AUSTRALIAN
ENERGY
COUNCIL

Mr Warwick Anderson
General Manager, Network Regulation
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2600

20 April 2017

By email: DM@aer.gov.au

Dear Mr Anderson,

Re: Demand Management Incentive Scheme and Innovation Allowance Mechanism: AEC submission following AER workshop April 6, 2017

The Australian Energy Council (AEC) welcomes the opportunity to respond to the Australian Energy Regulator (AER) on the Demand Management Incentive Scheme (DMIS) & Innovation Allowance (DMIA) proposals following its options workshop in Melbourne on 6 April 2017.

The AER had recognised many of the competitive market issues created by the DMIS and DMIA proposals in its consultation paper. The options workshop provided a suitable opportunity to directly address and discuss the concerns of stakeholders, and we commend the AER on their consultative approach.

Summary

In general, merchant market participants at the workshop agreed that under the incentive regulation regime DNSPs have a strong financial incentive to invest in long term capital expenditure (capex) over operational expenditure (opex) solutions in any demand side investments. Providing financial incentives for DNSP's to undertake demand side investments under alternative schemes (including the DMIA & DMIS) will have limited success unless they are inefficiently generous. In the long run, they will add unnecessary costs to consumers for limited benefits.

Our first preference is that the AER refrains from making major changes to the DMIA or introducing a DMIS. The introduction of a DMIS, or significant change to the DMIA, in the current regime is not likely to change the investment bias DNSPs currently have towards capex.

We may need to accept the AER is legally obliged to implement a DMIA & DMIS in time for the next regulatory determinations. Given the inability of these schemes to address the DNSP investment bias towards capex, marginal changes to the schemes to reduce the inefficient costs associated with them are preferred. These include:

1. Maintaining the "status quo" for the DMIA;
2. Setting at close to zero any "uplift" payment on the amount spent by a DNSP on a demand side project under a new DMIS; and
3. Adopting a procurement only model for these schemes, thereby exposing competitive providers to the technical information and price signals that indicate where and when network support services are most valuable.

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We acknowledge that sharper pricing signals in new distribution pricing arrangements could encourage DNSPs to make efficient expenditure decisions in the long term. However various prohibitions on cost reflective pricing means that other changes are required to the incentive framework to address the commercial (and eventually the cultural) bias that DNSPs currently have towards capex over any opex solutions.

Capex v Opex bias

AusNet Services view is that an uplift in the range of 30-50% balances the objectives of providing a sufficiently strong incentive to DNSPs to change behaviour, and ensure consumers receive value from the scheme[1]. This view goes some way to illustrate why distributors may have a capex bias.

DNSPs prefer to invest in long term capital investments that are rolled into their regulatory asset base (RAB) and receive the allowed rate of return (WACC) over the life of the assets. Under the incentive framework the AER approves the capex 'ex-ante' allowing cost recovery over the life of the asset. Even when an investment is inefficient ex-post, DNSPs still recover the cost of that investment.

Favourable regulatory arrangements like this have resulted in a commercial and cultural bias towards long term capital investment solutions applied by DNSPs. As a result, DNSPs have built up large RABs providing them with stable long term cash flows.

Without major changes to the current regulatory arrangements, DNSPs will have no real incentive to invest in demand side solutions to reduce overall demand (or more importantly peak demand). Investing in demand side investments under the current regulatory arrangements would only limit their opportunity to build the more desirable long term capital investments.

Consequential effects

The great disadvantage of obligations upon the AER to implement the DMIA and DMIS is that there is a convergence of technical innovation and improvement, evidence of increasing consumer interest in participation in demand side activity, and the growing value of the wholesale and network energy peaks. This convergence means that DNSPs are not the best party to make these investment decisions.

The DNSPs willing haste to position themselves at the centre of any market model[2] needs to be viewed in the light of their potential to crowd out more efficient service providers from the Demand Response/Network Support market in the short-term. This crowding out diminishes productive efficiency, and would have a chilling effect on competition and technological development in the market in the long-term. This in turn diminishes dynamic efficiency.

Direct investment by DNSPs in distributed energy storage and distributed generation is a form of vertical integration. Vertical integration is generally more likely to result in the exercise of market power if at least one of the segments of the integrated entity is a monopoly. In these circumstances distributors are much more likely to have the incentives and ability to leverage the monopoly power they have to restrict competition.

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[1] Response to Demand Management Incentive Scheme and Innovation Allowance Consultation Paper, Ausnet Services, February 2017

[2] ENA/CSIRO NTR, ENA DMM

Allowing distributors revenue which includes an uplift on the amount spent on a demand management project so that they receive an 'instant return' on their investment provides further monopoly leverage for them to restrict competition unless accompanied by strict controls, such as a prohibition on direct investment by DNSP's, and strict ring fencing.

Broader reforms

The AEC is proponent for a suite of rule changes currently under Australian Energy Market Commission (AEMC) consultation[3]. These rule changes clearly intersect and overlay with the AER's consultation on the Demand Management Incentive Scheme and Innovation Allowance Mechanism. Part of the AEC rule change is that DNSPs must procure network support services externally where they are provided by an asset that provides services in addition to the conveyance of energy.

In practice this requires broad approaches that:

- Consider the classification of Distribution Services;
- Exclude DNSPs from direct investment in customer side or beyond the meter (BTM) assets; and
- Change the Regulatory Investment Tests (RIT) to ensure competitive non-network solutions are considered for the widest practicable range of investment decisions.

The AER has recognised in its consultation paper that to be truly effective that the framework also needs to reinforce competitive neutrality, i.e. maximise the scope for independent competitive providers to supply network support services to networks. To do this the competitive providers need to be exposed to the technical information and price signals that indicate where and when network support services are most valuable. These prices would ideally seek to put monetary values to any and all services that can be provided by BTM assets.

A range of regulatory tools are related to this and should be considered as being in scope in this regard, including:

- Legal separation of unregulated affiliates and strong ring-fencing[4];
- Cost allocation guidelines;
- The inadequacy of the DAPR, and better information provision of where on the network support services may have most value; and,
- Access to cost-reflective tariffs

The rule change also called for an examination of the incentive schemes such as the Demand Management Incentive Scheme (DMIS) and the Efficiency Benefits Sharing Scheme (EBSS). In particular to ensure they cannot be gamed by DNSPs to share benefits with an affiliate and thus gain advantage over other providers.

As raised at the AER workshop on 6 April, we recognise that altogether this represents a broad-ranging suite of reforms, the amendments proposed require careful and combined consideration, and should not be undertaken in a piecemeal manner.

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[3] Amendments to Chapters 5, 6, 6A and 7 of the National Electricity Rules in the Implementation of Demand Response and Network Support Services, Australian Energy Council, October 2016

[4] AER Ring Fencing Guideline Final Decision, November 2016

Legal obligation to implement DMIA & DIAS

The AER is legally required to implement a DMIA & DMIS under the AEMC Demand Management Incentive Scheme, Rule Determination of August 2015.

As argued above, because the cultural and commercial bias to invest in capex remains strong, providing financial incentives for DNSPs to undertake demand side investments under any alternative scheme (including the DMIA & DMIS) is likely to have limited success unless they are inefficiently generous.

Therefore, in the first instance, the AEC prefers that the AER refrain from making changes to the DMIA and from introducing a DMIS. If this is not permitted under the rule, then a contract market approach as discussed at the AER's 6 April Forum remains the next best interim approach.

Nevertheless, because the AER is legally required to implement a DMIA & DMIS before its next regulatory determinations, we prefer that any changes to the DMIA (or DMIS) are limited in their scope. This will help to reduce the inefficient costs of these schemes and other consequential effects.

Proportionate changes to DMIA & DMIS

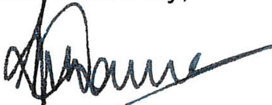
If the AER determines that it is legally obliged to implement both a DMIA & DMIS in time for the new regulatory determinations, then we would support the following approach to the DMIA & DMIS:

1. Status quo for the DMIA;
2. If the DMIS does necessitate an uplift value greater than zero, we urge the AER to consider the development of the market in the longer term and set the uplift allowance as close as practical to zero; and
3. Adopt a procurement only model for these schemes, exposing competitive providers to the technical information and price signals that indicate where and when network support services are most valuable.

For the removal of doubt, other generous solutions like the 'net market benefit' option are not supported.

Should you have any questions in relation to this rule change request please contact David Markham, telephone 03 9205 3111 or david.markham@energycouncil.com.au.

Yours sincerely,



Sarah McNamara
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