Explanatory Statement
Draft
Asset Exemption Guideline

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AUSTRALIAN ENERGY REGULATOR

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1 Background

1.1 Introduction

In its Contestability Rule Change, the Australian Energy Market Commission (AEMC) amended the National Electricity Rules (NER) to prohibit Distribution Network Service Providers (distributors) from including Restricted Assets in their Regulated Asset Base (RAB).

Under the amended Rules, assets are restricted and cannot be included in the RAB if they are on the same side of a customer's connection point as their metering point, unless that asset is a network device, the customer is a DNSP, or an exemption is provided by the AER.[1] The AEMC made these rules to respond to significant changes underway in the electricity market, driven by technological shifts that make it possible for customers to generate, store, and utilise energy in new ways.[2] Many of the technologies that are enabling this transformation, such as distributed energy resources and 'Internet of Things' devices, sit on the customer side of a connection point, for example rooftop solar, or battery storage.[3] These are commonly referred to as 'behind the meter' assets. ENA and CSIRO identified that controlling and understanding these resources would be a key area for innovation and development in order to harness their potential.[4] The AEMC considered that customers making choices in their own interests in a competitive market for these devices and the services they can provide would provide the most value and spur innovation.

This explanatory statement accompanies our Asset Exemption Guideline, made pursuant to clause 6.4B of the NER, and explains our process for assessing asset exemption applications. The purpose of this guideline is to provide a flexible and robust approach to assessing asset exemption applications. The focus of this guideline is on implementing the designation of restricted assets into the regulatory framework in the manner that delivers the most benefits for customers.

This guideline seeks to address situations where customers will receive benefits from distributor investment in restricted assets, and those benefits will not impede the development of the market for energy related services. It does so by establishing a two-limbed test for analysing the likely impacts of distributor investment in the assets the subject of an asset exemption. This test takes into account any impacts on the development of competition, and weighs them against specific categories of benefit that might result from the investment.

1.2 Contestability of Energy Services Rule Change

[1] National Electricity Rules, Chapter 10.
[2] For more information please see: <http://www.energynetworks.com.au/electricity-network-transformation-roadmap>
[3] AEMC, *Contestability Rule Change Final Determination*, 12 December 2017, i.
[4] ENA & CSIRO, Energy Transformation Roadmap Final Report, April 2017, 72.

The AEMC's contestability of Energy Services Rule Change created the rules that directed us to make this guideline. Understanding the broader impact of these

The importance of behind the meter assets

Innovations in service delivery, often relying on behind the meter assets, are an important element of the current energy transformation. [5] These devices may give customers a greater chance to be involved in their energy use, while providing greater visibility of localised generation to the broader market. Small-scale generation and localised control devices may deliver electricity more efficiently and meet divergent customer needs. However, distributed energy resources, other devices relying on new, internet enabled, functionality and other behind the meter technologies present opportunities and challenges for the grid and market participants. The decentralised nature of these resources means that extracting full value from these assets requires new approaches and modes of thinking. Some commonly cited examples of technologies that are facilitating this new approach are micro or nano grid projects and the development of platforms such as Greensync's DeX,[6] or Reposit's 'Grid Credits'.[7] Observers see such innovation as the best means of taking advantage of new, efficient energy resources.[8] The market for these kinds of services is likely to continue to grow as energy markets adapt to new technologies.

Behind the meter assets are frequently discussed only in terms of these radical changes that may soon occur as a consequence of their widespread adoption. However, behind the meter assets also perform more traditional network services. For example, Energex and Ergon Energy operate a system that controls the demand on the network from air conditioners in exchange for a fee paid to customers.[9] Jemena Electricity Networks (JEN) submitted that they use load control devices to manage the load of underfloor heating systems.[10] These devices sit on the customer side of the meter and adjust electricity flows according to signals received from the distributor. These kinds of devices provide valuable tools that assist distributors in managing networks efficiently. Therefore, behind the meter devices are an important part of the present and future of the National Electricity Market.

Definition of restricted asset

The Rules define a restricted asset as:

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[5] AEMC, *Supporting a reliable supply of electricity as the power system transforms*, 11 July 2017, Available at:<https://www.aemc.gov.au/news-centre/media-releases/supporting-a-reliable-supply-of-electricity-as-the>

[6] See: Greensync, *DEX: Creating Markets through the decentralised Energy Exchange*, Available at: <https://greensync.com/solutions/dex/>: Retrieved 31 May 2018.

[7] See: Energy Storage News, *Virtual Big Battery in Canberra turns 250 rooftop PV systems into lucrative grid resource*, December 4 2017, https://www.energy-storage.news/news/virtual-big-battery-in-canberra-turns-250-rooftop-pv-systems-into-lucrative Retrieved: 25 May 2018.

[8] ENA & CSIRO, *Energy Transformation Roadmap Final Report*, April 2017, p. 72.

[9] Energex, Air-conditioning rewards, https://www.energex.com.au/home/control-your-energy/positive-payback-program/positive-payback-for-households/air-conditioning-rewards Retrieved: 31 May 2018.

[10] Jemena Electricity Networks, *Submission on Issues Paper - Service Classification and Asset Exemption Guideline, February 2018*, p. 5.

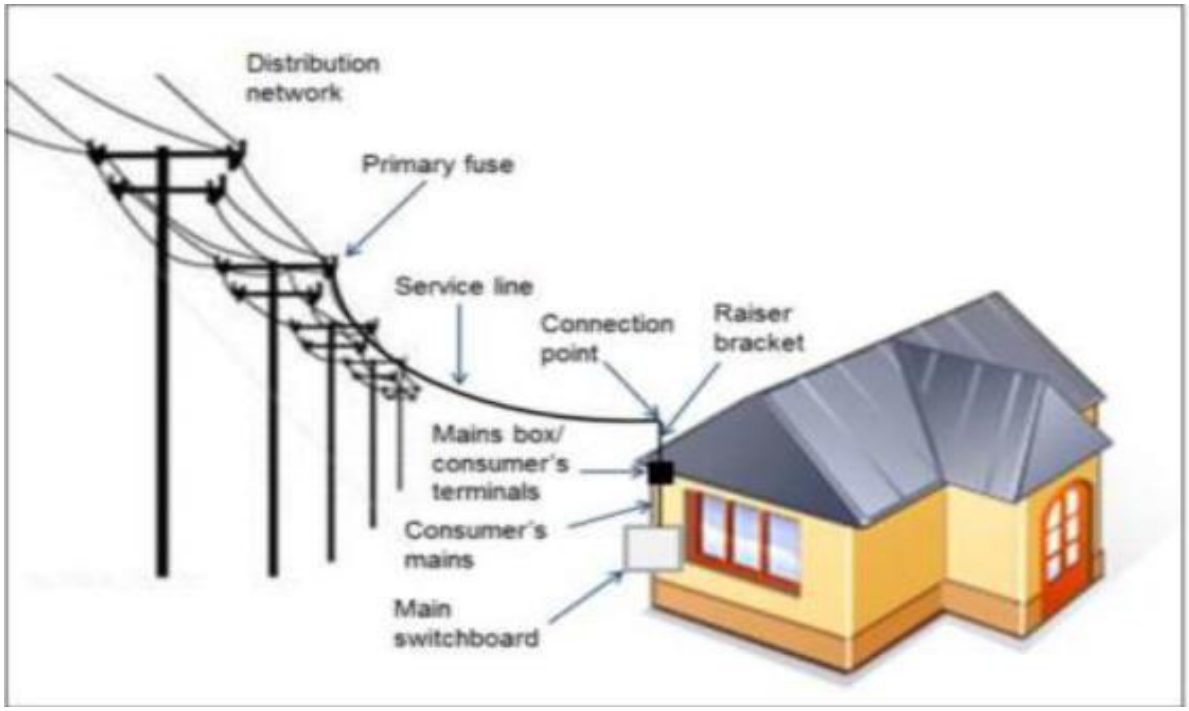
"An item of equipment that is electrically connected to a retail customer's connection point at a location that is on the same side of that connection point as the metering point, but excludes:

(a) such an item of equipment where that retail customer is a Distribution Network Service Provider and that Distribution Network Service Provider is the Local Network Service Provider for that connection point; or

(b) a network device."[11]

A connection point is defined in the Rules as "the agreed point of supply established between Network Service Provider(s) and another Registered Participant, Non-Registered Customer or franchise customer and includes a parent connection point."[12] Figure 1 below illustrates the various components of a customer connection and locates the connection point.

Figure 1: Customer Connection point



Please note that the definition of restricted assets does not apply to assets that are already included in a distributor's regulated asset base, or to expenditure made in the distributors current regulatory control period.[13]

Network devices

A core issue in the development of this guideline is the treatment and impact of network devices. The rules do not require that we provide guidance on network devices, however our

[11] NER, Chapter 10
[12] NER Chapter 10. Please note that the definition changes slightly in the case of an embedded network.
[13] See: clause 11.104.5 of the NER.

approach to them will form an integral part of the in practice operation of this guideline. The Rules define a network device as:

"Apparatus or equipment that:

(c) enables a Local Network Service Provider to monitor, operate or control the network for the purposes of providing network services, which may include switching devices, measurement equipment and control equipment;

(d) is located at or adjacent to a metering installation at the connection point of a retail customer; and

(e) does not have the capability to generate electricity."

Distributors are not required to apply for exemptions for network devices as they are excluded from the definition of Restricted Asset.

Load Control Devices

In its submission on the key issues paper, JEN proposed that we should provide exemptions for load control devices that provide network load control. JEN suggested that these kinds of devices might constitute a network device.[14] This Explanatory Statement is not the appropriate place for commenting on the characterisation of particular assets. We will work with distributors to assess each asset in the relevant circumstances. We consider that the definition of network device in the Rules is sufficiently clear to guide investment and our decisions. We therefore do not propose to provide further guidance on the interpretation of that definition in this document. If a load control device meets the definition of a network device then distributors will be permitted to include that investment in their regulated asset base.

We do not propose to grant a broad exemption for load control devices that are not network devices. We consider that the intent of the rule change was to prevent distributors from controlling these types of assets and to allow us to consider each asset in its own particular circumstances. Ownership of these assets by distributors may jeopardise the development of markets for the service these assets provide. Therefore, our consideration of asset exemptions in relation to load control devices will involve analysis of all the circumstances in which the particular investment will occur.

For clarity, the rule change does not prevent distributors from engaging in demand management programs using assets that sit behind a customer's metering point. What it does, in effect, is prompt distributors to engage in these programs with third party providers and procure services in this way. It also prompts customers to seek out solutions to their problems from a competitive market. Other mechanisms such as the Demand Management Incentive Scheme (DMIS) enable distributors to benefit from engaging in efficient demand projects where applicable.

Powers and obligations of the AER

[14] Jemena Electricity Networks, *Submission on Issues Paper - Service Classification and Asset Exemption Guideline, February 2018*, p. 2.

Clause 6.4B.1(a) of the NER requires that we not accept a proposal from distributors to include restricted assets in their regulated asset base unless we grant an exemption. Clause 6.4B.1(c) mandates that we develop maintain and publish an Asset Exemption Guideline that sets out our approach to determining whether to grant an asset exemption and the information we require distributors to provide in order to assess an asset exemption request. When making an asset exemption decision, clause 6.4B.1(b) states that we must consider the likely impacts on the development of competition in the market for energy related services, and the Asset Exemption Guidelines. The Asset Exemption Guidelines are required to state the information required by the AER in an asset exemption application, as well as the framework we will use for assessing those applications.

1.3 Interaction with other regulatory instruments

The Regulated Asset Base

We set a distributor's maximum revenue using the building block model outlined in Chapter 6 Part C of the NER. One input into this process is quantifying a distributor's regulated asset base (RAB). Including expenditure in the RAB allows distributors to recover the costs, plus an allowed rate of return, from customers.

Distributors must specify which kind of asset exemption they are seeking in their asset exemption application. The AER can grant four different types of asset exemptions related to proposed increases in capex:

- Increased forecast capital expenditure
- Increased proposed contingent capex
- A pass through application
- Increased capex in relation to a reopened distribution determination.[15]

The type of asset exemption sought does not affect our consideration of an exemption, but it does affect the associated process. Increased forecast capex and increased proposed contingent capex are elements of a distributor's revenue proposal that we consider every five years.[16] We consider pass through applications throughout a regulatory control period in response to events that impose extra costs on distributors that could not be anticipated at the time of the distribution determination.[17] Reopening a distribution determination mid-period occurs under different circumstances, during a regulatory control period, where changes in circumstances require re-examining the assumptions made in making a distribution determination and the distributor may require adjusted capital expenditure.[18]

No submissions addressed issues relating to the kind of asset exemption we will issue.

Granting an asset exemption is only one-step in our process of allowing distributors to include certain expenditure in their RAB. The regulatory framework aims to charge

[15] See NER 6.4B.1.
[16] See: NER 6.5.7(c)(2) and 6.6A.
[17] See: NER 6.6.1.
[18] See: NER 6.6.5(f1).

customers efficient costs. In adding expenditure to the RAB, we must consider a range of NER requirements, including the capital expenditure objectives. This Guideline does not affect the operation of these processes. For instance, we will consider the capex-opex trade-off the network has taken into account, including the consideration given to prudent non-network options as well as the approved capital expenditure in a prior regulatory control period. While the primary focus of this guideline is on competition, these other elements of the regulatory framework aim to add only efficient expenditure to the RAB.

Ring-Fencing Guideline

In accordance with clause 6.17.2 of the NER, the AER has published the Distribution Ring-Fencing Guideline. The AER is also responsible for maintaining and conducting compliance activities in relation to the Ring-Fencing Guideline. The Ring-Fencing Guideline prevents distributors from engaging in unregulated services, unless they use an affiliated entity separated by information sharing and accountancy barriers. The aim of this restriction is to prevent distributors from providing uncompetitive cross subsidies that would affect the contestable market. Distributors may seek waivers from some obligations under the Ring-Fencing Guideline, which we assess according to the impact of the waiver and the cost of compliance. This is somewhat similar to the process we will employ under this Guideline, in that it is a forward-looking exercise analysing the implications.

The Ring-Fencing Guideline shares a common goal with the Asset Exemption Guideline: to preserve the contestability of markets. However, during the contestability rule change, the AEMC considered that the Ring-Fencing Guideline mitigated only part of the risk posed by distributor ownership of behind the meter assets.[19] The AEMC considered that if distributors owned the assets, even if they were unable to provide cross subsidies to an affiliate, that the benefits to the distributor may be favoured over the benefits to other parties. However, the Ring-Fencing Guideline does mitigate some of the competitive harms and reduces the risk of other forms of competitive harm occurring. The extent to which the Ring-Fencing Guideline mitigates certain categories of competitive harm will be a relevant consideration in deciding whether to grant an exemption, but the prime focus will be on the competitive provision of energy related services.

[19] AEMC, *Contestability Rule Change Final Determination*, 12 December 2017, p. iv.

2 Developing the Guideline

Our development process has focussed on creating a guideline that provides flexibility so customers can make choices that suit their preferences and receive efficient services from their distributor. This section provides further background on the considerations the AER used to develop the guideline. It outlines our use of a principles-based approach that has regard to the requirements of the NER, NEL and regulatory design principles.

2.1 Rule considerations

We consider that the NER directs us to develop a guideline that will allow distributors to invest in behind the meter assets where doing so does not impede the development of competition in the market for energy related services. This foundation of this framework is the idea that consumers making decisions in competitive markets will best capture the benefits available from behind the meter assets. However, there will be some cases where distributor investment will lead to benefits without harming the development of competition.

When making the guideline we must have regard to the National Electricity Objective (NEO) alongside the requirements in the NER. The NEO is to "promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to: price, quality, safety, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system". The AEMC's principal justification for restricting behind the meter assets was that "if distributors are in control of such assets, they may favour network benefits at the expense of maximising the value across the electricity system as a whole".[20] The AEMC considered that creating conditions for customers to make choices in a robust and competitive market was the best means of addressing this risk.[21] These statements from the final rule determination inform our consideration of the provisions of 6.4B.

We consider that we can best achieve the policy goals of this guideline by providing exemptions in a robust and repeatable manner that will maximise value across the network. This approach recognises the benefit available from encouraging a competitive market in the provision of energy related services. It also recognises that there may be situations where distributor ownership of assets will assist in the maximisation of value across the system. However, we have been mindful that the benefits from competition in a fledgling market are potentially large but difficult to quantify at this stage. We have therefore made use of our discretion to implement a principles-based test that provides a framework to take account of the individual circumstances of each asset exemption application.

2.2 Regulatory design principles

[20] AEMC, *Contestability Rule Change Final Determination*, 12 December 2017, p. 32.
[21] Ibid, 31.

In developing the guideline, we have had regard to the COAG principles for best practice regulation.[22] In particular, we have had regard to whether the obligations contained in the Guideline are:

- targeted – at markets and services of concern to customers and the AER,
- proportionate – in that information to be provided is only what is required to make a determination,
- predictable – for distributors and other stakeholders,
- promoting confidence – in markets and regulatory outcomes.

This Guideline is a complementary piece of regulation, designed to make the contestability rule change a proportional response to the risks posed by distributor ownership of behind the meter assets. This guideline does not create a prohibition on distributor ownership of certain behind the meter assets by DNSPs. It is concerned with providing the flexibility necessary to apply the rules in a common sense fashion, while also preserving the possibility of competition where it exists. Therefore, the guideline seeks to ensure the broadly beneficial policy of not preventing distributors from investing in behind the meter assets, where doing so does not compromise competition, while providing necessary services to their customers.

The form of regulation factors found in Section 2F of the NEL also guided the development of this guideline. These factors direct regulators to consider how regulation should approach different markets given their unique competitive features. We have designed the test to require information and take account of benefits that promote customer welfare whilst aiming not to allow distributors to compromise competitive investments. The design of this test also takes account of the factors outlined in the rules and the considerations contemplated by the AEMC in the contestability rule change. The test specifically refers to the likely impacts on the development of competition, which is the only mandatory requirement in the rules. This Guideline directs our discretion to the areas considered relevant by the rules, based on principles derived from the AEMC rule change.

2.3 Stakeholder consultation

On 16 February 2018, we released the key issues paper. This issues paper sought stakeholder views on potentially contentious aspects of the guideline design process we identified during our preliminary policy scoping process. The issues canvassed were the frequency of exemptions, the nature of confidentiality and the criteria we should use for assessment.

In making the draft decision, we have considered all submissions received in response to the key issues paper. A summary is available at Appendix A. This explanatory statement considers the content of submissions where relevant.

2.4 International approaches

[22] Council of Australian Governments, *Best Practice Regulation: A guide for Ministerial Councils and National Standard Setting Bodies*, Available at: <https://www.pmc.gov.au/resource-centre/regulation/best-practice-regulation-guide-ministerial-councils-and-national-standard-setting-bodies>.

In making this Guideline, we have had regard to approaches adopted internationally. Although these approaches do not address the exact issues considered in this Guideline, they are instructive in underscoring the broader approach and importance of behind the meter and demand response technologies. The Federal Regulatory Commission in the United States adjusted its rules in 2016 to direct utilities to alter their tariffs to allow for the introduction of energy storage and demand response.[23] In 2011, the California Public Utilities Commission prohibited utilities from owning Electric Vehicle Charging stations, which often sit behind the meter, on the basis that this may deter competition. However, the Public Utilities Commission lifted this ban in 2015 to encourage investment from large private utilities.[24] This case emphasises the importance of caution in this area and of encouraging market development in the most sustainable means possible. In the California case, utilities were formerly required to demonstrate a market failure in order to justify their ownership of electric vehicle charging infrastructure. It should be noted that electric vehicle charging stations are just one element of a behind the meter energy service market. Given the broader focus of this guideline, we have chosen not to require such a high bar as market failure, but have also not adopted the complete liberalisation of the California approach in favour of a targeted test that preserves competition while considering other benefits where appropriate.

2.5 A principles-based approach

Regulation should identify principles that guide its design. We have defined two core principles that have shaped our approach. We have developed these principles with reference to the NER requirements and the AEMC's rule change determination, as well as the form of regulation factors found in Section 2F of the NEL. A principles-based approach has allowed us to develop a robust framework for assessing applications that will be applicable to a variety of circumstances and provide the AER with the necessary discretion to take account of differences between applications.

2.6 Exemptions should be relatively infrequent

In order for this Guideline to reflect the requirements of the NER, we consider that it is necessary to limit the scope of possible exemptions. The AEMC supported this approach in the final rule determination, indicating that exemptions should only be for 'incidental arrangements'.[25] We consider that this means our decisions should not consider broad notions of benefit, and that we should instead focus our enquiry on providing exemptions to cover incidental or limited situations.

In the key issues paper, submitters agreed with this approach, however some submitters raised potential issues. TasNetworks agreed with the approach but noted that the Guideline

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[23] Federal Regulatory Commission, *Electric Storage Participation in Markets Operated by Regional Transmission Organizations and independent System Operators*, 17/11/2016, Available at: <https://www.ferc.gov/whats-new/comm-meet/2016/111716/E-1.pdf>

[24] State of California Public Utilities Commission, *Application of SAN DIEGO GAS & ELECTRIC COMPANY (U902E0) For Approval of its Electric Vehicle-Grid Integration Pilot Program*, 14/11/2014, Available at: <http://docs.cpuc.ca.gov/PublishedDocs/Efile/G000/M140/K045/140045368.PDF>

25 AEMC, *Contestability Rule Change Final Determination*, 12 December 2017, p. 58.

should take account of jurisdictional differences in competitive conditions.[26] Energy Queensland submitted that they broadly agreed with the approach but that the actual number of exemptions should depend on how rapidly technologies evolve and markets develop.[27] We consider that the guideline addresses this feedback by not limiting the number of exemptions, but instead limiting the circumstances in which we will grant an exemption.

2.7 Maintaining responsiveness while ensuring clarity

We have preferred a non-prescriptive approach that will allow us to adapt to the circumstances of individual applications. As discussed in the introduction, this market is still developing. In this developing state, accurately predicting the shape and dynamics of the market is difficult. If the criteria in the Guideline are too prescriptive, we risk not being able to respond to this market development and creating a framework that will not provide for fair decision-making.

TasNetworks and SA Power Networks supported a non-prescriptive approach that retained discretion to allow the AER and businesses to adapt to a changing market.[28] SA Power Networks submitted that we should not just consider whether the service delivered by the asset was a contestable service, but the broader context in which the asset operates.[29] CitiPower, Powercor & United Energy submitted that the criteria should allow broad discretion to enable the AER and businesses to adapt to these customer needs.[30] We agree with the reasoning presented in these submissions and consider that our chosen approach allows us to consider context.

Other submissions considered that providing strict criteria would give the market and distributors a greater degree of certainty. AusNet Services submitted that we should establish principles-based criteria for considering an asset exemption, as this was required to give certainty to the market and allow distributors to develop solutions to the problems faced on their networks.[31] Red Lumo submitted that a narrowly prescriptive approach would provide the most certainty for competitive markets.[32] We have sought to provide certainty while addressing the risk that narrowly prescriptive or indeterminate criteria may impede our response to future changes in the market or exclude some classes of asset that the rules envisaged receiving exemptions. For instance, the AEMC suggested that temporary

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[26] TasNetworks, *Submission - Key Issues Paper, Service Classification and Asset Exemption Guidelines,* February 2018, p. 4.

[27] Energy Queensland, *Submission - Key Issues Paper - Service Classification and Asset Exemption Guidelines,* February 2018, p. 12.

[28] TasNetworks, *Submission - Key Issues Paper, Service Classification and Asset Exemption Guidelines,* February 2018, p. 4. SA Power Networks, *Submission, AER Issues paper - Service classification and asset exemption guidelines,* February 2018, p. 2.

[29] SA Power Networks, *Submission, AER Issues paper - Service classification and asset exemption guidelines,* February 2018, p. 2.

[30] Citipower PowerCor & United Energy, *Submission - Key Issues Paper Service Classification and Asset Exemption Guidelines*, February 2018, p. 2.

[31] Ausnet Services, *Submission - Key Issues Paper, Service classification and asset exemption guidelines,* February 2018, p. 5.

[32] Red Lumo, *Submission to the Key Issues Paper*, February 2018, p. 3.

generation assets for rural customers receive exemptions,[33] which would contravene Red Lumo's suggested criteria.

Therefore, we propose a test that takes account of a limited set of benefits in the context of the relevant competitive environment. We consider that this design provides distributors and the market with sufficient certainty to allow investment planning, while also considering a diverse range of circumstances.

[33] AEMC, *Contestability Rule Change Final Determination*, 12 December 2017, p. 63.

3 Process

This section sets out the process a distributor must follow when submitting an application, the content that must be included in an application and what happens after the AER receives the application. These elements of the guideline reflect the AER's commitment to a transparent and open process that efficiently provides for the assessment of applications.

3.1 Submitting an application

Pursuant to clause 6.4B.2(a) of the NER, distributors must make asset exemptions in writing. Distributors should submit their asset exemption applications alongside the revenue determination or cost pass through application to which the expenditure application relates.

3.2 Contents of application

Pursuant to clause 6.4B.1(c)(2) of the NER, the AER is required to set out in the Guideline what information will be contained in an asset exemption application. The Guideline identifies this information at section 2.2(1). We have tailored the information in this list to target the information necessary to assess the asset exemption. The information can be largely qualitative, although quantitative information will strengthen applications where appropriate, reducing the burden on distributors. The requirements also target areas of concern and competition, while remaining mindful of the burden imposed on distributors and information limitations that they might have.

In response to the key issues paper, SA Power Networks submitted that we should be clear about what information is required and how we will assess that information given the timing of the next reset processes.[34] We consider the detailed list of information provided at section 2.2(1) provides distributors with an appropriate level of certainty.

3.3 AER assessment of applications

The AER will assess applications according to the test outlined in section 4 of the Guideline. The timelines for this assessment will follow the timelines set out for the expenditure determination to which the asset exemption relates. This will vary depending on the type of expenditure determination the asset exemption accompanies.

3.4 Consultation

We run a variety of consultation procedures for each kind of expenditure determination, which are adapted to its particular features and circumstances. Distributors will submit their applications alongside an expenditure determination. We consider that this is appropriate and sufficient to conduct our own consultation on the asset exemption application.

However, we encourage distributors to conduct their own consultation prior to submitting the asset exemption, to assist us in understanding the views of market participants and

[34] SA Power Networks, *Submission, AER Issues paper - Service classification and asset exemption guidelines,* February 2018, 2.

customers on the proposed expenditure. This may allow distributors to reduce potential harms and to propose exemptions that are sufficiently narrow in scope to fit within the requirements of this Guideline.

3.5 An open process that respects confidentiality

It is important that the competitive market and distributors have confidence in the AER's assessment process. Building this confidence requires a transparent process that produces repeatable consistent results that reflect the NER. However, it is also possible that asset exemption applications will include information that is commercial in confidence.

In their submission on the key issues paper, AusNet Services submitted that their applications would be unlikely to have issues for confidential information, so long as they could exclude price information and commercial in confidence information.[35] TasNetworks also acknowledged that some information may be confidential but supported as much transparency as possible.[36]

We consider that while excluding price information may be appropriate, it is likely to be necessary to publicise the total expenditure that would be included in the regulated asset base, as this may materially affect consideration of the exemption. To assist with these situations, we have published a *Confidentiality Guideline* that outlines the process for submitting confidential information.[37] It directs that when making submissions, parties must provide the AER with a version of their report that is suitable for publication and the AER will work with the business to ensure that any information required for effective consultation on the asset exemption be available in some form.

[35] Ausnet Services, *Submission - Key Issues Paper, Service classification and asset exemption guidelines,* February 2018, p. 5.

[36] TasNetworks, *Submission - Key Issues Paper, Service Classification and Asset Exemption Guidelines,* February 2018, p. 4.

[37] See https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/confidentiality-guideline-2017.

4 Assessing exemption applications

This section outlines the framework the AER will utilise in conducting its assessment. We developed this framework through consultation with stakeholders and consideration of the NER and NEL. The foundation of this framework is a two-limbed test that requires us to be:

(a) Satisfied that, if the DNSP invests in the assets the subject of the exemption application, that investment is not likely to have any negative impact on the development of competition in a market for energy related services, or

(b) Satisfied that any likely negative impact to the development of competition in the market for energy related services is outweighed by the benefits delivered to customers by the expenditure for a restricted asset for one or more of the purposes that are listed in section 3(2).

The specific purposes for which distributor investment must be made are:

(a) Increasing the efficiency or effectiveness of service delivery for rural, regional, or remote customers,

(b) Efficient and effective provision of safety services that are required in order for the distributor to meet the requirements of good electricity industry practice, or

(c) Strengthening a distributor's ability to respond to a force majeure event.

For clarity, distributor investment may have multiple purposes, but we will only consider benefits resulting from the above purposes.

In designing this test, we have had regard to the NER, the AEMC final rule determination and submissions by stakeholders. The Rules direct that in making asset exemption decisions, we must consider the likely impacts on the development of competition in the market for energy related services.[38] The AEMC's final rule determination outlined a range of circumstances in which it considered it appropriate to grant an asset exemption. The assets specifically identified by the AEMC were:

- Generation assets for extremely remote customers,
- Safety equipment for very large customers, or
- Temporary generation assets that do not affect the wholesale market.[39]

We consider that these areas are places to begin when considering broad principles for assessing exemptions. The guideline therefore focusses on allowing networks to provide services where there are specific barriers that mean that the development of competition in relation to those particular services is unlikely. The cause of these barriers may be the remoteness of the customer, a force majeure event, or safety concerns that are appropriately the responsibility of the network. We consider that our test design takes account of this guidance and the submissions made by stakeholders.

[38] See clause 6.4B.1 of the NER.
[39] AEMC, *Contestability Rule Change Final Determination*, 12 December 2017, p. 63-64.

If the likely impacts of an investment will have no negative effects on competition, the first limb of our proposed test will allow the AER to approve an exemption application. We consider it reasonable to view distributor investment in environments where competition is feasible as likely to have at least some negative impact, even if it also has other positive impacts. Therefore, there are likely to be relatively few situations in which assets satisfy this limb of the test. These situations are most likely to occur where regulatory or technical barriers prevent competition, and we do not consider that it is likely this will change. In such circumstances, we do not consider that it is necessary to engage in a complex balancing exercise where we weigh non-existent detriments against benefits to customers. If there is any impact on competition, we are likely to consider that there will be at least one negative impact and will move to considering step two of the test.

There are some circumstances where there may be some negative impact on competition, but the benefits delivered to customers outweigh that impact. The second limb of the test addresses such situations. We will only consider expenditure to be delivering benefit for the purposes described in the Guideline. In these circumstances, it may be that investment by a distributor will have some negative affect on the development of competition, and the benefits must outweigh these negatives affects. Any 'benefit' that is ascribed to expenditure must not be able to occur if we do not grant the asset exemption. That is, if a contestable provider could deliver the same benefits, then we would not consider distributor investment to be delivering a benefit. Distributors will need to justify how their capital expenditure, as opposed to the possible service of a contestable provider, will deliver enough benefit to outweigh the negative impacts on competition. In circumstances where these benefits that distributors are uniquely able to deliver outweigh the negative impacts on competition, we may consider that there is merit in granting the exemption.

Submissions suggested alternative test designs. Trans-Tasman Energy Group submitted that the test should have a narrow scope for providing exemptions, and proposed that the test should be: 'would the distribution network work exactly the same if this service was not provided by a distributor?'[40] This submission provided a helpful starting point for designing the Guideline, as it prompts us to look at issues from a position of practicality and system function. However, we consider that this test does not provide the market with sufficient certainty in an environment where the nature of distribution networks and electricity delivery is changing so rapidly. It is possible that over the life of this Guideline the nature of what it means for a distribution network to 'work' will change considerably. We consider a test that focusses on the core consideration of the contestability rule change, the impact of the distributor investment on competition, will be more robust and adaptable over time.

Other submissions proposed criteria based test designs. For instance, AusNet Services submitted a range of criteria that could be used to grant an asset exemption:

- Are the assets used to provide regulated services?
- Do the assets promote efficient provision of regulated services to customers?
- Do the assets provide a credible bypass option in the event that contestable service provision is available but not suited for network purposes, and

[40] Trans-Tasman Energy Group, *Submission - Issues Paper, Service classification and asset exemption guidelines,* February 2018, p. 1.

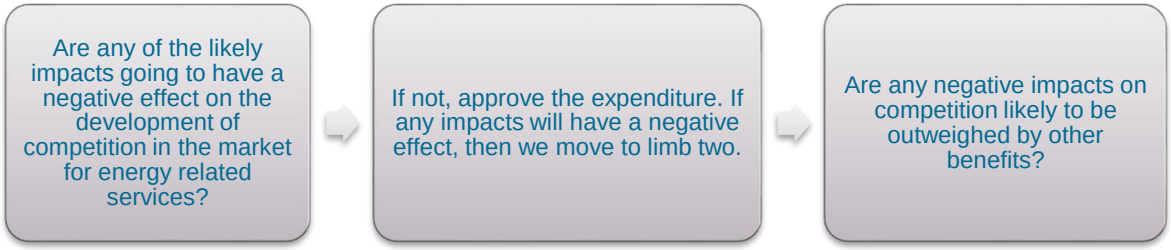
- Do the assets ensure public safety whilst facilitating the deployment of new technologies where the assets are similar to those assets commonly used in the provision of regulated services?[41]

Red Lumo submitted that the following criteria would form an appropriate basis for the test. In their view assets must;

- be unlikely to have an impact on the development of a competitive energy market,
- must not be able to store or generate electricity,
- must not be sub-leased to a ring-fenced affiliate, and
- have express permission from the customer to install the asset behind the meter.[42]

Ultimately, we concluded that competition should be the primary focus of the test. For the reasons discussed above, we decided against a prescriptive approach, preferring an approach based on principles that retain broader discretion and flexibility. We have however incorporated these submissions into the draft Guideline. We will consider aspects of the suggested criteria in the various categories of other benefits that we will consider under limb two of the test, while placing the likely impacts on the development of competition in the market for energy related services front and centre.

Figure 2: The Asset Exemption Test



4.1 Will any of the likely impacts on competition have a negative impact?

The first limb of the test requires that we define and assess the likely impacts on competition. An impact on the development of competition will be negative where the impact has a reasonable possibility of altering the competitive environment in the market for energy related services to the detriment of competition.

While it will likely be necessary to consider the market for energy related services in a broad sense, a proper understanding of the likely impacts of distributor investment may also require a more granular analysis of individual sub-markets. This is likely to increase in importance as the market grows, deepens and diversifies. It will also be necessary to consider the maturity of a given market, for instance the wholesale market

[41] Ausnet Services, *Submission - Key Issues Paper, Service classification and asset exemption guidelines,* February 2018, p. 5.

[42] Red Lumo, *Submission to the Key Issues Paper*, February 2018, p. 3.

This limb of the test is composed of three steps;

- defining the market,
- identifying the likely impacts of the investment on the development of competition in the market for energy related services within that area of competition, and
- considering whether any of those impacts are likely to have a negative impact on the development of competition in the market for energy related services.

What is the market?

Defining the area, or areas, of competition that a particular asset can or will affect is central to our assessment of an asset exemption. This exercise provides the scope for the inquiry that we will undertake to assess the asset exemption. It includes analysis of the services the assets could provide, as well as any assets that are a reasonable substitute for the proposed assets. This might entail analysing the geographic or demographic characteristics of the customers that the proposed assets will serve, as well as a detailed assessment of the asset's function including ancillary or potential future functions. However, it is also often difficult to draw clear boundaries given the interrelationships between different markets.

The Guideline requires information about the proposed definition of the market at section 2.2(1)(e), which requires that an asset exemption application include a proposed area of competition and supporting information to justify their market definition. The level of information that will be required in order to satisfy the AER that a particular market definition is appropriate will vary from case to case. We will gather supplementary information from interested parties through submissions and through our own inquiries. The following sections outline different dimensions of competitive markets that are relevant to market definition.

Product

The product dimension of a market concerns the features of the product or service. Analysis of the product dimension of markets involves considering the three different kinds of products or services that might compete with a particular product or service: identical, differentiated and substitute products. Identical products are those products or services that are identical to the product the subject of the asset exemption or a service provided by means of that product. Differentiated products or services are substantially similar to the product the subject of the asset exemption or to the services provided by means of that product, but customers see them as different due to various views they have about the product or service. Substitute products or services are different in technical terms from the original product or service, but may provide a sufficient alternative that customers would switch to in response to a change in the price or quality of the original product or service.

Example 1 - Substitute products

If a distributor wanted to implement a smart load control device that draws on battery power at times of constraint, we would also consider the ways that other parties might offer a service that could be used in place of a load control device purchased by the distributor. This could either increase or decrease the scope of impact, depending on whether the presence of this device will affect contestable provision of services.

Geographic

It is also possible to define markets by their geographic features. The location of customers that would participate in the market and the geography of the surrounding area may create differences between the services required for customers, or the services that a competitive market could theoretically provide. This dimension will be particularly important for distributors when attempting to claim benefits for rural or regional customers.

Example 2 - Geography

If a distributor wishes to install temporary generation assets on residences that are in a city and in a regional area, it may be that the two different locations create different markets. There may also be differences between cities, or different regional centres. Distributors should describe how the geographic differences influence the other dimensions of markets.

Time and Customers

It may also be necessary to consider the period of time across which the investment in the assets will occur and how impactful this will be on deterring investment by other parties and creating further barriers to competition. This will also be important in considering access to customers, which is potentially very important in these circumstances, given that we are dealing with monopoly businesses providing monopoly services.

Example 3 - Consumer dimension of markets

A distributor wishes to offer assets that are also theoretically obtainable from the contestable market. Customers may be more likely to engage with businesses that are familiar to them. Therefore, we would consider this customer attitude when assessing the competitive harm that a regulated business may have on the contestable market.

What are the likely impacts on the relevant market?

Once the relevant market(s) are identified, we must consider the likely impacts of the distributor's investment in the assets that are subject of the asset exemption. To this end, we will list the likely impacts before analysing their effects, in order to understand the outcomes

of those impacts. We will describe likely impacts with reference to the characteristics of the product or service the distributor is offering and what features of the market (outlined above) that the service will alter.

We will assess all likely impacts of the distributor's investment in the assets the subject of the asset exemption. A likely (or not unlikely) impact is any way in which it is reasonably probable that the distributor's investment in the assets the subject of the asset exemption will influence or otherwise affect a market for energy related services. No submissions received in response to the key issues paper addressed the definition of likely impact.

Will any of the likely impacts be negative?

Once we have identified the likely impacts on the relevant market, we will then move to understand whether any of those impacts are likely to have a negative impact on competition.

Where competition is possible and feasible, investment by an entity able to gain a certain return from a broad base of customers (i.e. the regulated business) will usually create barriers to competition for other providers. These providers invest on uncertain terms without the guaranteed rate of return available to regulated businesses. Therefore, in order to demonstrate that the investment will not have a negative impact on competition, distributors applying for asset exemptions should provide evidence that third party providers will not struggle to compete (based on the features of the relevant market) against the services offered by the distributor.

4.2 Are any of the likely negative impacts on competition outweighed by benefits to customers?

This stage of the test deals with circumstances where there may be some negative effect to the development of competition but the potential benefit to customers is significant enough to outweigh the negative impacts on competition. The other benefits to customers are required to outweigh the negative impacts on competition.

Therefore, we have developed the test to take account of situations where some of the likely impacts on competition have a negative impact. The intention of the test is to protect competitive markets while also allowing flexibility for investment to deliver the services customers require to receive the electricity they need. This portion of the test is about maximising good behaviour because we are encouraging distributors to positively identify benefits and explain why these benefits outweigh the negative impacts of the investment. Analysis of the future without the distributor investment will be a key consideration in this limb of the test - that is, we will consider not just what would happen in the case where the distributor does nothing, but also what would happen where the distributor takes the next best option.

We have defined the other benefits that we will consider in this limb in the Guideline. The following sections describe the process and reasoning for including these categories of benefit.

Benefits for regional or remote customers

One of the key challenges during the electricity transformation will be ensuring effective service delivery for customers outside the capital cities. While there is significant opportunity to decrease costs for regional customers using new technologies, there is also a risk that competitive markets will not find sufficient incentives to serve customers where costs are higher. Therefore, it may be appropriate in certain circumstances for the regulated monopoly business to distribute some costs of servicing these customers among all users of the network. The AEMC highlighted the example of temporary generation assets for remote customers as a potential case for exemptions.[43] Energy Queensland submitted that providing exemptions to rural or remote customers should look closely at how the market is developing in these areas to ensure they receive basic network services.[44]

We consider that including this category of benefit for consideration recognises the different circumstances in which electricity delivery occurs in remote areas and the impacts this may have on competition. However, we will also have careful regard to the benefits that may be available long term from competition and balance those concerns in making asset exemption decisions.

Safety benefits

Distributors have a responsibility to ensure the safety of the network they operate. This includes activities to prevent bushfires, electrocution, or unauthorised work practices.

In the Contestability Rule Change, the AEMC highlighted that safety equipment for very large customers was an appropriate scenario for exemptions.[45] In their submission on the key issues paper, AusNet Services submitted that they are in the process of installing Rapid Earth Fault Current Limiters to comply with jurisdictional safety requirements.[46] In some circumstances, the most cost effective solution is for AusNet Services to own these assets. These assets minimise the risk of electrical faults causing bushfires. AusNet also highlighted the importance of safety equipment for High Voltage customers in rural areas.[47] Energy Queensland submitted that security and reliability of supply be a category for exemption.[48]

We consider that the Energy Queensland submission provides a broad category of benefit that may go beyond the scope of this Guideline. For instance, a key advantage of behind the meter battery storage is it guarantees supply to the customer, but this kind of asset was the explicit target of the restriction. We have instead chosen to focus on safety benefits to the network. Reliability of the network will be a necessary consideration in relation to other benefits, such as benefits for remote customers or the ability to respond to a force majeure event. We consider that these two scenarios adequately cover the concerns submitters had around reliability, without requiring a broader category of benefit.

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43 AEMC, *Contestability Rule Change Final Determination*, 12 December 2017, 63.

44 Energy Queensland, *Submission - Key Issues Paper - Service Classification and Asset Exemption Guidelines,* February 2018, 12.

45 AEMC, *Contestability Rule Change Final Determination*, 12 December 2017, 63.

46 Ausnet Services, *Submission - Key Issues Paper, Service classification and asset exemption guidelines,* February 2018, p. 5.

47 Ibid.

48 Energy Queensland, *Submission - Key Issues Paper - Service Classification and Asset Exemption Guidelines,* February 2018, 12.

We consider that providing distributors with flexibility to ensure the safety of the network is likely to produce benefits where the investment has a low impact on competition. It is important to note that the test proposed in the draft determination will still weigh benefits delivered by these programs against competition concerns, and the magnitude of this benefit will be dependent on the ability of competitive providers to offer a similar service. Distributors will not receive blanket exemptions for any projects with a safety element rather they will have to demonstrate that the benefits that capital expenditure on those assets will have for the purposes of safety will outweigh the detriment to competition.

Ability to respond to a force majeure event

It is possible that in order to respond to force majeure events distributors will need to invest in assets that may sit behind the meter and possibly have impacts on competition.

While we are not aware of any particular examples of these kinds of assets, we consider that it is important to include this category of potential benefit to cover unforeseen scenarios, particularly given that the market is still developing and that market failures may occur during this time. The most likely scenario for considering this kind of benefit will be during a cost pass through application or a proposal relating to contingent capital expenditure. We will be very cautious in considering this category of benefit.

4.3 Conditions

If we consider it appropriate, we can provide an asset exemption that is narrower in scope than the exemption requested, or on conditions which otherwise limit the situations in which distributors may incur the expenditure. These conditions will address circumstances in which distributors may make an investment, rather than their use of that asset following the investment. It is unlikely that the AER would provide an asset exemption where the exemption would need to be conditional on the distributor's behaviour after the expenditure has been incurred (such as by only using the asset for particular purposes), as compliance with such a condition would be difficult to enforce.

The purpose of imposing conditions is to manage the risks of distributor investment in certain areas, while avoiding distributors resubmitting asset exemptions. This will allow us to make decisions appropriate to the circumstances of the individual application that both protect competitive markets and provide distributors with the ability to invest in assets that will provide customers with benefits without unduly harming competition. For clarity, conditions imposed on expenditure do not bind distributors to make any expenditure, once we make a decision distributors may elect to make use of the provided exemption and add expenditure to their regulated asset base or they can elect not to do so.

If a distributor seeks an exemption for a class of assets, we may choose to exclude some assets from the class exemption. For example, if the distributor intends to deploy the assets in multiple locations, we may find that some locations cause harm to a market, while others do not. In such a situation, we may limit the scope of the exemption accordingly. Conditions must relate to concrete factors, such as geographies, asset codes or network types.

Appendix A - Summary of submissions Table

Copies of all submissions are available on our website.

Name of Submitter	Summary of Submission	AER Response
SA Power Networks	The AER should be clear what information we require, and as soon as possible given timing of next determination	The draft sets out the information required in an exemption application.
	Should be clear how the AER will assess exemptions, and ASAP given timing of next determination	Draft guideline sets out a framework for assessing applications.
	Consideration should not be limited to whether the service to be provided by the restricted asset is contestable, but should include: (i) whether the desired investment is likely to affect competition (e.g. arms-length partnerships with unregulated firms (ii) likely cost impact on customers in both short term and long term situations. AER should conduct a cost assessment."	We have not limited consideration in this way. Cost assessment may form part of our broader competition assessment.
Tas Networks	Agreed with the general principle of promoting competition but noted that, in jurisdictions where competition is undeveloped and unlikely to change, rejecting an exemption application may result in customers not receiving the service at all.	Jurisdictional variations in competitiveness will be considered when discussing the significance of impacts on competition.
	Agreed that need for exemptions is likely to be rare.	
	Acknowledged that commercial confidence/privacy claims may be appropriate, but supports as much transparency as possible.	We agree with this approach and consider that it aligns with the goals of our Confidentiality Guideline.
	Supports a collaborative and	

	broad approach to developing and applying the Guidelines.	We agree with this approach and consider that our consultation processes will continue to reflect this.
CitiPower, Powercor & United Energy	Criteria should allow for broad discretion. Support using the NEO or impact on competition for energy related services as the criteria. Supports proposed scope. Suggested adding a process for AER to provide indicative view on whether an asset acquired during the regulatory control period would likely be granted an exemption, to reduce potential uncertainty.	One of the draft criteria is impact on competition in the market for energy related services and our broader guideline has regard to the NEO. We do not propose to provide indicative review. The context and details of an asset exemption are likely to be too vital to our assessment. The AER supports informal engagement on these issues in advance of a distribution determination.
Jemena Electricity Networks	Supports principle-based approach. Considers it is unclear whether a load control equipment that turns designated loads on and off at a customer's premises is considered a network device (and therefore exempted) - considers it should be. Seeks AER clarification.	We have taken this approach. Some load control devices may also be network devices. We do not consider that there is any meaningful supplement that we can provide to the definition of network device in the rules. We do not propose to provide a broader exemption for load control devices, that are not network devices, as these are exactly the kind of assets addressed in the rule change.
AusNet Services	AER should set out principle-based criteria in the GL. Suggested the following criteria: - Assets are used to provide regulated services; - Promote efficient provision of regulated services to customers; - Provide a credible bypass option in the event that contestable service provision is available, but not suitable for network purposes; and	We have incorporated most of these criteria and discuss them at length in the ES. We have taken the elements that we believe target the AEMC's considerations in their rule change. These include considerations around safety. The other considerations are likely to be factors in our assessment of the impact of the investment on competition. We do not propose to provide a broad exemption for load

	- Ensuring public safety whilst facilitating the deployment of new technologies, where the assets are similar to those assets commonly used in the provision of distribution network services. e.g. - Configurable timed switching for hot water heating loads in Vic; - HV premises connection assets historically provided for safety reasons. AusNet Services are currently installing a system Rapid Earth Fault Current Limiters (REFCLs) for safety. Establishing easements on the customer's premises is not appropriate as some new connections or upgrades may be more safely and efficiently provided via dedicated network assets on the customer's premises. Confidentiality claims are not likely to be material if limited to price and commercially sensitive info.	control devices for the reasons discussed in our response to JEN's submission.
Trans-Tasman Energy Group	Submits that the scope for restricting services should be as broad as possible, with the DNSP role preserved for that solely involved with "distribution" with the test being 'would the distribution network work exactly the same if this service was not provided by the DNSP?' A DNSP should not be able to benefit from its role as network operator. Any service provider must be accredited.	This test is a useful starting point but is too indeterminate and not sufficiently focussed on the requirements of the rules. We agree with this statement and consider that the guideline, in tandem with the building block model and Ring Fencing Guideline, deals with this risk appropriately.
Energy Queensland	Should also include a list of the	

exemptions granted to DNSPs.	
"Suggests the following criteria:	
Geographical location and market maturity– Whether there are locations within a DNSP's network where particular restricted assets are required to enable the ongoing provision of services and those services would not otherwise be accessible on a competitive basis.	The geography of customers is considered in defining the relevant market and in considering whether there will be benefits to rural or regional customers.
Security/Reliability of Supply – Where assets are required to ensure the security and reliability of the network until a load control/demand management market matures.	These will be part of considerations around safety of the network. However it is not appropriate that these be their own separate categories of benefit, because delivering reliable supply may be an important advantage of contestable products.
Recommend that exemptions be granted for:	
legacy network control programs/arrangements where capex continues to be required to purchase future assets for use in the legacy program.	We do not propose to provide a broad exemption for legacy products. These assets will be assessed the same as any other assets.
Regional or remote areas.	Regional or remote areas are an explicit category of benefits.
Exemptions will depend on how rapidly technologies evolve and markets develop. It is also possible that exemptions will be required for certain DNSPs serving remote areas.	
Considers assets such as those part of a long-standing demand response program should be exempted."	The Rule Change was designed to create a paradigm shift in the approach to these assets. Allowing the situation from before this rule change to affect our consideration of the future impedes that paradigm shift.
The Guideline should include transition process (to transition in third party provision of services) which does not limit a DNSP's ability to invest in restricted assets where the investment is in the long term interests of customers.	