Explanatory Statement

DRAFT
Electricity distribution service classification guideline

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Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
DNSP	distribution network service provider
Guidelines	the Distribution Service Classification Guidelines and the Asset Exemption Guidelines
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
NER, or the rules	National Electricity Rules
RERT	Reliability and Emergency Response Trader

Definitions

Term	Definition
distribution service	An electricity distribution service provided by means of, or in connection with, a distribution system, as defined in the NER.
regulatory asset base	the value of the assets that are used by a DNSP to provide standard control services

Contents

1 Overview

Service classification defines the type of economic regulation, if any, that will apply to services provided by electricity distribution network services providers (DSNPs). This includes whether or not a service is subject to regulation, the approach to cost recovery (at a high level) and whether or not a service will need to be ring-fenced from other services offered by a DNSP. Consequently, our service classification decisions form the regulatory foundation of the distribution determination we make for each DNSP, which is typically for a five-year period.[1] For consumers, classification identifies the services we will regulate. Classification also signals our view on the services that be provided in competitive markets.

The Distribution Service Classification Guideline (the Guideline) aims to provide clarity, transparency and certainty for distribution network service providers, and also to facilitate competition in markets for energy related services. It will do this by looking at how we classify distribution services across the NEM, rather than focussing on one particular jurisdiction or for one DNSP, which has been the standard approach up until now.

The Guideline will provide insight into service classification. This is important because energy markets are undergoing change driven by technology. In turn this is affecting the nature of energy markets that DNSPs operate in. For example, distributed energy resources and increased emphasis on energy reliability are creating market development opportunities that DNSPs may be able to participate in. The Guideline explains how we make decisions affecting how DNSPs can participate in these markets. We must publish the new guideline by 30 September 2018.[2]

On 12 December 2017, the AEMC changed the NER in response to two amendment proposals from the COAG Energy Council and the Australian Energy Council. The 'Contestability of energy services' rule change was intended to improve the ability of the rules to respond to emerging technologies and changing behaviours in markets for energy related services. It includes, amongst other things, changes to the rules relating to service classification and established the requirement for a service classification guideline.

The Guideline aims to make the service classification process more transparent and effective. The contestability rule change also aims to facilitate competition in markets for contestable energy services by making clearer the roles and opportunities of DNSPs, and therefore for other entities, operating in competitive markets.[3] Identifying opportunities to open markets to competition helps advance the long-term interests of consumers.

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1 NER, cl. 6.2.3A. The NER refers to the *Distribution Service Classification Guidelines*. However, we use the term 'service classification guideline' for simplicity, noting that only electricity distribution services may be classified.

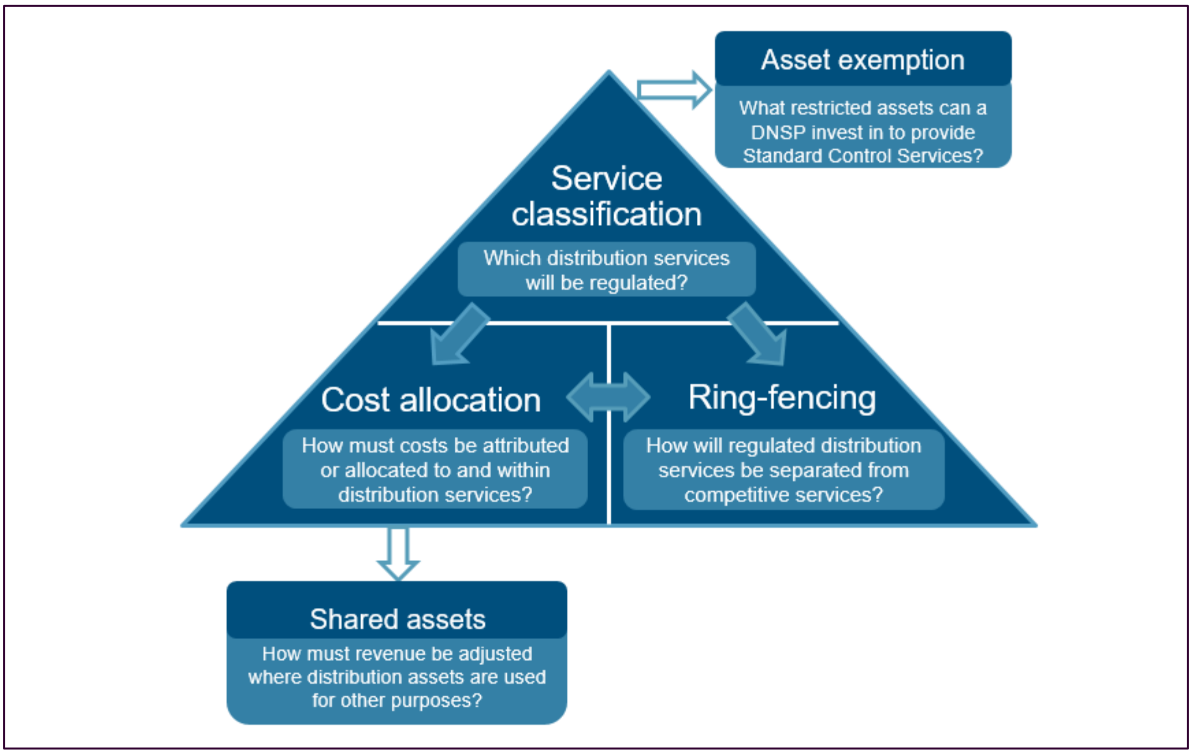
2 NER, cl. 11.104.2.

3 AEMC, *National Electricity Amendment (Contestability of energy services) Rule 2017*, December 2017. Also, we note that the role of DNSPs operating in contestable markets are subject to the provisions provided in the ring-fencing guideline 2017.

This Explanatory Statement should be read in conjunction with the Guideline and its Appendices; Appendix A and B which provide the baseline list of distribution services and worked examples of our approach to the classification of those services.

There are strong interrelationships between many of our Guidelines. For example, the classification of a particular service affects the treatment of that service for ring-fencing purposes. There are also inter-relationships between some guidelines, as illustrated in Figure 1 below. For example, the Cost Allocation Guideline sets out how costs for different services must be separated, while the Shared Asset Guideline explains how assets can be shared between regulated and unregulated services.

Figure 1: Interaction between elements of the regulatory framework



Source: AER

What does this guideline address?

The purpose of the Service Classification Guideline is to make our approach to service classification more transparent, consistent and predictable. The guideline will also explain the potential role DNSPs can play in providing services to contestable markets.

The rules, and the AER's work, revolve around promoting the National Electricity Objective (**NEO**), a key focus of which is the long-term interests of consumers. A critical trade-off in making service classifications is short-term expediency of a DNSP's provision of services (typically as the incumbent sole service provider) versus the potential for the development of new and competitive markets, including through different technologies, business models or different service providers. Where competition is feasible, we prefer regulatory approaches that create opportunities for the development of competitive markets.

Where competition is not feasible, the long-term interests of consumers will be best promoted through economic regulation. In some instances, regulation is consistent with creating opportunities for future competition.[4] For example, setting a regulated price for a service based on efficient costs of supply can create opportunities for third parties to compete with DNSPs, and for competition to develop over time.

We welcome views on any aspects of the guideline you think are relevant. In preparing the final guideline, we will consider and respond to the issues raised in each submission.

1.1 Our Issues paper and key themes raised in submissions

In March 2018, we published an issues paper that considered the issues we would need to address in developing the Classification Guideline.[5] We invited submissions on four key aspects of service classification. There were:

1. Our existing 'incremental' approach to classification
2. Whether it was desirable to harmonise distribution service typology across jurisdictions
3. Our interpretation of the form of regulation factors
4. How to interpret the definition of a distribution service

We also invited submissions on any other issues stakeholders wished to make. We discuss each issue below.

Incremental approach

In our issues paper we highlighted that our approach to date, in classifying services, is incremental. We explained that we typically looked only at new services offered by distributors and would only review existing services if affected by changes to market conditions or legislation. We noted the NER allows a more bottom up fulsome review of every service at every determination and that instead we had taken a more practical approach. We asked whether stakeholders considered our incremental approach was appropriate.

There was consistent support in the DNSP submissions for our incremental approach. However, one submission, from Red Energy and Lumo, took a different view and did not support an incremental approach going forward.[6]

- AusNet Services submitted that service classification should remain relatively stable across regulatory periods and that an incremental approach to service classification is consistent with this premise.[7]
- Citipower, Powercor and United Energy, in a joint submission supported our incremental approach adding that; "it is impracticable for the AER to assess each service against

4 NER, cl. 6.2.1.

5 AER, *Issues paper: service classification and asset exemption guidelines*, February 2018.

6 Red Energy and Lumo, *Submission to Issues paper: classification and asset exemption guidelines*, March 2018, p. 2.

7 AusNet Services, *Submission to Issues paper: classification and asset exemption guidelines*, March 2018, p. 1.

each form of regulation factor for every framework and approach paper it develops". Furthermore, "such detailed considerations would make it more difficult for stakeholders to understand and engage in the classification process." [8]

- Energex and Ergon Energy submitted that an incremental approach would allow us to take into account transitional and jurisdictional factors as we move toward greater harmonisation.[9] Jemena also supported our incremental approach to service classification suggesting a fulsome 'bottom up' approach was not needed at each determination.[10]
- Red Energy and Lumo submitted that our current incremental approach to service classification is no longer fit for purpose and should be replaced with a more fulsome bottom up approach to service classification to be undertaken at each rate review.[11]

We agree with the DNSPs that an incremental approach to service classification has many advantages. For example, it enhances the stability of service classification and predictability of the classification process by not revisiting every classification decision at every determination. An incremental approach also makes the regulatory process simpler, in that fewer issues must be considered by the distributors, stakeholders and us.

Nevertheless, we acknowledge the issues raised by Red Energy and Lumo and its preference for a 'bottom up approach'. We consider this type of approach is more in line with the approach set out in clause 6.2 of the NER. Therefore, the approach we have adopted in the draft Classification Guideline is a more fulsome consideration of each distribution service. By undertaking a thorough 'bottom up assessment' in the Guideline, we can take an incremental assessment of service classification at the time of a regulatory Determination for a particular DNSP, taking account of changes in technology, market conditions and other amendments to jurisdictional frameworks.

Harmonisation of distribution service typology

All submissions that addressed the issue of harmonisation supported the suggestion that distribution service names and descriptions be aligned where this was possible. Jemena noted that jurisdictional requirements may differ and that harmonisation should not be a driver of service reclassification.[12] Numerous other submissions made similar comments.[13]

We agree with the submissions and will seek to introduce greater harmonisation where this is feasible and meaningful.

Form of regulation factors

We set out our interpretation of the form of regulation factors by way of examples in Appendix A of our Issues paper. All submissions that referred to this issue agreed with our interpretations. Submissions did not seek further elaboration. On this basis, we do not intend to provide further guidance on interpreting the form of regulation factors.

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8 Citipower, Powercor and United Energy, *Submission to Issues paper: classification and asset exemption guidelines*, March 2018, p. 4.

9 Energex and Ergon Energy, *Submission to Issues paper: classification and asset exemption guidelines*, March 2018, p. 7.

10 Jemena, *Submission to Issues paper: classification and asset exemption guidelines*, March 2018, p. 3.

11 Red Energy and Lumo, *Submission to Issues paper: classification and asset exemption guidelines*, March 2018, p. 1.

12 Red Energy and Lumo, *Submission to Issues paper: classification and asset exemption guidelines*, March 2018, p. 1.

13 See for example, submissions from AusNet Services, TasNetworks or Energex and Ergon Energy.

Interpreting the definition of a distribution service

In our Issues paper, we asked what factors should guide our interpretation of a distribution service, noting that a distribution service is a defined term in the NER. We also asked if questions regarding whether a service is a distribution service within a regulatory period should be addressed by the AER. The NER defines a distribution service as:

> *A service provided by means of, or in connection with, a distribution system.*

In their joint submission, Citipower, Powercor and United Energy noted their concern that attempting to better define a distribution service may lead to confusion.[14] In particular, if further clarification in the Guideline leads to inconsistency between the definition in the NER, the interpretation in the Guideline, and the definition of 'electricity network services' in the NEL.

Energex and Ergon Energy noted there is still some ambiguity about the definition of a distribution service. In particular, they noted it would be clear if a service is provided "by means of" but it was less clear when a service was provided "in connection with" a distribution system.[15] Energex and Ergon Energy referred to the 2012 Federal Court decision.[16] This decision noted that the analysis of what is or is not a distribution service should be primarily be guided by:

- The text of the legislation itself
- The context in which the definition is found; and
- The purpose of the NER and as a subordinate part of the National Electricity Law.[17]

Energex and Ergon Energy also suggested it would be better for the Guideline to set out our views on what constitutes a distribution service rather than allowing this issue to evolve over time with each classification decision.[18]

AusNet noted that the Federal Court interpretation of the NEL gives good guidance on the manner in which services should be classified, and in particular noted that the Court found that:

> *"in connection with" does not require that the service be provided via the distribution system, as defined, only that the services be connected with that system.*[19]

We appreciate there are some difficulties in interpreting the definition of a distribution service in the NER. The definition does not provide a bright line threshold between services that are and are not distribution services. We agree with Citipower, Powercor and United Energy that attempting to better define a distribution service risks confusion. It is our intention therefore to continue to adopt the approach used by the Federal Court. We will therefore consider each service on a case-by-case basis in the context of the legislation that defines distribution

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14 Citipower, Powercor and United Energy, *Submission to Issues paper: classification and asset exemption guidelines*, March 2018, .p. 4.

15 Energex and Ergon Energy, *Submission to Issues paper: classification and asset exemption guidelines*, March 2018, pp. 8-9.

16 *Ergon Energy Corporation v Australian Energy Regulator*, FCA 393 (19 April 2012).

17 *Ergon Energy Corporation v Australian Energy Regulator*, FCA 393 (19 April 2012).

18 Energex and Ergon Energy, *Submission to Issues paper: classification and asset exemption guidelines*, March 2018, p. 9.

19 *Ergon Energy Corporation v Australian Energy Regulator*, FCA 393 (19 April 2012).

service and historical treatment. Nevertheless, the draft Classification Guideline sets out, for many of the services offered by DNSPs, our view on whether they satisfy the definition of a distribution service.

Other issues raised in submissions

We received two submissions that queried the interaction between the Classification Guideline and the distribution ring-fencing guideline and how this would affect the ability of DNSPs to offer services into competitive markets. Citipower, Powercor and United Energy submitted the AER should not seek to restrict DNSPs from competing in markets without demonstrating existing competition law is inadequate to protect competition.[20] In particular, the DNSPs currently offer reserve energy on short notice to AEMO's RERT scheme. SA Power Network also noted that DNSP voltage regulation equipment could compete on a fair basis with other providers to assist managing the broader market and these opportunities should not be unreasonably constrained.[21]

We appreciate the DNSPs' interest in participating in these markets. We also accept there are benefits from this occurring. We have no objection to their involvement in these markets where this accords with the relevant legislation. The DNSPs must also comply with our guidelines that place obligations on DNSPs when operating in contestable markets. We will return to this particular issue in Section 5 of this Explanatory Statement when we consider the interaction of service classification with other AER guidelines.

20 Citipower, Powercor and United Energy, *Submission to Issues paper: classification and asset exemption guidelines*, March 2018, p. 3.

21 SA Power Networks, *Submission to Issues paper: classification and asset exemption guidelines*, March 2018, p. 1.

2 Our approach to the classification guideline

We intend the Guideline to provide more clarity, transparency and consistency in our classification decisions. Importantly, the Guideline builds on—but does not replace—existing requirements for service classification under the NER. For example, our Framework and Approach papers must still address service classification for a forthcoming regulatory control period. We must also address service classification in the Determination. Many of our decisions on how to classify particular services are common across DNSPs and over time are unlikely to change. Classification changes are more likely at the margin where new technologies or increased competition could influence the role of a DNSP is providing a service.

Consequently, we think the Guideline will be most useful if it provides a single and enduring assessment of the classification of services that most DNSPs provide to customers. This will allow the Framework and Approach and the Determination to focus on changes that could affect the classification of a service offered by a particular DNSP rather than the underlying baseline services that have not changed.

Therefore, in response to the submissions to our Issues paper, and in the light of our own experience in service classification, we propose the following approach to the Classification Guideline:

- Focus the Guideline on the services provided by a typical or baseline DNSP
- Identify the baseline services
- Classify each of the baseline services
- Allow DNSPs to depart from the baseline where this is clearly justified given a DNSP's particular circumstances.

We think this will allow the Guideline to undertake a thorough consideration of the classification of each service—a bottom up assessment. Once established in the Guideline, we will only need to assess incremental changes to service classification for an individual DNSP. That is, service classification should be simpler at the time of the Framework and Approach paper and at the Determination. To the extent a DNSP's services reflect the baseline, little will remain to be done.

The further advantage of the baseline is that it will provide a means of establishing a consistent set of service descriptions and service classifications. The descriptions will only need to be varied where a DNSP offers a different service, where the jurisdictional circumstances warrant a different approach, or where the market for a service is different to that assumed in classifying the baseline. In addition, this approach will:

- be practical because it sets out our approach to classifying specific services rather than a likely or theoretical approach
- show how and why we apply the form of regulation factors to a given service.
- establish enduring descriptions for each of the baseline services
- represent a “line of best fit” across the DNSPs

Of course it is likely the baseline will not reflect all of the services any one particular DNSP provides to customers or can anticipate all the changes to the way services can be provided over time. Therefore, incremental adjustments to services will be required for some services. Where a DNSP proposes to depart from baseline, it will need to propose its reasons for doing so. We expect this will occur because the baseline services that have been classified in this Guideline make a number of assumptions—based on information at this time. These assumptions include:

- the contestability of services offered by DNSPs (barriers to market entry)
- jurisdictional obligations on DNSPs
- market maturity and the extent of competition in the markets into which a DNSP offers services
- the presence (or otherwise) of substitutes

Creating the baseline distribution services and classifications

In Section 3 of this Explanatory Statement we explain how we have created the baseline of distribution services.

In Section 4 we explain the rules for service classification.

In Section 5 we consider how the Classification Guideline interacts with other guidelines.

Sections 3, 4 and 5 should be read in conjunction with the draft Guideline.

There are two attachments to the draft Guideline. Appendix A is the baseline list of distribution services, it briefly summarises each service and its description. Appendix B applies the classification rules to each of the baseline distribution services to arrive at a classification for each service.

3 Creating a baseline of distribution services

Distribution Network Service Providers provide a range of distribution services to the markets they serve. Across the NEM, many of these services have common features, though they often have different names. This has led to some confusion when comparing services across jurisdictions. The AEMC contestability rule change allows us harmonise across jurisdictions where appropriate.[22]

In Section 3 of the Guideline, we set out our preferred approach to creating a baseline of distribution services, which will serve as the foundation for this Guideline. For each baseline service, we provide a description of the activities performed by a DNSP in providing that service in Appendix A. Similar types of services are gathered into groupings.

The baseline list of services serves as a guide to DNSPs in the identification, description and grouping of the services they provide. DNSPs may refine services listed in the baseline to suit their particular requirements and circumstances. However, in departing from the baseline, a DNSP should provide its reasons for doing so.

Services verses inputs

Before we create a baseline of distribution services, we need to distinguish between services and inputs. The term 'inputs' is taken to include all of the operating and capital inputs that contribute to the provision of a service. Only services can be classified. We cannot classify inputs.

The Guideline explains that services are provided to customers, while inputs are used by a DNSP to enable it to provide a service to a customer. Customers purchase services, while DNSPs acquire inputs. Consider the following examples:

> Example 1: vegetation management. Vegetation trimming, while not in the strictest sense a distribution service[23], is required to be undertaken by DNSPs to maintain proper clearances of vegetation from their distribution assets (electrical lines) for safety reasons. If a DSNP undertakes this work, the activity is an input to the provision of the common distribution service. As an input, this activity is not classified. If a DNSP wanted to offer vegetation trimming as a service to a third party, we would need to consider whether or not it is a distribution service and if so, whether it should be classified.
>
> Example 2: network energy storage: In order to relieve congestion, a DNSP might install a battery or other storage device on its distribution network. If the DNSP uses the battery for network purposes only (i.e. to relieve network congestion), then the battery is an input to the common distribution service. However, if DNSP traded energy from the battery in the wholesale market, this would be a service (which, by the way, is not considered to be a distribution service—refer to the case studies in Section 5).

As further guidance, we consider services and inputs can be distinguished by the following traits:

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22 NER, cl. 6.2.1 (b) (3).

23 Because in most cases it is not provided "by means of or in connection with a distribution system". For exceptions, see the case studies in section 4.

- An input differs from a service in that it is not offered to an end customer on a standalone basis.
- While a DNSP may incur costs in utilising an input, costs can only be recovered by offering services. Distribution services have prices, and are offered to distribution customers in return for payment, inputs generally do not, and are not offered to customers on a stand-alone basis.
- A bundled service might be made up of several potentially separate inputs. However, if a consumer may not purchase the services separately, then the bundled service is regarded as a single service, while the potentially separate services are considered to be inputs.

Service groupings

Under the Rules we may group distribution services together for the purpose of classification rather than classifying each individual service.[24] With respect to the baseline distribution services, we have classified each individual service. However, service groupings comprise many similar types of individual activities and services, reflecting their common attributes—for example, the similarity of services within 'metering services'. The service groupings and their descriptions, encapsulate the individual services and activities they comprise.

Ascribing a service to a group of distribution services and indicating how we might classify that group, does not represent a constraint on how we might classify an individual service. Not all services, or activities within a given service group are required to have the same classification. Individual services that fit within the service grouping, but have attributes that require a different classification, can be classified separately to the rest of the group. Likewise, individual services that do not belong to any particular group can be classified individually. An example of this is the metering services grouping. The baseline services list contains five services within this grouping, with one service; a non-basic standard connection, having a different classification from the other services within the grouping.

DNSPs should keep and maintain a list of services they provide. Services should be sorted by the appropriate grouping. Reviewing the list of services from time to time, ensuring that services are up to date and match descriptions, will help to ensure that the business is offering services that are demanded by customers. It will also help to avoid service scope creep into competitive markets where the DNSP should not be acting directly. Having a well maintained, grouped, service list will also assist DSNPs to track the services they provide, leading to increased efficiencies through incremental change, rather than wholesale review during the Framework and Approach process.

Service descriptions

Service descriptions assist us in ensuring that the activities and services provided under the service name and grouping are classified correctly. The purpose of this section in the Guideline is to provide DNSPs with some guidance in relation to providing descriptions to the services they provide.

[24] NER, cll. 6.2.1(b) and 6.2.2 (b).

Service descriptions should clearly relate to the nature of the activities being performed by the DNSP. They should not reflect the purpose of the activity or the mechanism by which costs are recovered. For example; describing a service should not be described as a 'wasted truck visit'. Rather, this service is, for example, a connection or metering service where the service could not be provided because the customer was not at home. We would expect 'wasted truck visits' to be an attribute of the service not a service per se. These attributes would be identified in the pricing structure for the service. Other attributes might be 'after hours services' or other aspects affecting the cost of providing a service to a customer.

Where possible, service descriptions should match those provided in the baseline services list. The exception to this is for services which may have a similar name to those found in the baseline services list, but for operational reasons have different attributes which require the description to vary. Where this is the case, the description should provide a clear indication when comparing across jurisdiction as to the differences. Differences should not arise due to preferential wording only, but for demonstrated differences in the nature and operation of a given service.

3.1 Baseline service groupings

The draft Guideline's baseline services list covers most, if not all of the services commonly provided by DNSPs. It serves as a reference point for DNSPs in creating their own list of services. The baseline services have been developed from the service list approved for DNSPs in AER Determinations in recent years.

To be clear, the baseline service is not:

- an agreed list of services for every DNSPs
- an aspirational or benchmark list of services that DNSP should offer, or
- a default list of service that we fall back to in the event we do not agree with a DNSP on some aspect of its service list

Instead the baseline provides a starting point from which DNSPs can modify to reflect the precise services that it provides. The baseline service groups serve as a guide to where DSNPs should group related activities and services. They represent the core services which DNSPs provide. Where DNSPs deviate from the baseline services list, they should provide reasons for doing so.

Before any service can be assigned to a DNSP's list of services for classification, we must satisfy ourselves that it is a distribution service, as per the definition provided by the NER.[25]

Most individual activities and services that DNSPs provide are likely to fall into one of the baseline service groupings. The baseline service groupings are set out below:

(a) Common distribution service

(b) Network ancillary services

(c) Metering services

[25] NER, cll. 6.2.1(b) and 6.2.2 (b).

(d) Connection services

(e) Public lighting services

(f) Unregulated distribution services

Each grouping is discussed in turn below:

Common distribution service

Unlike other distribution service groupings, the common distribution service is not a group of services under a single group banner, it is a bundled suite of activities concerned with providing a safe and reliable electricity supply to customers.[26] Activities within the common distribution service group are intrinsically tied to the network infrastructure and the systems that support the shared use of the distribution network by customers. Customers use or rely on access to common distribution service activities on a regular basis. Providing a common distribution service involves a variety of different activities, such as the construction and maintenance of poles and wires and other equipment used to transport energy across the shared network. The precise nature of activities provided to plan, design, construct and maintain the shared network may change over time. Regardless of what activities make up the common distribution service, this service group reflects the provision of access to the shared network transporting electricity to customers.

Network ancillary services

Network ancillary services are services that relate closely to the common distribution service but for which a separate charge applies. Network ancillary services share the common characteristics of being services provided to individual customers on an 'as needs' basis with the specific charge that can be applied to the customer(s) requesting the service (e.g. meter testing and reading at a customer's request, moving mains, temporary supply, alteration and relocation of existing public lighting assets).

Network ancillary services involve work on, or in relation to, parts of the distribution network. Therefore, similar to common distribution services, only the distributor may perform these services in its distribution area.

Metering services

All electricity customers have a meter that measures the amount of electricity they use.[27] Typically, metering services are made up of a number of activities including: installation services, and meter provision, maintenance, reading and data services. However, since commencement of metering contestability, on 1 December 2017, as part of the Power of Choice reforms[28], DNSPs are restricted to the metering services they can provide without a waiver from their ring-fencing obligations.[29]

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26 NER, Chapter 10 glossary.

27 All connections to the network must have a metering installation (NER, cl. 7.3.1A(a)).

28 AEMC, *Competition in metering services information sheet*, 26 November 2015.

29 Victoria is also an exception under a separate moratorium under a Victorian jurisdictional instrument

As a result, we no longer regulate a number of metering services due to their being supplied on a competitive basis. For example, while type 1-4 meters are not, and have never been, subject to regulation under chapter 6 of the NER, they still fit the definition of a distribution service where they are provided "*by means of, or in connection with a distribution system"*. On a short term basis, some DSNPs are continuing to provide metering support services under ring-fencing waivers[30], and there are legacy services being provided by DNSPs, such as type 5 and 6 services, to support the transition to full contestability. These are not permanent arrangements, and we envision the number and range of metering services provided by DNSPs to diminish over time.

One notable exception to this is type 7 metering services, which is an unmetered site (such as for lighting in a public park), which will continue to be provided by DNSPs for the foreseeable future.

Connection services

Connection refers to the physical link between a distribution system and a retail customer's premises to allow the flow of electricity.[31]

The approach we have taken for the classification of connection services for the baseline differs to the approach we have used in past regulatory Determinations for DNSPs. In the past, our classification of connection services has largely followed the jurisdictional approaches and we have not sought to align connection services across the jurisdictions to date. We consider this Guideline presents a good opportunity to introduce a more consistent single framework to naming and classifying connection services. However, we expect that there will be differences in how these services are classified due to the different circumstances in which connections services are offered between jurisdictions.

The terms 'basic', 'standard' and 'negotiated' connections are defined in Chapter 5A of the NER, which is concerned with customer connections to a distribution system. We propose to use these terms to describe the main types of connections. In addition, non-standard connections and enhanced connection services are used to describe other less frequently requested types of connections. This approach would allow better alignment between the classification of connection services, Chapter 5A of the NER, the AER's Connection Charge Guideline under Chapter 5A and the connection policies DNSPs. The draft Guideline adopts these five connection service groupings to encapsulate the connection services that DNSPs provide.

A complication arises when a parts of a connection service have different levels of contestability. For example, the connection of a premises to a network may be contestable, while an associated upgrade (augmentation) of the network might not be contestable. In this circumstance, there may need to be different classifications despite there being just one overall customer connection. In our Connection Charge Guideline, we detail a formula for connection charges paid by connection applicants.[32]

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30 For example, Ergon Energy's Mt Isa-Cloncurry network in Qld, which is not part of the NEM.

31 NER, cl 5A.A.1.

32 AER Connection charge guidelines for electricity retail customers, June 2012, p. 10.

Connection Charge = AS + CC + PS

Where:

- AS—is the total charge payable to the distribution network service provider for all relevant alternative control connection services
- CC—is the total capital contribution payable to the distribution network service provider for all relevant standard control connection services. This is to be calculated with reference to the cost-revenue-test set out in section 5 of [the] guideline.
- PS—is the total charge payable to the distribution network service provider to account for any pioneer scheme applying to the assets to which the connection applicant connects

Breaking down connections into sub-services (premises, extension and augmentation sub-services) could fit beneath the basic, standard and negotiated connection services, as discussed earlier. We have not provided this breakdown in the baseline distribution services, but could consider doing so following stakeholder comment.

The classification of a connection service is largely driven by whether or not a connection service is contestable. There are other considerations, such as past approach to classification, but contestability tends to be a key driver. For connections that are contestable, the most appropriate classification is either alternative control (ACS) or no classification (unregulated). For connection services classified as ACS, the price reflects the full cost of connection. An ACS price creates the opportunity for a third party to offer a connection service in competition with the DNSP. However, if there is sufficient competition for connection services, it may be appropriate to not classify the service because a DNSP does not have sufficient market power to set prices above the efficient cost. In this case, the connection service would be unregulated, which is the case for some connection services in NSW already.

If a service is not contestable or provided on a monopoly basis, there are good reasons to suggest standard control (SCS) is the preferred classification. A new connection is efficient if the connecting customer pays sufficiently to cover all the costs they impose on the network as well as making a contribution to the shared costs of the network. In this way, existing customers obtain a net benefit from connection of the new customer. New customers contribute by way of their network tariffs over time. In simple terms, if the cumulative tariffs to be paid (in present value terms) exceed the connection cost, the connection is efficient. That is, it is in the interests of all customers for the new customer to be connected because existing customers will face lower shared network costs. In this case no additional connection cost need to be recovered through, for example, an upfront connection charge. However, if the present value of the network tariff to be paid by a customer is less than the connections cost, a capital contribution will be required. Payment of an appropriate capital contribution will result in the connection not imposing net costs on other customers.

This is a different approach to contestable connections where a full upfront payment is charged, which is potentially open to competition. In the case of ACS connection charges, no account is made of the incremental revenue a new customer brings to the network, only the cost they impose on the network. For this reason, we consider SCS is the best classification for connections where connections services are not contestable because incremental revenue is taken in account when considering the efficiency of a new connection.

We welcome stakeholder feedback on these revised approaches to connection classification.

Public lighting services

The NER does not define public lighting services. However, we have consistently defined public lighting services in other distribution determinations as:

- the operation, maintenance, repair and replacement of public lighting assets
- the alteration and relocation of public lighting assets, and
- the provision of new public lighting.

Public lighting is usually provided by DNSPs either to local councils and government departments responsible for public lighting or on their behalf. Public lighting is not a natural monopoly in the same way as the DNSP's network of poles and wires is. However, most DNSPs have some monopoly power to the extent that their networks of poles and wires are integral to the provision of public lighting services.

Unregulated services

Services where our consideration of the form of regulation factors, along with the other factors we must take into account, leads us to conclude that regulation is not required.

3.2 Services identified within a regulatory period

The Guideline outlines the approach we will take for new distribution services or activities identified within a regulatory control period. Where it is clear that the newly identified service relates to an existing service or service grouping and is consistent with the classification for that existing service or grouping, it would not make sense to expect DNSPs to wait until the next regulatory period to commence the service.

In our recent preliminary Framework and Approach paper for Energex and Ergon Energy, we suggested that rather than introducing new services at any time, DNSPs should notify us at the time of the annual price submission, regarding the new service and the price they plan to charge.[33] We did not receive any submissions to this proposal, but would welcome input from stakeholders in their responses to this draft explanatory statement.

Any proposed new services that do not fit within an existing grouping and classification will be treated as an unregulated service until they can be considered at the next regulatory determination. This means that the part of a DNSP that provides direct control service cannot commence or continue a newly identified service, within the current regulatory period, without a waiver from ring-fencing obligations. Furthermore, in the rare event where a DNSP might identify an existing service, which has not been previously listed or classified, the DNSP should immediately report a breach of their ring-fencing obligations.

33 AER, *Preliminary Framework and Approach paper for Energex and Ergon Energy*, March 2018, pp. 41-42.

In submissions, Jemena suggested that the Guideline provide descriptions of distribution service groups such that they are flexible for introducing a new service within a service group in the middle of a regulatory period.[34] We agree with Jemena and have, in our baseline services list, include descriptions of service groupings which allow for the introduction of new services, within a regulatory period, that clearly align with existing service groupings.

34 Jemena, *Submission to Issues paper: classification and asset exemption guidelines*, March 2018, p. 1.

4 Classifying service groupings

Clauses 6.2.1 and 6.2.2 of the NER set out the steps that we must follow in classifying distribution services. However, the AEMC suggested the Classification Guideline would improve clarity and transparency by stepping out how we apply the service classification factors in practice.[35]

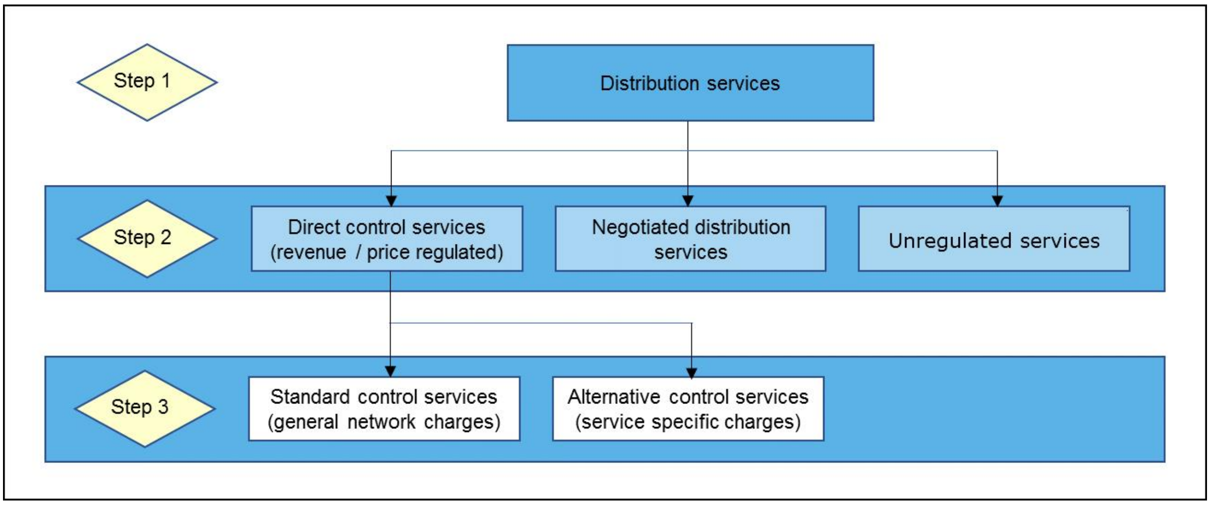
This section sets out our approach to how we apply the factors as provided within the NER and the NEL to the classification of distribution services. It describes, how we apply the factors to the classification of the baseline list of distribution services, using the baseline list, and examples of possible deviations from that list, to provide the clarity sought by the rule change.

4.1 NER requirements

Service classification occurs over a number of different stages. Figure 1 in the Guideline sets out, albeit at a high level, each step in the service classification process and, for the sake of convenience, is repeated below as figure 2.

This section discusses our approach at a high level, relevant to the factors we must have regard to at each point of the process, according to the NER and the NEL.

Figure 2: The classification process, factors and their regulatory implications



Source: AER

Step 1: Is it a distribution service?

Distribution services are defined in the NER as a "*service provided by means of, or in connection with, a distribution system*". As noted in Section 1, our approach in using this test is simply to discern between distribution and non-distribution services based on whether or not the proposed service is consistent with the relevant legislation. We also are mindful of previous regulatory practices in regard to a particular service.

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35 AEMC, *Final Determination, Contestability of Energy Services Rule Change December 2017*, p..93.

Step 2: Should it be a direct control or negotiated service?

With respect to all distribution services, we must decide whether to classify the service. In doing so we must have regard to the form of regulation factors, previous regulatory approaches and consistency with regulatory approaches elsewhere. The form of regulation factors refer to forms of market failure that suggest some form of regulatory intervention may be required. Restrictions on market entry, the existence of market power by a business, the absence of substitute services or information asymmetry are typical causes of market failure that may suggest regulatory intervention should be considered.

If the service is offered in a competitive environment, economic regulation is not likely to be required. However, DNSPs regularly offer services to customers where only one distribution licence is available or where ownership and control of its infrastructure prevents or restricts alternative suppliers.

Having decided that a distribution service requires economic regulation, the next step is to decide whether it should be a direct control or a negotiated service. In making this decision, we must under Clause 6.2.1(c) have regard to:

- the form of regulation factors; and
- previous classification of the service (if any); and
- desirability for consistency
- any other relevant factor

Step 3: Standard control or alternative control service?

Having determined that a service should be classified as direct control, the next step, under Clause 6.2.2 of the NER, is to further classify it as either a standard control or alternative control service. We may at this stage group services together for the purposes of classification. We do this as previously discussed in Section 2. In order to classify a direct control service (or the grouping of services or activities) as either standard control or alternative control, we must have regard to the following:

- the potential for development of competition in the relevant market and how the classification might influence that potential; and
- the possible effects of the classification on administrative costs of the AER, the Distribution Network Service Provider and users or potential users; and
- the regulatory approach (if any) applicable to the relevant service immediately before the commencement of the distribution determination for which the classification is made; and
- the desirability of a consistent regulatory approach to similar services (both within and beyond the relevant jurisdiction); and
- the extent the costs of providing the relevant service are directly attributable to the person to whom the service is provided; and
- any other relevant factor

All of these factors are important in our decision making, however, according to the circumstances relevant to each service, some may be more important than others. For example, when classifying a service as alternative control, we will give primacy to the level of or potential for competition in the market as well as whether the costs of providing the service can be attributable to the person to whom the service is provided. The other factors for consideration then may reinforce the decision. Worked examples of this approach are in Appendix B of the Guideline.

4.2 Baseline service classification

Clause 6.2.3A (b) requires us within the Guideline to set out an explanation of our proposed approach (including worked examples) to:

- determining whether to classify a distribution service;
- applying the factors set out in:
    - clause 6.2.1(c), when classifying distribution services as direct control services or negotiated distribution services; and
    - clause 6.2.2(c), when classifying direct control services as standard control services or alternative control services;

Appendix B of the Guideline provides worked examples of our approach to classifying distribution services with reference to the baseline services list. The baseline services list has been classified, for the purposes of the Guideline, using a set of given market assumptions which may or may not reflect the conditions within which individual DNSPs may be operating. Where markets within jurisdictions match those provided by the baseline list, we would expect similar classification outcomes. The baseline services list is not however a benchmark for classification purposes, a default to which we may resort, nor is it aspirational. It simply serves to provide a reference point to provide transparency, clarity and some predictability to our approach to the classification process.

Where appropriate, in the Guideline's worked examples we have classified groupings, rather than individual services or activities. The baseline list in Appendix A also reflects the individual activities and services that make up the groupings, Appendix B provides worked examples of our approach to classify each service within the baseline list for a given set of assumptions.

4.3 Services that are not classified

Unregulated distribution services

Unregulated services are distribution services by definition, because they are provided *"by means of, or in connection with, a distribution system".* Unregulated services is the term we use to describe distribution services which we have not classified as either direct control or negotiated services.[36] It is not a service classification within the current service classification framework. DNSPs may provide certain distribution services on an unregulated basis which

36 AER, *Electricity distribution ring-fencing guideline explanatory statement*, November 2016, p. 13.

are also potentially provided by other service providers in a competitive market. Under Ring-fencing obligations, if DNSPs are to provide these services, they must functionally separate the provision of direct control services from the provision of other services.[37] For example, Type 1-4 metering services are contestable and are therefore unregulated. While the services satisfy the definition of a distribution service, a DNSP faces restrictions with respect to use of its brand as well as restrictions on staff and office sharing.

Non-distribution services

Non-distribution services are, as their name indicates, services which are not provided "*by means of, or in connection with, a distribution system"*. Non-distribution services are not regulated or classified under the national energy regulatory framework. As a result, they cannot be provided by DNSPs without a waiver from ring-fencing obligations.

In our issues paper, we canvassed whether we should make clear those services we have decided not to classify because they are not distribution services. To this question we received a mixed response, ranging from requests for a full list of non-distribution services to suggestions that any guidance must be kept non–prescriptive and also allow flexible consideration of new services as they arise within a regulatory control period.

AusNet Services submitted that providing additional guidance on what constitutes a distribution service is more appropriate than "*seeking to pre-emptively compile an exhaustive list of services that are not distribution services*". However, they further submitted that once we have made a specific decision, it would be beneficial to provide a central reference point for all such decisions.

Ergon Energy and Energex consider that a list providing clear examples of the services which are not classified, and the basis on which it was determined that they were not distribution services, would prove helpful for network businesses.

Jemena considers there is no need to make a full list of unregulated services, as it is not possible to know all of the services—now or in the future—to be able to develop the list.

Red and Lumo Energy submitted that service classification decisions should identify unclassified services. Furthermore, "*service classification decisions must contain a complete listing of distribution services for the benefit of DNSPs and other stakeholders. This should include those services the AER has not classified*".

SA Power Networks submitted that there might be merit in us providing some guidance on our interpretation of what comprises an unregulated distribution or non–distribution service. "*However, any guidance must be kept non–prescriptive and also allow flexible consideration of new services as they arise within a regulatory control period. Given the pace of technology change, it is difficult to predict, ahead of a five-year regulatory period, the full extent of possible unregulated services*."

We appreciate the desire for increased transparency regarding what might or might not be a non-distribution service or an unregulated distribution service. However, we do not believe it

[37] See section 3 of the AER's Ring-fencing Guideline, October 2016.

is possible or desirable to create and maintain an exhaustive list of competitively provided distribution services or non-distributed services. However, where we are requested to make clear our view on whether or not a service does not require classification, we will provide a statement of our views.

4.4 Departures from the baseline classification

The concept of a baseline of distribution services explicitly allows for departures by DNSPs to suit their particular circumstances. We expect DNSPs will find reason to depart from the baseline because, for example:

- the description of the services they offer may be different to the baseline
- there may be different jurisdictional obligations that affect the nature of the services being offered
- the contestability of providing a particular service may be different from that assumed for the baseline list of services.

We anticipate a DNSP would propose departures from the baseline in its advice to the AER on whether the Framework and Approach paper, for a forthcoming regulatory control period, requires adjustment.[38] Alternatively, the AER may adopt the conventions and approaches outlined in the Guideline and will provide reasons for doing so, in the first instance, during consultation on its Framework and Approach paper.

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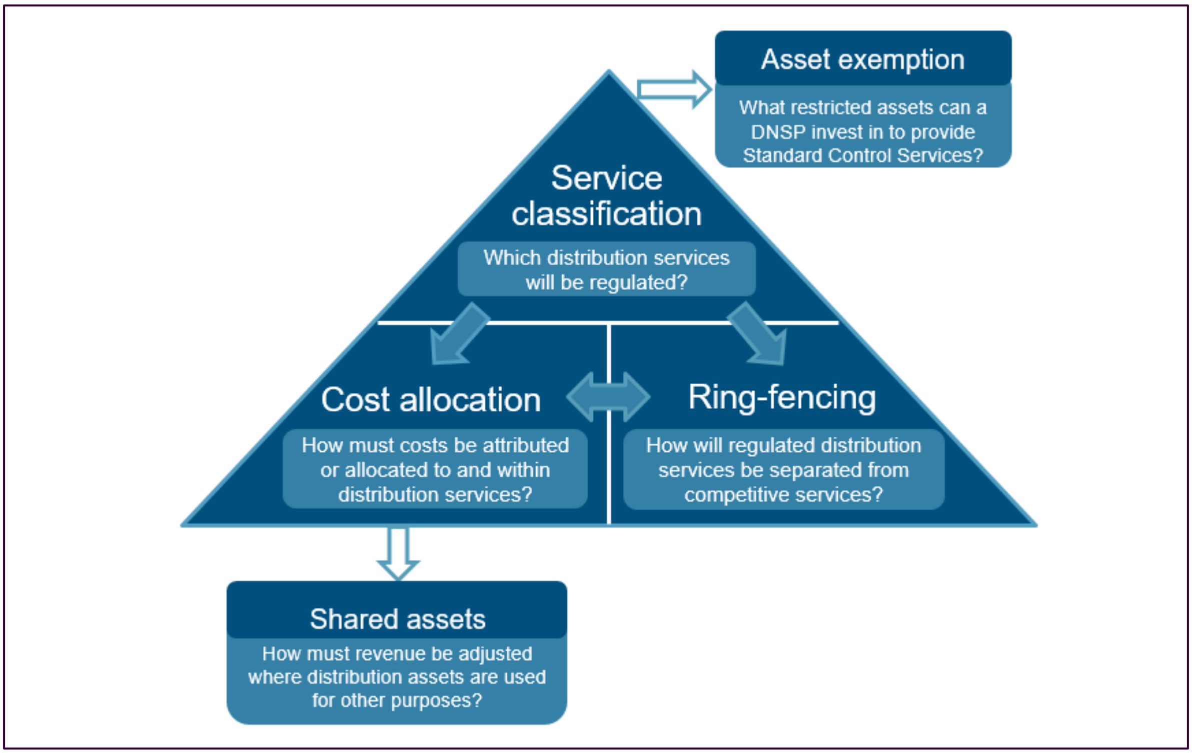
38 NER, cl. 6.8.1(c)(1).

5 Interaction of service classification with other aspects of the framework: case studies

The Service Classification Guideline is just one element of the regulatory framework contained in chapter 6 of the rules and in the NEL. It is important to understand how this Guideline interacts with other aspects of the regulatory framework. This section uses a number of case studies to draw out these interlinkages.

Figure 3 below illustrates some of the key interrelationships between the classification, ring-fencing and other guidelines. These relationships are demonstrated through cases studies of distribution services that are considered contentious within this framework.

Figure 3: Interaction between elements of the regulatory framework



Source: AER

These interlinkages are best demonstrated through case studies that have been chosen because they represent some of the more complex situations that can arise in practice. We welcome stakeholder feedback on the issues presented by these case studies.

Case study: DNSP provision of FCAS services

Reliability of the NEM has become increasingly important due to the changing mix of energy sources. Distributors can and are offering services into emerging markets for frequency control ancillary services (FCAS) using their network control systems.

Network control systems are fundamentally part of a distribution system. Consequently, services offered that use a network control system appears to satisfy the definition of a distribution service in that they are provided "by means of the distribution system". As the services are contestable, we expected these services would not be classified by the AER and so would be offered as unregulated services.

A DNSP offering these services would be required (under the Ring-fencing Guideline) to ensure it does not favour or provide an advantage to a related electricity service provider offering contestable services—this includes a separate part[39] of the same DNSP offering FCAS services. In other words, a DNSP would be required to functionally separate those parts of its business offering direct control services from those parts of the DNSP offering FCAS services. This is in addition to a general obligation to not discriminate in favour of a related electricity service provider offering FCAS services. Precisely how a DNSP would achieve functional separation in practice, with regard to a DNSP's control system, is unclear. A DNSP providing FCAS services could seek a waiver from these obligations. In doing so, the DNSP would need to demonstrate that removal of one or more ring-fencing obligations is in the interests of consumers. The extent to which other forms of regulation (e.g. Australian Competition Law) reduce the potential harm from a breach of the ring-fencing obligations[40] is a matter that could be raised in such a waiver application.

Of some concern to us is the risk of cross subsidy. DNSP control systems sit within the regulatory asset base. If a DNSP uses its control systems to provide FCAS services, it may seek to use the Shared Asset Guideline (SAG) to provide a benefit to distribution customers from use of regulated assets to provide unregulated services. There are several problems with this approach:

- SAG is designed to encourage DNSPs to use underutilised regulated assets for the benefit of customers. SAG is not intended to reflect the correct allocation of costs and as a result, the proposed use of the SAG would result in a cross subsidy. This because the revenue sharing arrangements in the SAG are not intended to be an alternative cost allocation method.
- Use of the SAG is restricted to circumstances in which the use of assets in the RAB will not materially prejudice the use of the asset for standard control purposes. DNSPs would need to ensure that use of regulated assets to provide FCAS does not affect the provision of standard control services.
- The SAG cannot be used in a forward looking manner. That is, when a DNSP invests in new control systems, the use of these systems must be factored into allocation of costs. This means that a future investment in its control system should reflect the expected future use of the assets for network system control and FCAS service delivery. SAG cannot be used for future investments.
- There is a risk that in providing FCAS services, DNSPs may be encouraged to over invest in control systems and attribute this to meeting network requirements.

39 A Related Electricity Service Provider is defined in the AER Ring-fencing Guideline.

40 Citipower, Powercor and United Energy, *Submission to Issues paper: classification and asset exemption guidelines*, March 2018, p. 3.

- Given the above, it could be difficult to avoid cross subsidies becoming embedded in the provision of FCAS services. This would be detrimental to the development of the markets and is prohibited under the Ring-fencing Guideline.

We have not included FCAS services as part of the baseline of services in the draft Guideline. Instead, we will assess applications for FCAS services by DNSPs on a case-by-case basis. We welcome feedback from stakeholders to the issues raised in this case study.

Case study: battery storage systems (shared with retailers)

In this case study, consider a battery that has been installed by a DNSP to provide grid support. If the DNSP uses the battery for network purposes only (i.e. to relieve network congestion), then the battery is an input to the common distribution service. However, if the DNSP traded energy from the battery in the wholesale market, this would not be a distribution service. This conclusion can be drawn because while the service is provided by means of the distribution system, the NEL defines network service separately from electricity generation and sales of energy. On this basis, we are satisfied that a DNSP's use of a battery to sell electricity into an energy market is not a distribution service.

Case study: co-located battery asset

Another battery related case study is concerned with the location of assets. In this example, a battery is owned by a DNSP that is not used for regulated purposes. The battery is owned by the DNSP but is fully leased to a retailer and used by the retailer to generate electricity for its customers. The battery is not included in the RAB and does not contribute to the provision of distribution services. However, the battery is located within a distribution substation. What is the correct regulatory treatment of this asset the service is used to provide?

The only regulatory issue in this case study is the use of the substation to locate the battery. As the property on which the battery sits forms part of the RAB, the Shared Asset Guideline is used to provide distribution customers with a share of the unregulated revenues earned by the battery. The rental payments to locate the battery at the substation are the unregulated revenues that are shared with distribution customers.

6 Transitional arrangements

The NER makes some allowance for transitional arrangements in the period between when the new rule commenced, in December 2017, and when the new arrangements apply in determinations for DNSPs. Transitional arrangements for each of the terms within the contestability rule change are detailed below. However, for the purposes of providing a summary, the general approach established by the transitional arrangements is that the new rules do not apply to the next round of distribution determinations for the NSW, ACT, Tasmanian and Northern Territory DNSPs, and that the previous rules continue to apply for those determinations.

DNSPs in South Australia and Queensland, where the preliminary Framework and Approach has recently been published, have indicated their in-principle support for the approach we have taken in the Guideline. They are expected to adopt the baseline list of services and classification where practical.

No presumption in favour of retaining previous classification

We note that the transitional arrangements in the new rule mean that we will still need to have regard the previous rule[41], which required us not to depart from a previous classification or the previously applicable regulatory approach unless that different classification is clearly more appropriate. This applies to our forthcoming distribution determinations for the NSW, ACT, Tasmanian and Northern Territory DNSPs.[42]

Departures from the guideline

We note that the transitional arrangements in the new rule mean that this Guideline will not apply to our forthcoming distribution determinations for the NSW, ACT, Tasmanian and Northern Territory DNSPs.[43]

Changing service classification

The new rule changes the threshold for us changing a service classification or control mechanism between the Framework and Approach and the distribution determination from “unforeseen circumstances” to “a material change in circumstances”.[44] We note that the transitional arrangements in the new rule mean that the "unforeseen circumstances" threshold will still apply for our forthcoming distribution determinations for the NSW, ACT, Tasmanian and Northern Territory DNSPs.[45]

41 Under Clauses 6.2.1(d) and 6.2.2(d) (now deleted)
42 See clause 11.104.3(b)
43 See clause 11. 104.3(a)
44 See clause 6.12.3(b)
45 See clause 11. 104.3(a)