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12 October 2017

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Via email: DM@aer.gov.au.

Dear Warwick

Draft Demand Management Incentive Scheme and Innovation Allowance Mechanism

AusNet Services welcomes the opportunity to respond to the AER's draft decision on the Demand Management Incentive Scheme (DMIS) and Demand Management Innovation Allowance Mechanism (DMIA). While the two regulatory arrangements are separate, they have related objectives:

- The DMIS provides distribution businesses with an incentive to undertake efficient expenditure on non-network options relating to demand management.
- The DMIA provides distribution businesses with funding for research and development in demand management projects that have the potential to reduce long term network costs.

The AER's guiding philosophy is that it should improve incentive regulation to deliver long term benefits for customers in accordance with the National Electricity Objective. In this regard, the AER has stated:

> "*It is our view that our proposed demand management incentive scheme should assist the industry in taking a more balanced approach in considering solutions from both the demand-side and supply-side. Taking a broader, more holistic view should support distribution businesses in making investment choices that deliver the most value to electricity consumers.*
>
> *It is important for us, the AER, to also take a holistic view. This means exploring other ways to improve the way we regulate so that distribution businesses use*

> *demand management whenever doing so is in the long term interest of consumers.*"[1]

AusNet Services strongly supports incentive regulation as the best means for achieving the National Electricity Objective. In relation to demand side management, AusNet Services supports many aspects of the proposed DMIS and DMIA arrangements, and we support the AER's intention to introduce these schemes as soon as possible through a Rule change. Under current arrangements, Victorian customers would be denied the benefits of the proposed schemes until 1 January 2021, without good cause.

Demand Management Incentive Scheme

In relation to the DMIS, AusNet Services has identified two areas where the AER's proposed scheme could be further improved:

- The 50% cost multiplier should be fixed for the duration of each regulatory period. The current proposal to allow changes during the regulatory period unnecessarily introduces regulatory risk and uncertainty. AusNet Services considers that the standard regulatory practice of maintaining incentive parameters for the duration of the regulatory period should also apply to the DMIS.

- The compliance reporting requirements should be less onerous by focusing on the information required to administer the scheme. At present, the proposed information requirements include annual ex post assessments of the benefits from delivered demand management projects, which will impose significant costs on distributors and, ultimately, customers.

AusNet Services considers that these relatively modest changes to the proposed DMIS would have a significantly positive impact on the value the scheme delivers to customers. Further detailed information on the rationale for our proposed changes is provided in Attachment 1 to this letter.

Demand Management Innovation Allowance

In relation to the DMIA, AusNet Services supports the AER's approach, including the extended reporting requirements so that the benefits from innovation can be shared across the sector. A continuation of the DMIA is essential in fostering innovation to deliver long term savings to customers.

However, the proposed increase in AusNet Services' allowance represents an overall real decline from the annual allowance it received in 2011, when it was first subject to the scheme. This is a disappointing outcome given the speed of development and change in energy technologies and demand management techniques and the intent to encourage networks to enhance their innovation in demand management.

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[1] AER, Fact Sheet, Draft decision: Demand management incentive scheme and innovation allowance, 28 August 2017, page 1.

In addition, the extra reporting requirements will impose an additional cost, such that the value of the allowance is further eroded. On these bases alone, AusNet Services considers that a further increase in the proposed allowance is warranted.

While AusNet Services acknowledges that funding for demand management innovation is available from other sources, such as ARENA, this is a relatively new development and there is no guarantee of its consistency. A contribution from the business is required to secure ARENA funding, so ARENA funding is a supplement to rather than a true alternative to DMIA funding.

To enable AusNet Services to bolster its demand management innovation activities, and additional consumer benefits, an increase in the innovation allowance is required. This would allow AusNet Services to deliver some of the unfunded but beneficial projects proposed during the 2016-20 EDPR[2]. These projects include testing an automation platform for C&I demand response and trialing thermal storage to manage C&I cooling loads. Details of these projects are contained in Appendix 9A of AusNet Services' Regulatory Proposal.

Information on the consumer benefits of DMIA projects delivered to date are included in Attachment 2.

AusNet Services welcomes further engagement in this process. If you would like to discuss this submission in further detail, please contact me on 03 9695 6309 or by email charlotte.eddy@ausnetservices.com.au

Yours sincerely,

Tom Hallam
General Manager Regulation and Network Strategy
AusNet Services

[2] In AusNet Services' 2016-20 determination process, it proposed a material increase in its innovation allowance to $2m per annum. The AER maintained the current $600k per annum, on the basis that it was appropriate to allow the level of the allowance to be considered at the whole-of-industry level in the current review.

Attachment 1: Detailed comments on the Demand Management Incentive Scheme (DMIS)

1. Introduction

AusNet Services strongly supports the AER's draft decision in seeking to improve the regulatory incentives in relation to demand side management. As an electricity distributor, AusNet Services has an important role in exploring innovative demand side solutions that deliver better outcomes for our customers.

The unprecedented transformational changes on our networks requires us to find better solutions to meet our customers' energy needs. It is timely that the AER is also exploring regulatory innovations to promote efficient non-network investments.

AusNet Services supports many aspects of the AER's proposed DMIS, including:

- The AER's decision to broaden the definition of eligible projects, which will ensure that demand management projects are not inadvertently excluded from the incentive payments.
- The AER's minimum project evaluation requirements, which places reasonable requirements on the distributor to seek demand management solutions.
- The AER's choice of a cost multiplier approach as an incentive arrangement, which is preferable to the alternative options considered.
- The AER's proposed cost multiplier of 50% and its decision not to make any adjustment to the other incentive schemes (STPIS, EBSS and CESS) to account for demand management projects.

AusNet Services has identified two areas where the proposed DMIS could be further improved:

- The cost multiplier should be fixed for the duration of each regulatory period, which is a principle applied consistently across all incentive schemes.
- The compliance reporting requirements should be less onerous than proposed in order to reduce the costs of the scheme and deliver improved outcomes for customers.

Each of these proposed improvements is explained below.

2. Updating the multiplier in the Scheme

The AER proposes that the cost multiplier is set in the DMIS rather than in the distribution determination. This approach allows the AER to vary the cost multiplier at any time by varying the scheme. As such, the cost multiplier is not set for the duration of the regulatory period.

The AER explains that while it may adjust the cost multiplier over time, the new incentive will only apply to new projects prospectively (that is, the AER will not apply an ex-post adjustment for projects that distributors have already committed). Therefore, distributors will make investment decisions having regard to the existing cost multiplier, while the AER has flexibility to change the cost multiplier. It regards this flexibility as particularly valuable given the market for demand management appears to be rapidly evolving.

The AER also provides the following examples on how the multiplier may change in response to the operation of the scheme:

- *Downwards if there are compliance breaches under the Scheme.*

- *Downwards, but also possibly upwards in response to regulatory changes that affect distributors' incentives to undertake efficient demand management. Since the regulatory framework is evolving to better facilitate efficient investment decisions, we consider an upwards movement unlikely.*

- *Downwards, but also possibly upwards in response to market changes that affect the likelihood of distributors undertaking efficient demand management. We consider the market for demand management services is new and growing and will likely develop to provide more relevant and efficient services. These developments should increase the likelihood that distributors will undertake more efficient demand management.*

- *Upwards if distributors face a greater imbalance in incentives against demand management than was initially considered when setting the cost multiplier.*

AusNet Services notes that the AER considers that its flexibility in resetting the cost multiplier part-way through a regulatory period will not expose the distributor to regulatory uncertainty because the change will only apply prospectively to projects that are not committed. On this basis, the AER considers that it can obtain the benefits of increased flexibility without exposing distributors to uncertainty that will affect their investment decisions.

The AER's reasoning on this point is flawed because only 'committed projects' are protected from changes in the cost multiplier. A committed project is one where:

(a) The distributor enters into a demand management contract with another legal entity to procure the demand management required to deliver that preferred option; or
(b) An officer or employee of the distributor, delegated by the chief executive officer of the distributor, approves a proposal for the distributor to provide in-house demand management services.

As such, the distributor faces significant resource costs and lead times, including contract negotiations with third parties, in taking a proposal to 'committed project' status. If the AER announces that the DMIS cost multiplier is to be reviewed, distributors will not proceed with projects that are 'in the pipeline' but unlikely to reach 'committed project' status prior to the AER's completion of its DMIS review. Contrary to the AER's reasoning, therefore, the flexibility to amend the cost multiplier during a regulatory period will significantly detract from the effectiveness of the scheme by creating regulatory risk.

Increased regulatory risk undermines the incentive schemes designed by the regulator. The effectiveness of incentive regulation depends on providing regulatory certainty, which is achieved by the regulator committing to clearly defined parameters that apply for the duration of the regulatory period. The AER's proposal to revisit the cost multiplier rate during a regulatory period will undermine the objectives of the scheme.

AusNet Services accepts that the cost multiplier may change from time to time, but it should not be changed part-way through a regulatory period. This principle applies to each of the AER's incentive schemes, and there is no reason to treat this scheme any differently.

3. Compliance reporting

Clause 2.4 of the draft DMIS requires distributors to submit a demand management compliance report to the AER annually, no later than four months after the end of the regulatory year. The compliance report contains two parts:

- Part A provides information on committed projects; and
- Part B provides information on projects that the distributor has identified as eligible projects.

AusNet Services supports compliance reporting in relation to projects that attract an incentive payment under the scheme. However, the scheme only provides incentive payments in relation to <u>committed</u> projects, not eligible projects. The compliance reporting therefore seeks information on projects that may not proceed and for which the distributor is not entitled to an incentive payment.

While AusNet Services expects that most projects will progress from 'eligible' status to 'committed', reporting on eligible projects will add to the compliance burden for no discernable benefit. AusNet Services therefore considers that compliance reporting should be confined to providing information on committed projects, not eligible projects.

In relation to committed projects, the AER summarises its proposed reporting requirements as follows:

> *"The distributor must include data pertaining to expenditure incurred in the past regulatory year for which it is seeking incentives. Data must include sufficient information for us to verify what outcomes were achieved due to that expenditure. Specifically, this includes listing the committed demand management projects and reporting the kVA per year of demand management delivered under committed projects. It also includes reporting on the benefits the distributor estimates the demand management to have realised."*[3]

As noted in the above excerpt, the AER requires the distributor to provide on-going estimates of the benefits obtained from delivered demand management projects. The AER intends to collect

[3] AER, Explanatory Statement, draft Demand Management Incentive Scheme, August 2017, page 47.

this information because it believes it will provide useful data on the efficacy of the scheme, which the AER will publish in an annual performance report:

> *"The annual performance report will assist us in identifying if there is merit in altering the magnitude of the cost multiplier in a future version of the Scheme."*[4]

AusNet Services is concerned that estimating the actual annual benefits from delivered demand management projects is a non-trivial exercise, which is inconsistent with the ex ante design of the scheme. The AER discusses the benefit of an ex ante design in relation to the calculation of incentive payments as follows:

> *"Accruing the incentive ex ante also has the benefit of a low administrative burden. In considering example projects, we formed the view that the administrative burden of ex post review, particularly for projects that extend over a significant period, would be high. Some example projects that we identified could run for up to 25 years. Other measures, such as paying the incentive ex post but within a set number of regulatory control periods, would only have a marginal impact on lowering the administrative burden."*[5]

The AER's observations regarding the administrative burden of conducting ex post reviews are also applicable to compliance reporting. The estimation of the ex post benefits from delivered projects will be a very onerous task, which is unlikely to provide much useful information on the efficacy of the scheme. As demand management projects may deliver benefits over 25 years, the calculation of annual actual benefits over this period will impose significant costs on distributors. Furthermore, the efficiency of a project with a 25 year life cannot be assessed solely on the basis of its early years of operation.

AusNet Services notes that the regulatory framework has been designed to obviate the need for ex post reviews of expenditure, by providing strong financial incentives to ensure that actual expenditure is prudent and efficient. In contrast to this design, the AER's compliance reporting includes an ex post review of delivered projects, with all the associated costs and challenges.

In summary, AusNet Services' view is that the compliance requirements should be substantially reduced so that they focus on the information needed to administer the DMIS efficiently. AusNet Services recognises the need for the AER to review the performance of the scheme. However, the costs of such a review will be minimised if the information sought is targeted to address the identified issues of concern at that time. In the meantime, a more focused approach to compliance reporting will reduce the costs of implementing the DMIS and maximise the benefits to customers.

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[4] Ibid, page 48.

[5] Ibid, page 52.

Attachment 2: Overview of Benefits of Demand Management Innovation Allowance Projects Delivered by AusNet Services

- Grid Energy Storage System

In 2012 AusNet Services initiated a trial of a Grid Energy Storage System (GESS). This trialled the use of a large battery storage system to manage peak demand on the distribution network and explore other potential benefits, including power quality improvement and providing supply to an islanded group of customers as a minigrid. The trial is currently in its final stage, and planning is underway to enhance and re-deploy the GESS in a remote network location where it will operate as part of the network on an ongoing basis and deliver significant reliability benefits to around 1,000 customers. The trial has also enabled deeper engagement with commercial parties that are looking to build and connect large scale storage to our network, and to evaluate the network benefits that such systems may provide.

- Residential Battery Storage Trial

This DMIA-funded project has been completed. The trial informed the development of suitable connection policies for battery storage and has enabled us to build understanding of battery storage, enabling engagement with providers from a more informed position. Through this engagement we have investigated specific network opportunities with commercial providers, including managing peak loads on distribution transformers, 22kV feeders and SWER lines.