14 February 2019

Mr John Pierce
Chairman
Australian Energy Market Commission (AEMC)

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Dear Mr Pierce

Electricity network economic regulatory framework review

SA Power Networks welcomes the opportunity to comment on the AEMC's approach paper for its 2019 network regulatory framework review **(the 2019 review)**. These annual reviews are of crucial importance at a time of rapid technological and market change. We look forward to engaging further over the course of this review and welcome the AEMC's willingness to adopt a more informal engagement approach.

The approach paper appears to have effectively scoped the range of issues that should be subject of the 2019 review. Below we provide a few further and general considerations.

Measured evolution in regulation

We support regular evidenced–based reviews to 'stress–test' the regulatory framework given rapid changes in the services that customers and markets are demanding of distribution networks, particularly via the connection and use of Distributed Energy Resources (DER). We continue to support the AEMC considering the pros and cons of potential alternatives to the model by which to renumerate and incentivise distribution businesses. For the 2019 review, our view is that:

- The role of regulatory predictability and stability for investors in network infrastructure must be recognised. Regulatory reforms should aim to be evolutionary, and carefully staged with regard to evidence and assessment principles and preferably tested via trials if feasible. It may be premature to evaluate how the current regulatory framework has performed, given the relatively recent introduction of the complementary incentive schemes applying to capital expenditure and demand management.
- This is an opportune time for the AEMC to reaffirm its support for the role of incentive regulation in promoting ongoing efficiencies in service delivery to customers, or otherwise engage in an open discussion with the sector on alternatives. This is noting that recent regulatory decisions have:
    - trended toward what appears to be a potential undermining of the incentive framework.[1] These decisions have seemingly ignored the role which the various opportunities for outperformance afforded by the current framework have had in driving efficient outcomes for customers of privately owned networks in particular—evidenced by the long–term performance of businesses such as ours which consistently benchmark favourably against other distribution businesses; and
    - reflected a lack of faith by market bodies with respect to the role of incentives in driving efficient choices by network businesses, such as between the use of network vs demand–side solutions, and 'in–house' activities vs outsourced procurement of inputs to distribution services.[2] We also observe a desire on the part of some stakeholders (as noted in the AEMC's approach paper) to extend the AER's ex–post expenditure review powers. These trends all appear to reflect a desire to move much closer toward a cost–of–service regulatory model. Any such desire should be subject to wholistic and transparent consideration rather than introduced inadvertently via narrowly focussed reviews.

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[1] This is observed in the approaches to: the Rate of Return review; the potential introduction of pre–emptive operating expenditure productivity adjustments; and the approach to and discussion around the need for reporting of profitability measures.

[2] This is reflected in decisions such as: the imposition of pre–emptive prohibitions on networks fully funding or co–funding with third parties solutions involving behind the meter assets; the approach to distribution ring–fencing guidelines; and some of the views expressed on how reforms to allow distributors to provide stand–alone power systems should occur.

Need for regulatory reform

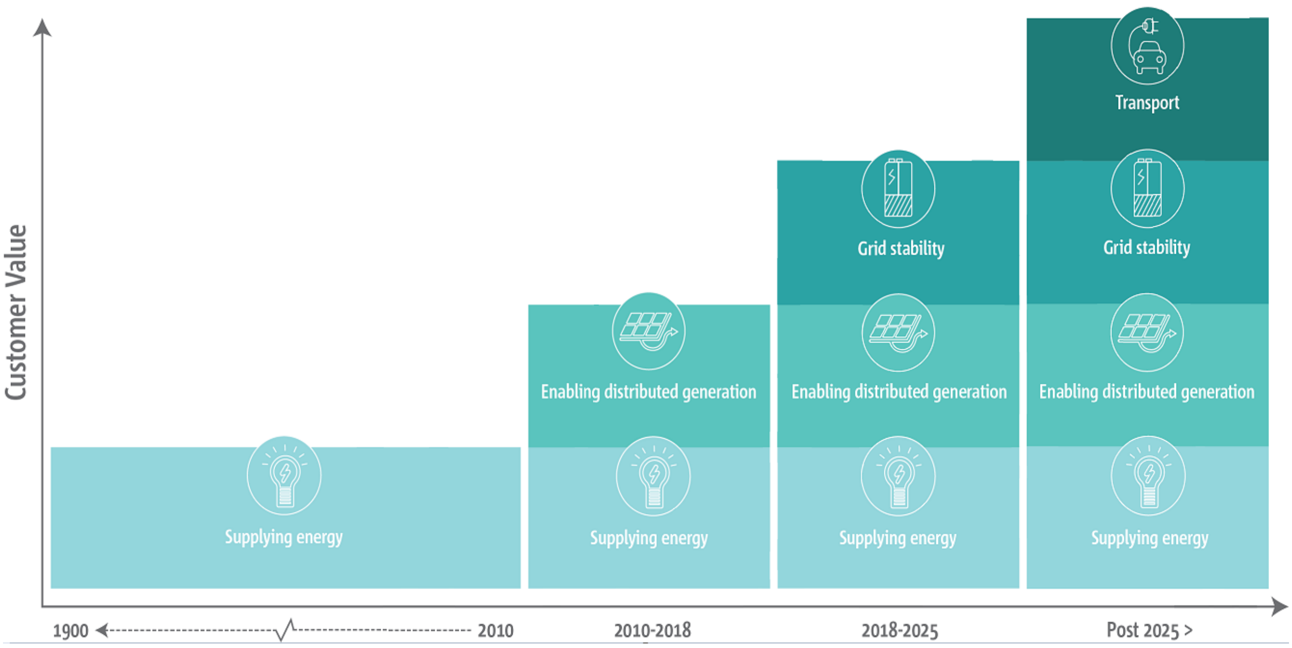
In assessing the case for regulatory reform, consideration should be given to the impacts arising from technological and market changes.

Services sought by customers

Customers are increasingly seeking to use distribution networks in different ways—connecting DER and other new applications, and using the network as a platform for exporting and trading energy as outlined in Figure 1. Distribution networks will therefore increasingly need to adapt and invest in new ways to continue to deliver efficient, safe and reliable services to customers.[3] This raises questions as to the following:

- How these proposed investments will be accommodated under current regulation including expenditure assessment processes. We urge the AEMC to closely monitor the latest / next round of distribution determinations and or Regulatory Investment Tests, as we expect these will start to reveal how well the current regulatory framework is suited to examining the value for customers arising from these network investments.[4]
- How the services that distribution networks are increasingly providing are treated under regulation such as via connection pricing, or measures of distribution network 'outputs' used for expenditure assessments and benchmarking etc. For example, we observe that while 'energy throughput' and 'maximum demand' are factors included in AER benchmarking and opex growth forecasting, these factors are increasingly ceasing to adequately reflect network constraint and cost drivers. There may be better ways of recognising the service 'outputs' that customers are now demanding of networks.

Figure 1: the changing role of the distribution network[5]



[3] Such as by investing for better visibility of areas of network where generation has not typically connected (low voltage networks) and investing in the means to be able to provide signals to customers and their agents and interact with third party data to manage two-way energy flows.

[4] This includes for example, how to conceive of the value for all customers and the broader market arising from the release of greater volumes of distributed generation exports.

[5] Source: SA Power Networks

Increasing alternatives to traditional network investments

There are increasingly viable alternatives to investing in traditional network infrastructure. This includes not only the ability to draw on customer and third–party owned DER and information (e.g. metering data) to manage network constraints, but also the increasing opportunities to pursue software as a service (e.g. cloud solutions) as alternatives to network business owned hardware/software, among other potential examples. To the extent that these new options involve decisions between capex and opex, questions are raised as to the following:

- the long–term impact on financeability of network businesses under the current regulatory framework should there be an increasingly material shift toward opex–based solutions to network needs. While this matter was briefly raised in a report prepared by the AEMC's consultant in the 2018 review, it warrants much greater attention.[6] Financeability should also be a core focus in considering any potential alternative regulatory models of remuneration such as total expenditure models ('totex');
- the appropriate framework to direct distributors to invest efficiently between network vs non–network options, in–house vs outsourced activities, and grid vs stand–alone power systems. On this issue, the AEMC's 2018 review considered that under certain conditions, the incentives to choose between capex and opex solutions may be misaligned. We urge the AEMC to reconsider these previous findings and consider other impacts, in light of the recent application of the unprecedented and lowest ever Rate of Return applied by the AER; and
- how changes between the use of capex and opex based solutions are treated under regulation. For example, distributors who have (for efficient reasons) more aggressively sought opex based solutions will benchmark less favourably under current approaches to undertaking benchmarking solely from the perspective of opex. These current approaches are also susceptible to influence from factors that may be independent of efficiency, such as differing business specific / legacy approaches to capitalisation.

Regulatory sand-boxes

We fully support the introduction of regulatory 'sand–boxes' as a highly innovative approach by which to allow networks to collaborate with other parties to manage unique challenges that may emerge. This may be particularly pertinent to the management of broader electricity system security, or other situations where the fixed responsibilities of different market participants may present barriers to promoting outcomes in the long–term interests of consumers.

We would be happy to discuss our submission further and look forward to engaging further with the AEMC and stakeholders on this important review. If you have questions on any matter we have raised, please contact Bruno Coelho on 08 8404 5676.

Yours sincerely

Richard Sibly
Head of Regulation

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[6] For example, the report prepared by Cambridge Economic Policy Associates indicated that under the current regulatory framework, there may emerge concerns that a primarily opex focussed business may not be equally preferred by investors in regulated network assets, arising from investors equity having to be used as working capital to cover liability created from the adoption of opex based solutions (which may involve higher risk and or transaction costs), as opposed to being used for capex (and therefore backed by the RAB). CEPA, *Incentives faced by network service provider—Report prepared for the AEMC*, pp.58-60.