Note: AER's Demand Management Options Day

To	Warwick Anderson, AER General Manager
From	Ausgrid
Date	21 April 2017
Subject	AER's Demand Management Options Day

We welcome the opportunity to provide this note on the questions raised at the recent Demand Management Options Day to assist in the development of a new demand management incentive scheme (Scheme) and innovation allowance mechanism (Allowance Mechanism).

Question 1: Should we introduce a scheme?

Ausgrid supports the implementation of a demand management incentive scheme.

In our view, the introduction of such a scheme is in the long term interests of consumers where the introduction of efficient incentives encourages greater competition from non-network options in meeting network needs. More broadly, we consider the issue as to whether a demand management scheme should be introduced has already been dealt with by the Australian Energy Market Commission's (AEMC) 2015 rule determination.

Question 2: Should a scheme include incentives or cost recovery for supporting infrastructure?

We do not support the introduction of incentives or cost recovery for supporting infrastructure.

Ausgrid is of the view that the introduction of incentives or a cost of service regime for supporting infrastructure is highly unlikely to be supported by a robust cost-benefit analysis. We therefore do not consider this to be an option which would represent value for money for customers.

Question 3: Should a scheme provide financial incentives?

We support the inclusion of financial incentives in the Scheme.

While we agree with the AER's concern that the scheme might over-incentivise demand management activity, the Rules provide the AER with the discretion to modify the incentive level to correct for any imbalance. Ausgrid is of the view that any modest excess incentives will be offset by the development of a healthy and competitive alternative to network investment.

In our experience, the "D-factor" Demand Management Incentive Scheme which operated in NSW between the years of 2004–05 to 2013–14 was effective in encouraging networks to consider and implement demand management solutions to meet network needs. In this period, Ausgrid delivered more than 30 demand management projects with over 80 percent of Ausgrid's demand management implementation costs sourced from external service providers. These included providers of customer power factor correction equipment, embedded generator services, and customer energy efficiency equipment and services.

Question 4: How can we link incentives to performance?

Ausgrid supports the linking of incentives to performance, but expresses caution about the introduction of a prescriptive approach which could hinder flexibility or stifle innovation.

When linking incentives to performance, we understand that the AER may have concerns about which deliverable to incentivise and a desire to minimise compliance costs. Ausgrid considers that any concerns from stakeholders and the AER can be met through the requirement for appropriate consultation and consideration of market-led non-network solutions. For those projects subject to the Regulatory Investment Test (RIT), the compliance obligations under 5.17 of the Rules may offer a sufficient level of certainty that the non-network solutions selected are cost efficient. For projects not subject to the Regulatory Investment Test, a less formal process may be more appropriate given the level of expenditure involved. This may be limited to the publication of an options paper and, following this, a final report.

Question 5: How should we determine the magnitude of financial incentives?

Ausgrid supports an incentive level derived from an estimate of the upstream value of non-network solutions relating to demand management or a revenue uplift based on a target rate of return. In our view, the calculation of these financial incentives does not present any significant challenges.

While we expressed a preference for an incentive based on a share of net-market benefits in our submission on the AER's *Consultation Paper*, we would support a scheme based on a revenue "uplift" derived from a target rate of return. Alternatively, the uplift could be based on a percentage of costs, such as under the Network Capability Improvement Incentive Scheme. The NSW "D-Factor" demand management incentive scheme, which Ausgrid applied to deliver 30 demand management projects over a 10 year period, used the uplift approach.

In determining the magnitude of financial incentives, Ausgrid is of the view that the AER should have regard for the current immature state of the demand management market and the likely modest scale of total scheme incentives over the near to mid-term. We would note that at present replacement expenditure comprises the majority of network capital investment—which typically requires greater network support and consequently a higher cost in comparison with peak load type constraints. Considering the discretion available to the AER to adjust incentive levels, we would recommend erring towards higher incentive levels in the near term to help build market capability and encourage a competitive market.

Question 6: How should the Scheme account for interactions with other incentives?

At this stage, we do not consider the Scheme should account for interactions with other incentives.

Ausgrid notes that the AER is currently consulting on a review of the service target performance incentive scheme (STPIS). We consider any changes (if needed) can be addressed via that review.

Question 7: Should we apply an Allowance Mechanism

Ausgrid supports the implementation of a demand management allowance mechanism.

In our view, the Allowance Mechanism should provide an effective funding arrangement for electricity distributors to engage in efficient demand management research and development projects that have the potential to reduce long term network costs. We also consider the issue as to whether a demand management allowance mechanism should be introduced has already been dealt with by the AEMC's 2015 rule determination.

Question 8: What type of Allowance Mechanism would best achieve the NEO?

In our view, the AER should design an Allowance Mechanism which combines, with some refinements, options 1 and 2 in the AER's *Consultation Paper*.

We consider the combination of these options would best achieve the Allowance Mechanism objective by maximising the efficient research and development of both small and large cap demand management projects. We refer you to our comments in our submission to the consultation paper dated 23 February 2017.

If you have any queries or wish to discuss this matter in further detail please contact Craig Tupper, Manager — Demand Management and Forecasting, on (02) 9269 2277 or via email ctupper@ausgrid.com.au.