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Mr Warwick Anderson
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By email: DM@aer.gov.au

Dear Warwick

Demand management incentive scheme
Draft demand management innovation allowance mechanism
Drafts for review August 2017

The Major Energy Users (MEU) welcomes the opportunity to provide its views to the AER on the draft demand management schemes. Except where detailed below, the MEU generally supports the AER draft schemes.

In principle, the MEU supports the concept of providing incentives to the networks to deliver better outcomes for consumers. Equally, the MEU is concerned that over the years, regulators and rule makers have implemented incentives that have resulted in considerable harm to consumers, both current and future.

In this regard, the MEU points to some examples of over-incentivisation:

- The incentives embedded in the revised energy network rules in 2006 (electricity transmission), 2007 (electricity distribution) and 2008 (gas transport) where there was an excessive incentive to invest in network assets. The results of this excessive incentive will be felt for decades to come.
- The NCIPAP incentive scheme for electricity transmission networks, where the incentive was poorly structured and projects were undertaken just to utilize the allowance provided, many of which provided little value to consumers but increased their costs

It is clear that the AER has devoted considerable effort to develop the two schemes, and the MEU notes that the predominant input to the AER discussions has been provided by networks. The Explanatory Statements provided by the AER about each of the schemes provides clarity as to why the AER has elected to implement certain options and the MEU accepts the concepts embedded in the explanations detailed.

At its most fundamental, the investment made by consumers (whether as an incentive – DMIS – or as a grant - DMIAM) to get better outcomes from networks, the payments made must deliver a net benefit to consumers. If they do not, then the scheme becomes merely a mechanism to increase network profitability.

With these thoughts top of mind, the MEU provides the following observations about the two schemes – demand management incentive scheme (DMIS) and the demand management innovation allowance mechanism (DMIAM)

DMIS

The MEU has concerns at the size of the bonus payment and the fact that it is paid ex ante.

- The MEU has concerns (as expressed by others during the development of the scheme) that the opacity of the RIT-D has with regard the selection of the alternatives because the network has control over the entire process. This means that the network is expected to identify non-network options as part of the RIT-D process. If the network does not identify a non-network option, this does not mean that the process for identifying non-network options has been exhaustive, although the AER hopes that the size of the incentive will encourage the networks to be exhaustive in their investigations.
- Because the incentive payment is a percentage premium to the size of the DM cost, this provides an active incentive for the network to seek the highest cost DM option rather than the lowest. The scheme needs to be adjusted to ensure that the lowest cost DM option is the one implemented. One way of achieving this would be to assess each DM option in terms of the total cost to consumers (ie DM cost plus bonus) to determine which DM program (or network option) delivers the lowest all up cost for consumers. Another refinement would be to assess the bonus in terms of value to consumers rather than the cost to networks
- Paying the DMIS bonus ex ante assumes that the DM program will be completed. However, the MEU can envisage where the DM program is terminated early from a number of causes (and therefore would not deliver the benefit to consumers) yet the bonus will have been paid. Does the AER expect that the network will return the bonus if the DM program does not get completed?
- The AER has justified the 50% bonus on the DM scheme on the basis that it reflects the equivalent of 6.5 years of return at the current WACC used for networks. The MEU can envisage that a DM scheme might operate to defer a network augmentation for just one year and therefore consumers have avoided the cost of a network option for the same period. Despite this, the size of the bonus implies that consumers would anticipate getting a greater

benefit than just one year of network augmentation deferment. Equally, the DM program might be extended for a number of years, and cause consumers to pay more than the deferment warrants. For example, if the DM program is extended annually, then over four years, consumers would have provided bonuses totaling 26 years of a WACC reward less the 4 years of the deferment – a net 22 years of WACC reward – yet extending the DM program annually would cost the network very little other than the DM payments which consumers pay for anyway.

DMIAM

The MEU is concerned that the decisions about which projects are to be followed through lie entirely with the networks (subject to some ex post assessment the AER might impose) and that there is no certainty that the projects will deliver benefits to consumers or even that projects will be "invented" so that the allowance will be spent.

- One way to ensure that projects are likely to be delivered and provide value to consumers is by requiring that the projects get some form of pre-approval. A feature of the NCIPAP was that projects were to be included in the revenue reset documentation which gave consumers an opportunity to assess the merits of the projects proposed; this approach should be used for the DMIA.
- The NCIPAP also requires projects to have a notional payback of 4-6 years maximum if they are to be implemented. The MEU considers that projects undertaken by the networks under the DMIAM should also be considered to have a similar payback.
- The MEU is not a supporter of allowing the networks "free rein" as to which projects should proceed. A frequent criticism of the previous DMIA was that projects proposed by a network had already been carried out by another network. While the MEU recognises that the mechanism does aim to prevent this occurring, the MEU considers that there needs to be a process where it can be demonstrated ex ante that each project proposed is new and not being a replicate of another earlier project. This could be effected by projects having to be included in their revenue reset process (like the NCIPAP) as noted above. To assist consumers provide a view about the projects suggested, the AER could include in its Issues Paper its views as to whether each project included in the DMIA is demonstrably a "new" project and not a repeat of an earlier one.
- The MEU also notes that there are multiple networks seeking to expend their DMIA, and that, in total, networks would be provided with some $10m each year for DMIA projects. So even though the process outlined for the DMIAM seeks to prevent duplication (see table 3 in the draft mechanism), it is possible that different networks will initiate similar projects at the same time. This can be, in part, avoided by each network providing details of each proposed project at its revenue reset so that duplication can be avoided. If in a reset proposal, two different networks propose similar projects, the AER would have to decide which network was to proceed with the project.

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We appreciate the opportunity to have provided this input to the drafts of these two schemes. Should you wish for amplification of any of the comments provided in this response, please contact our Public Officer (David Headberry) on 03 5962 3225 or at davidheadberry@bigpond.com .

Yours faithfully

David Headberry
Public Officer