chapter 5 also addresses under and over investment and consideration of this is key to assessing the flexibility of the framework.

Because the regulatory framework is so complex, it is possible that even a comprehensive analysis of the existing system may not identify all gaps and omissions where modernisation and flexibility is needed.

Framing the approach – key issues

Local generation network credits

Network businesses need a mechanism that enables local electricity generation and consumption to pay lower network charges than those paid for consumption of centralised generation. This would offer an alternative to behind the meter solutions, and to the establishment of embedded privately operated networks within the distribution network. This maintains utilisation of the network, which is in everybody's interest, and avoids the duplication of infrastructure.

The LGNC rule change was designed to improve the financial viability of a range of decentralised energy projects involving local councils, shopping centres, office buildings, apartments, precinct scale co- and tri-generation, community energy and aggregated small scale solar and storage. In terms of how the methodology for cost reflectivity should be applied, and how transaction costs should be accounted for, PIAC joined the proponents in calling upon the AEMC to contribute to the data pool and assist in providing the necessary evidence-base to make an informed decision.

The AEMC rejected the LGNC rule change proposal and stated that existing provisions for network support payments, combined with cost reflective tariffs, are sufficient to incentivise efficient local generation.

In PIAC's view this warrants further consideration. We disagreed with the AEMC's interpretation of the scope of the rule-change, and with the scope of economic modelling it carried out.² The Institute of Sustainable Futures has produced further evidence that incentivising local renewable generation is economically efficient and environmentally responsible. This has been reinforced by more recent research from Energeia for the ENA/CSIRO Network Transformation Roadmap, which forecasts higher economic benefits from networks buying services from prosumers.

Overall, we believe there is a clear case for action in this regard. It is an area where the regulatory framework is currently not appropriately flexible.

² PIAC, 'Local Generation Network Credits Rule Change – PIAC submission to AEMC draft determination', 16 November 2016, available at <https://www.piac.asn.au/wp-content/uploads/2016/11/16.11.16-PIAC-LGNC-submission-pdf>

Stand-alone systems

There are a number of overlapping issues between demand management and stand-alone systems. The AER is in the early stages of developing a guideline and framework for implementing the recent rule change to strengthen the Demand Management Incentive Scheme (DMIS) and Demand Management Incentive Allowance (DMIA). In the case of distribution owned and led stand-alone projects, it is likely that incentives will be required along with changes to existing connection and planning frameworks. PIAC notes that it is important to ensure that any incentive framework developed for stand-alone systems allows customers receive a share in benefits in a clear and defined manner and does not allow networks to collect benefits from multiple incentive programs.

In PIAC's view, the current network connection framework does not adequately encourage competition for stand-alone systems. Outside NSW, jurisdictional frameworks prohibit competition. Even in NSW the framework limits innovation and the connection of stand-alone systems. PIAC understands that the developers of the Huntlee project in NSW decided not to connect to the grid because current procedures would require that once the system was operational they would have had to hand over the infrastructure to the distribution network. Going off-grid may be the most sensible solution, but in cases where connection to the grid does not occur because of current regulations, there may be missed opportunities from remaining connected. There is also greater risk to customers from being off-grid rather than having a grid connection as a backup.

In its submission to the COAG Energy Council, PIAC recommended that the Energy Council review current connection and planning frameworks in light of new technology options and if necessary propose a rule change to address the issue of limited competition.³ PIAC also recommended that the Energy Council review Ofgem's approach to managing competition in connection and ensuring flexibility, as the UK has more experience in promoting competition and alternative energy systems for the benefit of consumers.

PIAC also argued that the AER should be asked to re-examine the price cap applied in embedded networks and consider a possible price cap for stand-alone systems to ensure that customers of these systems are not paying more than the applicable market contract. PIAC's view is that customers of stand-alone systems need to be able to access concessions, rebates, hardship programs and multiple payment options.

PIAC urges the AEMC to take these issues into account in its assessment of the flexibility and adaptability of the network regulation framework.

Ring fencing and storage

As we have argued in our submissions to the AER, PIAC considers it critical that the overriding objective and outcome of ring-fencing or related reform in the NEM should be to expand the reach of competitive markets for contestable services and to restrict the reach of monopoly

³ PIAC, 'Regulation of the energy wild west: Stand-alone systems in the electricity market', December 2016, available <https://www.piac.asn.au/2016/11/18/regulation-of-the-energy-wild-west-stand-alone-systems-in-the-electricity-market/>

regulated businesses.⁴ The challenge, as has been recognised by the AER, is to do this in a way that does not overly restrict networks from investing in or facilitating the rollout of energy storage on either side of the meter, especially where the network may be best placed to invest in storage, such as at the edge of the grid where a competitive market may never develop.

PIAC remains concerned that there is no evidence that without the supplementary actions ring-fencing arrangements provide new entrants with an adequate level of protection from the damaging market power of an incumbent. In such a context, including where structural separation cannot currently be enacted,⁵ PIAC is of the view that ring-fencing needs to be as robust as possible, and in particular should contain strong measures around monitoring, transparency and compliance, so that consumers can have confidence that the guideline is being strongly enforced.

Consideration of the effect and effectiveness of ring fencing is necessary if this review is to be a comprehensive review of network regulation.

Network pricing reform

New pricing principles were introduced in 2014 to require networks to set cost reflective prices. The main aim of the pricing reform was to send signals to consumers about the costs of using the network at peak periods. This would encourage consumers to use less energy at those times and thus reduce the need to expand the network, a key driver of recent price increases.

The introduction of the new pricing principals has been phased in with the first round of tariff structure statements to be in place for two years. This will allow the networks and consumers time to introduce tariffs that are progressively cost reflective. To date, all distribution networks across the state have submitted TSS to the AER for approval.

This provides time for the AEMC and AER to review the process and outcome of the TSS against the intent of the pricing reform to ensure that the next round of TSS, that lasts for five years is effective and does not lock in poorly designed tariffs that send the wrong investment signals.

Based on its experience in the NSW networks tariff process PIAC has identified a number of areas that require strengthening or review:

- Lack of clarity in the network pricing rules
- AEMC's decision not to allow the AER opportunity to develop an AER Guideline regarding new pricing principles
- Budget and capability constraints of the AER
- Lack of scrutiny by the AER's Consumer Challenge Panel

Of particular concern is the lack of clarity between marginal capacity and infra-marginal capacity in the network. Congestion pricing makes sense when there is congestion, however when it is applied to infra-marginal use, the costs outweigh the benefits. This results in consumers being charged marginal prices when they system is not constrained, causing them to pay more than is

⁴ PIAC, 'AER Draft Electricity Ring-fencing Guideline 2016', September 2016, available https://www.piac.asn.au/wp-content/uploads/2016/11/28.09.16_draft_ring_fencing_guideline_piac_submission_copy-1.pdf

⁵ The contestability rule change will be dealing with this issue.

fair and sending incorrect price signals.⁶ Additionally PIAC has concerns that the balance between residual and long-run marginal cost (LRMC) is distortionary and could lead to consumers and business making paying more than necessary for their energy on the basis of decisions that do not benefit the grid. If these issues are not addressed the potential costs will outweigh any benefit of greater cost reflective tariffs.

PIAC is concerned that the customer impact of cost reflective pricing has not effectively been considered. This is particularly important for vulnerable and low income consumers. Many low-income consumers are high energy users⁷ and may receive high bills if they are unable to shift demand away from peak periods. It is an imperative for the networks to address this issue and to find ways to soften the impact of this transition on those customers worse off under a cost reflective price. PIAC is disappointed that the networks have failed to use this two-year transition period to implement trials and studies to understand the impact on their customers and to develop policies and tariffs that may help these customers.

PIAC remains involved in the wider conversation about the role of cost reflective pricing and the journey towards more innovative tariffs. Consumers are making investment choices about solar and batteries based on today's electricity pricing and tariffs, resulting in sunk costs, locking them into a household energy supply for a number of years. Choices consumers make today will have an impact on the NEM well into the future. While PIAC acknowledges that price is not always the deciding factor for households adopting solar and batteries - many doing so for environmental and social reasons - price is a driving factor for many.⁸ Consumers are impacted while networks slowly develop dynamic cost reflective tariffs and provide information to the market.

PIAC is also concerned that too much emphasis has been placed on network tariff reform without corresponding attention to how those tariffs are translated into retail prices and how they are communicated to consumers. If consumers do not understand and adopt cost reflective prices, then the intended benefit of the pricing reforms will not eventuate. PIAC recommends that the AEMC consider both retail tariff design and any state level policy, such as Victoria's opt-in policy towards cost-reflective pricing,⁹ as part of this review.

Demand management

Related to pricing reform is the current review of the Demand Management Incentive Scheme (DMIS) and Demand Management Innovation Allowance (DMIA). Demand management is another tool to encourage more efficient use of the network and to reduce or shift peak load to reduce pressure on the system. Demand management can include multiple responses such as demand response, energy efficiency and embedded or distributed generation.

⁶ Sapere Research Group, 'Sapere Review of AER draft decision; tariff structure statement proposals, Ausgrid, Endeavour Energy, Essential Energy', August 2016, v-vi.

⁷ AGL, *Effective support for vulnerable households – closing the gap between capacity to pay and cost of consumption Part 2*, <http://aglblog.com.au/2015/09/effective-support-for-vulnerable-households-closing-the-gap-between-capacity-to-pay-and-cost-of-consumption-part-2/> September 2015. Viewed 23 January 2017.

⁸ KPMG, *Residential PV, Customer experiences and future developments*. A report for Energy Consumers Australia, December 2016 37.

⁹ DELWP, *Managing Electricity Demand* <http://www.delwp.vic.gov.au/energy/electricity/managing-electricity-demand>, Viewed 27 January 2017.

To date, the economic regulatory framework has failed to provide the right incentives for networks to adopt demand management.¹⁰ While this issue has not directly been identified as a priority for the AMEC in this current review, it will be important to monitor new DMIS and DMIA as they are implemented to determine if they are achieving their intended goals.

The current system also lacks incentives for innovation and research and development. For example, the research and development to test the feasibility of LED for public lighting is being funded by the Sydney City Council, and not Ausgrid who is the public lighting provider. Research for Ausgrid's *Smart Grid, Smart Cities* research program was funded by the Australian Government.

The failure of the framework to incentivise networks make such investment and any lessons learned from attempts to correct this could be useful for the AMEC to review, or at least to capture in its system wide considerations.

Timeliness of rule change processes

Concerns remain that the AEMC's rule change processes are slow and inefficient. PIAC's research found that the system suffers both from a bureaucratic inefficiency and an industry bias, at the expense of the consumer's interests.¹¹

The lack of timely responsiveness contributes to uncertainty and excess investment and network prices that are significantly higher than they could have been. For example, the problem of inefficient network pricing was raised in 2006, but the relevant rule changes were only made in 2014, and with a lengthy transition period. This demonstrates that the system as it currently exists is not flexible or adaptable.

The timeliness of the AEMC's processes was raised in COAG's Review of Governance Arrangements for Australian Energy Markets and has not yet been fully addressed. This is another issue that the AEMC should explicitly address in considerations of the flexibility of the regulatory framework.

¹⁰ TEC, 'Demand management incentive scheme rule change request: Submission to Australian Energy Market Commission', November 2013, 3.

¹¹ PIAC, 'From complex fragments to competitive consumer-focused market: Submission in response to Review of Governance Arrangements for Australian Energy Markets: Issues Paper', May 2015, available https://www.piac.asn.au/wp-content/uploads/150508_governance_review_piac_submission_final.pdf; Penelope Crossley, 'Review of the institutional governance arrangements of the national electricity market', May 2015, available https://www.piac.asn.au/wp-content/uploads/150508_governance_review_piac_submission_final.pdf