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12 October 2017

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 260

Submitted electronically: DM@aer.gov.au

Dear Mr Anderson,

Re: Demand Management Incentive Scheme

Summary

Red Energy (Red) and Lumo Energy (Lumo) welcome the opportunity to respond to the Australian Energy Regulator's (AER) Demand Management Incentive Scheme (DMIS).

Red and Lumo do not support the AER's application of the DMIS. Our concern lies with the DMIS not being able to mitigate the perceived bias towards capital expenditure (capex) over operating expenditure (opex) with the mechanism detailed in the Draft Decision.

Further, we are concerned the AER implementing the generous DMIS at this time will result in sub-optimal outcomes and unintended consequences specifically as it applies to the Distribution Ring-fencing Guideline (the Guideline).

We note that distribution regulation is subject to change, as there are rule changes are currently being progressed that will likely restrict Distribution Network Service Providers (DNSPs) from directly investing behind the meter, and we know the Australian Energy Market Commission (AEMC) has committed to undertaking a broader review of the incentive regulatory framework in 2018. As such, changes to the DMIS could be considered futile.

This submission will detail these concerns.

General principles of incentive regulation

Providing financial incentives for DNSPs to undertake demand side investments under alternative schemes like the DMIS will most likely have limited success. These "band aid" solutions fail to address the bias that currently exists for DNSPs to invest in capital expenditure investments over demand side solutions.

Red and Lumo agree that DNSPs prefer to invest in long term capital investments (compared to opex solutions) that are rolled into their regulatory asset base (RAB) recovering an allowed return over their economic life. Under the incentive framework, the AER approves the capex ex-ante that allows cost recovery over the life of the asset. Even when an investment is inefficient ex-post, the DNSP still recovers the cost of that investment.

Similar favourable regulatory arrangements have led to a DNSP capex investment bias over demand side projects. As a result, DNSPs have built up large RABs providing them with stable long term cash flows.

Without a thorough investigation into the incentive regulatory arrangements that have contributed to the capex investment bias, DNSPs will continue to overlook demand side solutions. To properly mitigate this issue, we consider it is necessary undertake a holistic review

of the incentive arrangements to investigate the key reasons for any bias further. In this regard, we support the the AEMC review of the incentive framework scheduled to commence next year.

Broader review of the incentive framework required to properly address lack of DNSP demand side investment

Red and Lumo consider that a broader review of the DNSP incentive regulation arrangements is necessary to properly understand the reasons for the DNSP capex investment bias. It is only in these circumstances that an improved understanding of the circumstances will be understood.

Therefore, we support the AEMC's decision to undertake a broader review of the incentive regulatory framework as part of the 2018 Electricity Network Economic Regulatory Framework Review to address this problem next year.

In the AEMC's contestability of services draft decision, the AEMC makes reference to the cultural bias that DNSPs have towards capex under the incentive regulation framework¹. They themselves argue that a review of the incentive framework will be required as part of its 2018 Electricity Network Economic Regulatory Framework Review to address this problem.

If AER decides to apply a DMIS we prefer a small uplift payment

Red and Lumo consider that providing DNSPs with a 50% uplift payment provides greater financial leverage to DNSPs to award demand side contracts to their own independent affiliates by allowing the affiliate to price the demand side option more aggressively than their competitors. As a result of this, we would support the AER monitoring this outcome by developing a guideline that requires DNSPs to report on any transactions between a DNSP and its affiliated entities.

Our firm view is the application of a significant DMIS at this time will have a limited ability to address the DNSP's capex investment bias. We would be more comfortable with the AER providing a marginal uplift to continue to encourage DNSPs to investigate and utilise demand side options (where appropriate), with the opportunity to review the scale of the uplift following resolution of the regulatory processes highlighted above. It will just lead to additional costs being passed on to consumers with minimal success in terms of delivering more demand side by DNSPs.

As such, if the AER decides it must apply a DMIS, we prefer that it only includes a marginal uplift payment of less than 10%. Given our concerns regarding its ability address the current DNSP investment bias towards capex, this amount is reasonable without adding undue costs being passed onto consumers.

Interaction with the Distribution Ring-fencing Guideline

Red and Lumo are concerned a DMIS that includes a significant uplift payment has the potential to undermine the Guideline. Specifically, this change may impact the discrimination provisions in the Guideline which includes a range of specific obligations on a DNSP not to favour a DNSP related service electricity provider.

¹ AEMC - Contestability of Services - draft rule 29 August 2017 p. 55

"The AEC's proposed changes to the RIT-D, planning framework and cost allocation are designed to address perceived biases exhibited by DNSPs under the existing regulatory framework. The AEMC considers that these biases relate to the incentives provided to DNSPs under the incentive regulation framework and are separate from the core focus of the rule change requests - the introduction of contestable frameworks for inputs to standardised control services related to behind the meter assets. The AEMC considers that these broad issues need to be addressed within a review of the overarching incentive design, not within a rule change request targeted at contestability of energy services. The AEMC will be undertaking the review of the incentive framework within the 2018 *Electricity network economic framework review*."

For example, when a DNSP awards a contract to a third party (including a ring fenced affiliate) it has an obligation to award a contract to the party that provides the solution under the RIT-D investment option that maximises the net benefit to consumers. Alternatively, if the investment relates to a reliability option, the DNSP will award the project to the party that provides the least cost solution.

However, if a DNSP uplift payment of 50% on opex is introduced under the DMIS, this provides a greater financial leverage to award demand side contracts to their own independent affiliate by allowing the affiliate to price the demand side option more aggressively than their competitors. Any loss that the DNSP incurred in doing this to keep these projects within the same corporate group will be offset by the 50% uplift payment awarded to the DNSP.

Therefore, we urge the AER to fully consider the broader impacts and unintended consequence of the DMIS before it confirms its final determination.

If the AER confirms the decision to maintain the 50% uplift payment, then we consider it essential for the AER to require greater transparency of contracts between a DNSP and a ring fenced affiliate, in particular regarding Section 3.2.1 of the Guideline. While we are not convinced that this would adequately address the matters raised above, transparency will provide an improved understanding of any demand side contracts entered into between DNSPs and their ring fenced affiliates.

Early application of the DMIS

On the basis of the submission above, Red and Lumo do not support the AER's proposed rule change allowing eligible DNSPs to request approval to apply the DMIS midway through an existing regulatory control period. We consider this a controversial rule and that it is likely to have unintended consequences as described above. Red and Lumo will provide further views to the consultation when the rule change is lodged.

About Red and Lumo

Red and Lumo are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria, New South Wales, South Australia and electricity in Queensland to over 1 million customers.

For any further enquiries regarding this submission, please call Con Noutso, Regulatory Manager on 03 9976 5701.

Yours sincerely

A handwritten signature in black ink, appearing to be "Ramy Soussou". The signature is stylized with loops and a long horizontal stroke at the end.

Ramy Soussou
General Manager Regulatory Affairs & Stakeholder Relations
Red Energy Pty Ltd
Lumo Energy Australia Pty Ltd