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3 May 2018

Re: Preliminary framework and approach:
Energex and Ergon Energy Regulatory control period commencing 1 July 2020
SAPN Regulatory control period commencing 1 July 2020

AGL welcomes the opportunity to comment on the Australian Energy Regulator's (AER) preliminary framework and approach (F&A) for both the 2020-25 distribution determination for the Energex and Ergon distribution networks in Queensland and the 2020-25 distribution determination for SAPN in South Australia (the DNSPs).

AGL is one of Australia's leading integrated energy companies with over 3.5 million electricity and gas retail accounts in New South Wales, Victoria, Queensland and South Australia. In addition, AGL is continually innovating our suite of distributed energy services and solutions for customers with behind the meter solutions including new and emerging technologies such as energy storage, electric vehicles, solar PV systems, digital meters and home energy management services.

AGL understands the F&A is only the first step in the AER's determination process for electricity distribution services in Queensland and South Australia but considers it an important stage as it determines how network services are classified and therefore how they are regulated and priced.

This is especially the case for new network determinations as the AER is required to incorporate significant changes to the regulatory framework such as:

- the Australian Energy Market Commission's (AEMC) amendment of the framework used to classify network's electricity distribution services;
- the introduction of metering contestability to residential electricity consumers through the Power of Choice reforms;
- the introduction of the demand management incentive scheme (DMIS) and demand management innovation allowance (DMIA); and
- the national Ring-fencing Guideline.

AGL notes that the AER's preliminary position on the F&A is to largely accept the initial views of the DNSPs whilst accommodating the amendments to the regulatory framework that are highlighted above.

However, AGL believes the AER has been highly conservative with its approach to the F&A, including the classification of distribution services, and it has chosen to align with the previous F&A unless the regulatory framework has compelled a change. The opportunity exists for the AER to take a proactive role and encourage or facilitate contestability by moving a wider range of legacy services into the contestable sphere (i.e. as alternative control, negotiated or unclassified services). New technologies are showing promising signs that they can replace legacy regulated services with contestable markets and this requires the AER to examine in more detail some of these services.

Consequently, AGL's comments and queries on:

- service classifications;
- forms of control; and
- the AER's various incentive schemes;

are detailed below.

Classification of distribution services

The AER has retained the existing service classifications for most distribution services in its F&A which in the main, AGL supports.

However, the F&A fails to clarify the provision of current standard control services that are aimed at the control of customers' load control, a matter of continued debate.

AGL appreciates the distinction between distribution services provided to customers by network businesses and the various inputs procured by network business in the efficient delivery of those distribution services is not always a clear one. However, this ambiguity can have notable impacts on the development of competitive markets for those services.

Network businesses offer a controlled load tariff to customers who are prepared to have hot water, air conditioning or another appliance loads directly controlled by the DNSPs. The customer pays a different, lower tariff for the controlled load and is provided as a unique product that is offered to and selected by the customer. It is not a uniform service provided to the majority of electricity customers so AGL query why it is currently included as a standard control service. With the implementation of cost-reflective network tariffs, the financial benefit for shifting load to off-peak periods should be available to all customers and any competitive service provider will be able to provide behind-the-meter services to optimise the customers' bill. These will also be able to provide networks with valuable demand response.

The networks have previously proposed that the load control benefits are system wide and require its inclusion a standard service. AGL would contend that structuring this as a standard control service effectively precludes competition for delivery of load management services. Legacy load control programs reflect the state of technology and industry development at the time they were de implemented. There are more advanced demand management solutions becoming available and, with the introduction of Power of Choice, a developing competitive market for load management services that respond to customer preferences.

It may be that the definitions of distribution services remain appropriate but AGL would like to see the AER identify that inputs to distribution services are treated as such rather than allowing them to be standard control services as a means of preventing their competitive provision.

For example, AGL questions the inclusion of *network demand management for distribution purposes* activities within the common distribution services and is uncertain whether this refers to legacy load control services, the potential demand management input activities under the incentive schemes or the provision of other demand management services to customers. AGL understood any demand management activities were an input to network service delivery and to be procured through competitive markets. This needs to be made clear.

Form of control

The AER's preliminary position on the form of control mechanisms for the DNSPs over the 2020–25 regulatory control period is to retain:

- a revenue cap for standard control services; and
- price caps on individual alternative control services.

The reasons for the AER's support for a revenue cap are highlighted in the table below. However, we have also highlighted in the table the reasons why we believe any support for the position is questionable and that AGL currently maintains a preference for average revenue or price cap control of common distribution services.

AER Position	AGL Comment
No additional administrative costs and allow for consistency between periods	Agreed but not an overriding argument given the AER has overseen many networks transitioning from price cap to revenue cap control in recent determinations.
Revenue control mechanism ensures efficient cost recovery while limiting recovery above costs.	AER's review of form of control focuses on the revenue determination process rather than DNSP behaviour during the period. The determination process only estimates efficient cost and will be in error. AGL prefers a control that limits the price to customers rather than focussing on limiting revenue with the potential for significant price increases.
Revenue cap can lead to less volatility across regulatory control periods as if falling consumption was evident then prices would adjust in the current regulatory period.	This argument assumes that efficient network prices would need to increase significantly in the next period in line with the fall in demand and consumption. AGL would hope that if network utilisation fell markedly then other cost components would also be re-examined by the AER. Revenue cap control simply ensures DNSPs recover a forecast of network revenue.
More incentive for DNSPs to undertake demand side management projects that reduce costs because revenue is unaffected.	AGL agree in principal however, it has not been supported by DNSP behaviour to date as conceded by the AER through its introduction of schemes to incentivise DNSP's use of demand management response.
Efficient tariff structures can occur under all forms of control mechanisms.	Agreed, but DNSPs pricing preferences appear to be trending towards revenue recovery, because of the form of control, rather than alignment to drivers of network cost.

In saying this, AGL concedes that moving to cost-reflective network pricing (no longer linked to electricity consumption) will both diminish the advantages of price cap regulation whilst reducing the problems with revenue cap control. If the AER maintains revenue cap control in the next regulatory control period then it needs to be accompanied by the requisite network pricing reform.

AGL would also expect the AER to be similarly supportive of revenue cap regulation in the F&A of future regulatory control periods if circumstances change to make price control more advantageous for DNSPs, for example if electricity consumption and network utilisation increases.

Incentive schemes

The AER preliminary position is to apply the following incentives schemes on the DNSPs in the 2020-25 regulatory control period, namely the:

- Service Target Performance Incentive Scheme (STPIS);
- Efficiency Benefit Sharing Scheme (EBSS);
- Capital Expenditure Sharing Scheme (CESS);
- Demand Management Incentive Scheme (DMIS); and
- Demand Management Innovation Allowance (DMIA).

AGL understand that the DNSPs regulatory determinations requires service targets and the STPIS is therefore a reasonable method for establishing this.

AGL also recognises the DMIS and DMIA are new schemes implemented to encourage DNSPs to utilise non-network solutions that are lower cost to investing in network assets. AGL is hopeful the schemes are successful in encouraging this behaviour given DNSPs preferences to date are inevitably network solutions.

However, the EBSS and CESS, appear to be theoretical solutions to the AER believing the regulatory framework and revenue cap form of control are not providing the correct incentives to DNSPs. AGL believes and has previously submitted that the effectiveness of these schemes is highly doubtful and cannot demonstrate any long-term benefit to consumers.

Any improvements in efficiency of operational and capital expenditure are driven by the AER's determination process and benchmarking of DNSPs efficiency against each other. In AGL's experience, a business in a competitive industry will only be able to accrue the benefits of cost efficiency gains for a year or two at most before its competitors act accordingly and any gains in efficiency are reflected in competitive price reductions. Under the regulatory framework, the DNSPs accrue immediate financial benefit from greater reductions in operating and capital expenditure than forecast. That these benefits need to be extended for five or more years in order for a DNSP to act appropriately is confounding.

AGL would also note the following on the incentive schemes:

- **STPIS**: How the service performance and targets are measured can significantly impact the STPIS. AGL supports the AER approach that bases its performance targets on the DNSP's average performance over recent years. The AER has indicated it would use the last five regulatory years which AGL would consider a maximum length of time given the changes in the network assets, customer loads, and behaviours.

- **EBSS**: AGL notes the AER will only utilise an EBSS if it is satisfied that the scheme will provide benefits to consumers and if it is using the distributors' revealed costs. AGL supports this approach and would contend that the scheme will provide no additional benefit to consumers.

- **CESS**: In AGL's experience, many privately owned DNSPs have acted commercially and chosen to not to spend expected capital allowance because of the incentives already inherent in the regulatory framework, without the need for a capital based incentive scheme. The requirement for a CESS indicates that the AER believes that these incentives are not enough to avoid DNSPs investing in inefficient or imprudent capital. Obviously, the risk weighted return on capital investment is too great under the current regulatory framework.

  Customers paying for inefficient or imprudent capital investment is not acceptable but requiring customers to pay additional revenue simply to avoid even greater and longer term payments is a second best option. AGL cannot support the CESS.

- **DMIS and DMIA**: These schemes are to encourage efficient expenditure on non-network options relating to demand management. When establishing the DMIS and DMIA, AGL would support the AER communicating clearly its expectations on how the DNSPs select relevant projects and that it enables third parties to propose and implement demand management solutions.

If you wish any further information, please contact me on (03) 8633 6207 or Patrick Whish-Wilson on (02) 9921 2207.

Yours sincerely

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