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Economic Regulation Authority
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Submitted via email by graham.pearson@energycouncil.com.au to publicsubmissions@erawa.com.au

Framework and approach for Western Power's fifth access arrangement review: Issues paper

The Australian Energy Council (the "**AEC**") welcomes the opportunity to make a submission to the Economic Regulation Authority (the "**ERA**") on the *Framework and approach for Western Power's fifth access arrangement review* issues paper (the "**Issues Paper**").

The AEC is the industry body representing 22 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

The AEC makes the following comments in relation to the Issues Paper:

2. Code objective

What information or data might be available to assist the ERA in considering each of the limbs, particularly the environmental consideration, in determining consistency with the Access Code objective. For example, information on greenhouse gas emissions.

As discussed later in this submission, the changes to the Electricity Networks Access Code 2004 (the "**Access Code**") mean that the network operator can earn unregulated revenue from regulated assets, such as network connected batteries, to the detriment of competition in the Wholesale Electricity Market (the "**WEM**"). Accordingly, the ERA should obtain information about the impact on competition from regulated AA5 activities, including whether alternative options provided by third parties better serve the long-term interests of consumers.

Data is also required to demonstrate how investment options meet the Access Code objectives and put downward pressure on costs. This is particularly the case when the network operator favours its own alternative option over those potentially provided by a network user or a third party. The ERA should have access to information that substantiates this investment decision and shows how the Access Code objectives are better met by the network operator than if a non-network operator alternative option was adopted.

Where stakeholders foresee conflicts arising between the Code objective and particular criteria or criterion in the Access Code. For example, the new facilities investment test may produce a result that is inconsistent with the environmental limb of the Access Code objective.

In the AEC's view, a conflict may occur between the Access Code objectives and criteria in the Access Code where:

1. the network operator proposes to provide services in competition with third parties; or
2. the network operator proposes an investment that a third party could provide at least cost.

Some of the issues for the ERA to consider are:

Multi-function assets

- What assets will be used as multi-function assets? Are network connected batteries that satisfy the New Facilities Investment Test (the "NFIT") multi-function assets?
- What network services will be provided by multi-function assets?
- In what circumstances will multi-function assets be permitted to create a new line of business in competition with third parties?
- What assessment will be conducted, and what information is required, to determine if the network operator multi-function asset is the least cost solution?
- What information will the ERA require the network operator to disclose and publish? For example, will this include a list of unregulated services a network operator provides and the total unregulated revenue from shared assets.

Alternative options

- How is the network operator going to be compelled to adequately engage the market to provide alternative option solutions?
- How will the ERA promote the network opportunity map to assist in creating an open and efficient market for alternative options?
- How will the ERA compare alternative options and ensure the least cost alternative option solution will be provided irrespective of service provider?
- Will a network operator's capital investment be put in the regulated asset base if an alternative option is more efficient? Or, will this become an excluded service if it meets the criteria?
- What factors need to be considered in relation to valuation methodologies for different types of services/solutions? How are environmental benefits valued?

Net benefit guidelines

- How will the net benefit test be undertaken and the results presented?
- What methodology and key inputs will be used to assess the net benefits of a service?
- Over what time horizon is the net benefit test to be undertaken?
- What discount rate is used in the net benefit test?
- Will the quantification of net benefits be undertaken using recognised engineering and economic models?
- What environmental benefits will be assessed as part of the net benefit test and how are they valued?

Demand Management Innovation Allowance ("the DMIA")

- What activities involve research and development?
- How is a demand management innovation project defined?
- How will the ERA identify whether a potential demand management innovation project is already being considered or undertaken by third parties?
- Will a national and international survey be conducted to ensure the demand management innovation projects hasn't already been progressed elsewhere?
- What criteria will be used to determine whether a demand management innovation project is actually innovative and likely to provide a positive benefit within a reasonable period?
- What criteria will the ERA apply to ensure a demand management innovation project does not fund new lines of business for the network operator in competition with network users?

- What criteria will the ERA apply to assess if the demand management innovation project will generate unregulated revenue?
- Who determines, and how, whether other sources of funding are available?
- Will each demand management innovation project be subject to public consultation?

2. Code objective & 3. Classification of services

The AEC made a submission to Energy Policy WA on the proposed changes to the Access Code, and expressed concern that the amendments opened up opportunities for the network operator to use network connected batteries to provide services to the competitive market.¹ The Government's policy is that Western Power should be enabled and permitted to deploy storage in response to an identified network need, and that the intention is not to allow Western Power to develop new lines of business.² However, in practice, the changes when combined with the existing provisions in the Access Code mean that:

1. Western Power can provide some services directly to AEMO via bilateral contracts (for example, ancillary services); and
2. Western Power can lease the battery to a third party to provide services directly into a specified energy market, and by doing so, Western Power can monetise the economic benefit the battery provides via a lease payment with the third party intermediary.

Western Australia is the only state without nationally recognised and applied ring-fencing provisions to prevent regulated businesses from discriminating in favour of their related parties to the disadvantage competitors operating in the market. The AEC therefore retains strong reservations about Western Power being able to use regulated network batteries to earn unregulated revenue without ringfencing provisions. In this regard, the AEC engaged Oakley Greenwood to produce an independent report to:

1. Consider the impact on competition of Western Power being able to provide regulated and unregulated services from network connected batteries; and
2. Make recommendations on the measures that should be considered to prevent or mitigate any negative impacts on competition that could arise from Western Power providing unregulated services from network connected batteries.

This report is now finalised and will be released publicly in the days following this submission. In summary, the Oakley Greenwood report raises strong concerns that the overall changes made to the Access Code will reduce productive and dynamic efficiency, incentivise the network operator to make inefficient investment, increase costs for consumers, and ultimately mean that there is a reduced likelihood of achieving the Access Code objective to:

promote the efficient investment in, and efficient operation and use of, services of networks in Western Australia for the long term interests of consumers

Oakley Greenwood concluded that the cause of this is the NFIT, specifically Clause 6.52 (b) (ii), that allows Western Power to recover the costs of network battery investments based on their potential to produce net benefits (including potentially environmental benefits).

¹ See [AEC submission on the proposed changes to the Electricity Networks Access Code](#)

² See p21, [Explanatory Memorandum presented in the Legislative Assembly](#)

The AEC's interpretation of the Access Code is that it now allows the full capital cost of a network connected battery to be rolled into the capital base if it passes the NFIT. With the full cost of the network connected battery already in the capital, Western Power will recover, as a minimum, the cost of building the asset and this expenditure will flow through to higher reference tariffs. In addition, if the network connected battery is able to be used to sell services into competitive markets, it will retain:

- 100% of the net incremental revenue up to a materiality threshold of \$1m for the year (underpinned by the new additions to the Access Code that relate to multi-function assets), and
- 70% of any net incremental revenue that exceeds the materiality threshold.

Based on this, Western Power would be incentivised to justify making investments in network connected battery solutions, as compared to other assets that could provide equivalent network support services, even where network connected batteries may not be the most efficient solution. This is because it can recover the cost of building the asset plus keep 100% of the revenue up to the materiality threshold.

If Western Power can make 'excess profits', due to the way the regulatory framework accounts for this unregulated revenue, then, everything else being equal, Western Power will be incentivised to over-invest in network connected battery services at the expense of procuring such services from third parties because Western Power will forgo the possibility of earning excess revenue over and above the actual cost of investment if the service is instead provided by the market.

This scenario will have a chilling impact on competition in the WEM. Put simply, the expected financial returns that would accrue to Western Power (i.e. recovering the cost of building the asset plus keeping the revenue), as compared to third parties (who do not automatically recover the cost of building the asset and have exposure to full market risk), for the provision of exactly the same asset at exactly the same costs, creates an uneven playing field. Such circumstances are likely to have the effect of crowding out parties who may otherwise have competed for the provision of those services, impacting the market for those services in the medium and the long term, and negatively affecting customer outcomes.

This has the potential to:

1. *Reduce productive efficiency and increase costs to consumers.* This is because Western Power is incentivised to make investments in multi-function assets, relative to other types of assets, due to their ability to capture and retain either 100% or 70% of the incremental unregulated revenue that can be generated from those assets, on top of recovering 100% of the economic costs of installing those assets in the first place. These costs will be passed on to customers.
2. *Reduce dynamic efficiency.* The financial flows that ensue from the adoption of grid-side batteries, even for the same asset providing exactly the same economic benefit, differ depending on whether the network operator or a third-party provider owns and operates the asset. This disadvantages third party competitive providers and will disincentivise those parties from competing to provide these services. Less competition means less innovation and, generally, diminished economic efficiency in the long-term.

For these reasons, the AEC supports the ERA in classifying network connected batteries as excluded services. This will level the playing field for third parties, promote competition and ensure the least cost solution is adopted.

4. DMIA mechanism

The ENAC changes introduced a new DMIA mechanism for ex-ante funding of the network operator's research and development into innovative projects related to demand management with the intent that it has the potential to reduce long term network costs.

Whilst this is a reasonable objective, the potential problem is that it could provide a means for the network operator to develop products and services, and compete using these products and services, that could otherwise be developed by parties operating in the competitive market. For the network operator, this research and development expenditure is a “riskless” exercise, in that it is fully recoverable from regulated customers under the DMIA, hence its shareholder is not actually putting any of its funds ‘at risk’ compared with third party providers operating in the competitive market, whose investment in the same type of research and development would involve them putting their shareholders’ funds ‘at risk’. This situation could lead to market participants who may have otherwise undertaken research and development D in order to expand their capabilities to provide demand management services, to be crowded out of the market (i.e. elect not to put their shareholder funds at risk due to the perceived unequal playing field).

As noted in the AEC’s submission on the scoping paper, it is not reasonable for network users to fund any activity for a monopoly network operator at the expense of the network user’s own business and where there is no benefit or return to the investor.³ The guideline will be critical to ensuring that the DMIA mechanism only funds projects that are genuinely innovative and likely to provide consumers a positive cost/benefit outcome within a reasonable period, does not duplicate other projects either nationally or internationally, and does not fund new lines of business for the network operator in competition with network users.

Noting the above and the ongoing need to limit costs for users, the AEC advocates for capping the innovation allowance to align with the AER’s scheme. However, the AEC would like to review the draft guidelines before finalising its views.

Conclusion

The AEC appreciates this opportunity to provide feedback on the Issues Paper and encourages the ERA to consider the issues raised above.

Please do not hesitate to contact Graham Pearson, Western Australia Policy Manager by email on graham.pearson@energycouncil.com.au or by telephone on 0466 631 776 should you wish to discuss this further.

Yours sincerely,

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³ See page 2 & 3, [AEC submission on the Western Power AA5 Review – Framework & Approach – Scoping Paper](#)