



8 July 2021

Mark Feather
General Manager
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Lodged via email: AERringfencing@aer.gov.au

Dear Mr Feather

RE: Electricity ring-fencing guideline review

Shell Energy Australia Pty Ltd (Shell Energy) welcomes the opportunity to respond to the Australian Energy Regulator's (AER's) draft electricity distribution ring-fencing guideline (the Guideline) and explanatory statement.

About Shell Energy in Australia

Shell Energy is Australia's largest dedicated supplier of business electricity. We deliver business energy solutions and innovation across a portfolio of electricity, gas, environmental products and energy productivity for commercial and industrial customers. The second largest electricity provider to commercial and industrial businesses in Australia¹, we offer integrated solutions and market-leading² customer satisfaction, built on industry expertise and personalised relationships. We also operate 662 megawatts of gas-fired peaking power stations in Western Australia and Queensland, supporting the transition to renewables, and are currently developing the 120 megawatt Gangarri solar energy development in Queensland. Shell Energy Australia Pty Ltd and its subsidiaries trade as Shell Energy.

www.shellenergy.com.au

Overview

Shell Energy considers a strong ring-fencing framework for distribution network service providers (DNSPs) is critical for both stand-alone power systems (SAPS) and energy storage systems (ESS). Our rationale is that ring-fencing helps to provide a level playing field for contestable services, which enables competition and ultimately improves outcomes for consumers.

On the topic of ESS, we agree with the AER's view that there is typically value in using one ESS to provide multiple services. We also agree with many of the AER's views on the risks associated with DNSPs providing contestable services. However, we believe that the proposed changes to the Guideline may unintentionally allow DNSPs to receive waivers more easily than intended, introduce uncertainty for third party ESS providers, and/or restrict the business models of third party ESS providers. We believe that these issues could be addressed by modifying the Guideline to mandate a transparent, competitive process for DNSPs to acquire ESS services from third parties.

¹ By load, based on Shell Energy analysis of publicly available data

² Utility Market Intelligence (UMI) survey of large commercial and industrial electricity customers of major electricity retailers, including ERM Power (now known as Shell Energy) by independent research company NTF Group in 2011-2020.



On the topic of SAPS generation, we acknowledge that, in some limited circumstances, consumers may benefit if DNSPs are exempt from ring-fencing arrangements. We also note that SAPS deployment is not yet widespread, but is expected to substantially increase over the next 5-10 years in regional areas. With this in mind:

- we consider that the AER's proposed approach is broadly sensible in the near term, as long as DNSP revenue caps for SAPS generation are sufficiently conservative and do not increase above the proposed levels
- in addition to what the AER is proposing, we suggest establishing a threshold SAPS size, over which DNSPs are required to conduct market sounding for third party providers prior to supplying SAPS generation
- we recommend that the AER closely monitors DNSPs' behaviour and instigates a review of the Guideline in two or three years, or if it appears to no longer achieve its intent.

The remainder of this submission provides more detailed feedback on how the Guideline treats ESS and SAPS.

Energy storage systems

Shell Energy agrees with many of the AER's views relating to ESS. In particular, we agree that:³

- there are likely to be situations where the most efficient outcome for the electricity system would be for an ESS to "provide [both] regulated network services (or inputs to regulated network services) and contestable services"
- "there needs to be robust safeguards in place to mitigate the risks from DNSP discrimination and cross-subsidisation in order to encourage competition"
- "achieving the greatest benefit [does not require] DNSP ownership of [ESS]"
- "benefits identified by the DNSPs could equally be achieved where DNSPs procure [ESS] network support services from third parties, and the third parties then redirected excess capacity to other contestable markets"
- there should not be "changes to the ring-fencing framework to allow a DNSP to provide other contestable services using [ESS] excess capacity".

However, while we agree with the AER's intent, we believe that the proposed changes to the Guideline could be further improved.

Waivers

The explanatory statement outlines the AER's draft position is to:⁴

- prohibit DNSPs from providing contestable services with an ESS
- grant waivers allowing DNSPs to supply excess ESS capacity to a third party "where there are clear consumer benefits of DNSP ownership of the [ESS] and demonstrable mitigation of the risks to competition".

The AER also notes that "there are no barriers, in terms of ring-fencing, to third parties providing a range of services from their own batteries, including to DNSPs"⁵.

³ AER, *Draft electricity distribution Ring-fencing Guideline, Explanatory statement*, May 2021, pp 30, 35, 39, 38

⁴ Ibid, pp 30-31

⁵ Ibid, pp 30



When considered together, it appears the AER's draft position aims to encourage efficient outcomes by indirectly increasing the likelihood of DNSPs contracting with third parties to provide network services as part of an ESS value stack. However, we believe the AER's draft formulation is unnecessarily indirect and has two major drawbacks.

The first drawback is that the waiver process appears to require significant discretion from the AER. The lack of a clearly defined decision-making process may reduce investment in the relevant contestable markets due to the risk that the AER grants waivers to DNSPs.

The second drawback is that DNSPs may be able to receive a waiver more easily than anticipated, and this could result in inefficient outcomes. For example, consider a scenario where a DNSP installs an ESS solely to provide regulated network services. It is likely that the ESS would not be in use for a significant portion of the time. After the ESS installation, given that the capital costs are already sunk, the DNSP may be able to demonstrate consumer benefits if the DNSP was able to supply the 'spare' capacity to a third party (to provide contestable services).

As noted by the AER, allowing DNSPs to supply excess ESS capacity to third parties has the potential to harm competition between ESS providers (e.g. due to preferential network arrangements use or cross-subsidisation)⁶. Additionally, it is unlikely that the ESS would have the technical specifications (e.g. size of the inverter and/or energy storage) that would maximise the total value stack if the DNSP designed the ESS solely to deliver the required network services at the lowest cost. Conversely, if a third party had designed the ESS to optimise the value from providing network services and contestable services, the ESS technical characteristics would likely be different. The additional benefits from optimising the value stack would ultimately flow through as lower costs to consumers.

To facilitate competition and efficiency, and avoid the unintended consequences discussed above, we recommend that the Guideline is changed to facilitate the following process.

1. Prior to installing an ESS, require a DNSP to undertake a competitive process to procure the required network services. This would require the DNSP to release a well-defined problem statement with appropriate technical details and sufficient time for the market to respond.
2. Unless the DNSP could deliver the required network services at a lower cost than third parties by unilaterally installing the ESS⁷, require the DNSP to procure the services from the third party that offered the best value. The DNSP decision-making process would need sufficient ring-fencing to ensure that a DNSP affiliate does not receive an unfair advantage over other market participants (e.g. by having access to additional information).
3. In the (unlikely) situation where the AER was convinced the DNSP could unilaterally deliver the required network services with ESS at a lower cost than third parties, prohibit the DNSP from supplying excess capacity to a third party without first receiving a waiver from the AER. Upon receiving a waiver, require the DNSP to periodically disclose the value of the contestable and non-contestable services provided by the ESS to verify consistency with the problem statement provided to market, and the waiver application provided to the AER.

Step 3 is effectively what the AER is proposing in the explanatory statement, with an additional reporting requirement.

This process would ensure transparency, foster competition between ESS providers, and allow DNSPs to efficiently procure network services from ESS. All three of these outcomes would ultimately benefit consumers.

⁶ Ibid, pp 31 and Section 3.2.1

⁷ We consider this to be an unlikely situation, given that the third parties would be able to value stack with contestable services, whereas the DNSP would not.



Additionally, this three-step process would provide greater clarity and certainty than the AER's current proposed waiver process, which appears to allow a high degree of discretion.

As stated by the AER in its consideration of SAPS, "ideally, a minimum tendering requirement to demonstrate that there is no economical third party provider would best meet the objective of ring-fencing where a contestable market is reasonably established"⁸. We believe this argument is applicable to ESS ring-fencing and is satisfied by the three-step process above.

Business models

If a DNSP and a third party entered a commercial arrangement under Step 2 above, we believe the Guideline should not place undue restrictions on the contract.

There are a variety of commercial arrangements that could be appropriate in different situations. For example:

- a. The third party could potentially own and operate the ESS.
- b. The third party could supply the ESS, sell it to the DNSP, and have a contractual arrangement whereby the third party has access to the ESS (to provide contestable services), except for where it prevents the ESS from providing the DNSP with defined network support services.

As long as the above three-step process is followed, we consider that there could be limited risk allowing contractual structures whereby the DNSP ultimately owns the physical ESS (e.g. as in example b above)⁹. Indeed, this may be the most efficient outcome in some cases (e.g. where the ESS would be located on DNSP land, or where financing arrangements were more favourable).

This appears to conflict with the AER's draft position in the explanatory statement, which would prevent a situation like in example b above without the DNSP first seeking a waiver, which adds a potentially unnecessary administrative burden. We believe amending the Guideline to enable the above three-step process would meet the AER's intent, whilst allowing sufficient flexibility to drive efficient commercial outcomes. However, we note that requiring a waiver may still be necessary if party accessing the contestable services is affiliated with the DNSP, or is on-selling access to a DNSP affiliate.

Improvements outside of the Guideline

Over the longer term, we believe that further consideration should be given to incentive schemes to make procuring non-network alternatives attractive to DNSPs. We acknowledge the AER's position that this this was out of scope of the current review, but welcome the AER's commitment to explore these issues further in the future.¹⁰

Stand-alone power systems

Revenue caps

Like the AER and other market participants, we do not support DNSPs providing SAPS generation services on a large scale¹¹. However, we acknowledge that there may be limited situations where cost-effective third-party generation is not available – particularly for small-scale SAPS. We therefore understand the AER's rationale that

⁸ AER, *Draft electricity distribution Ring-fencing Guideline, Explanatory statement*, May 2021, pp 20

⁹ For the avoidance of doubt, we do not support DNSP ownership of an ESS that provides contestable services unless the ownership arises from Step 2 in the three-step process described in the previous section.

¹⁰ AER, *Draft electricity distribution Ring-fencing Guideline, Explanatory statement*, May 2021, pp 36

¹¹ *Ibid*, pp 18



allowing DNSPs to provide SAPS generation up to a revenue cap could be an effective method to deliver benefits to consumers, while mitigating the risk of damaging competition and market development¹².

For the revenue cap to effectively encourage a competitive market, it is crucial that the cap is not too high. We support the AER's intent to enforce a conservative cap in order to mitigate the risk of damaging the market for SAPS generation services¹³. However, we believe that the draft AER methodology to calculate the revenue cap may result in an inefficiently high value. In particular, the AER appears to use high-range estimates for the number of SAPs that will be required in the future. For example, ENA estimated a range of 1000-2000 SAPs may be required in Ergon's network, and the AER used 2000 to calculate Ergon's notional revenue cap (0.2%)¹⁴. We encourage the AER to consider whether a more conservative approach would be appropriate as part of a broader review of the methodology and its input assumptions.

Market sounding for SAPS over a defined threshold

The AER considers that it may be efficient to deploy thousands of SAPs in the next 5 to 10 years. Further, the AER has observed "a limited level of third-party SAPS generation providers". These two points underpin the AER's rationale that it would be inefficient (and therefore detrimental to consumers) to require DNSPs to apply for a waiver or test the market in every instance where they seek to supply SAPS generation.¹⁵

Shell Energy acknowledges the AER's rationale. However, we recommend that the Guidelines establish a threshold SAPS size, over which DNSPs are required to conduct market sounding for third party providers prior to supplying SAPS generation. We believe an appropriate threshold would limit unnecessary administrative burden for DNSPs, while addressing stakeholder concerns that DNSPs may overlook cost-effective third-party SAPS generation. For the avoidance of doubt, we are proposing this requirement in addition to the revenue caps the AER is proposing. We also recommend the AER consults on the value of the threshold.

Future Guideline reviews

We agree with the AER that a future review of the Guideline is likely to be appropriate, given the relative immaturity of SAPS deployment. We also acknowledge that it is difficult to assign a specific review timeframe given that Energy Ministers have not yet approved the relevant rule change package. Therefore, we recommend that the AER closely monitor DNSPs' behaviour and instigates a review as soon as the Guideline appears to no longer achieve its intent, or two to three years after the changes come into effect.

Clarifying DNSP responsibilities

Our understanding is that DNSPs providing SAPS services would be required to meet all technical and performance standards stipulated in the National Electricity Rules (e.g. the reliability standard). When the AER delivers its final explanatory statement, we consider it would be useful to confirm this interpretation so to give stakeholders additional clarity around the type of SAPS that DNSPs are able to target.

Conclusion

Shell Energy considers a strong ring-fencing framework for DNSPs necessary to provide a level playing field for contestable services, which enables competition and ultimately improves outcomes for consumers.

¹² However, as discussed in the next subsection, we believe that the revenue cap should be supplemented by an additional 'threshold size' safeguard.

¹³ AER, *Draft electricity distribution Ring-fencing Guideline, Explanatory statement*, May 2021, pp 22

¹⁴ Ibid, pp 80

¹⁵ Ibid, pp 19-20



We are broadly aligned with the AER's intent behind its proposed changes to the Guideline for both ESS and SAPs ring-fencing. However, we believe that the suggestions in our submission would further improve the AER's proposed changes, and ultimately deliver better outcomes for consumers.

If you would like to discuss this submission further, please contact Matthew Ladewig, Policy Adviser at matthew.ladewig@shellenergy.com.au or on 03 9214 9397.

Yours sincerely

Libby Hawker
GM Regulatory Affairs & Compliance
03 9214 9324 - libby.hawker@shellenergy.com.au