Paula Conboy
Chair
Australian Energy Regulator
Email: DM@aer.gov.au

20 April 2017

Re. Demand Management Incentive Scheme and Innovation Allowance Mechanism

Dear Ms Conboy

Thank you for the opportunity to provide a supplementary submission on the Demand Management Incentive Scheme (Scheme) and Innovation Allowance Mechanism (Allowance Mechanism). This submission should be read in conjunction with the Energy Efficiency Council (EEC)'s previous submission.

The EEC is the peak body for energy management. The Council is a not-for-profit membership association, and its goal is to make sensible, cost-effective energy management measures standard practice across the Australian economy. Our members include independent experts, businesses and various levels of government.

The Australian Energy Regulator (AER) must put in place a substantial Scheme and Allowance Mechanism, in order to drive investment in demand management and reduce expenditure on network infrastructure. This is critical to meet the National Electricity Objective (NEO), *"to promote efficient investment in, and efficient operation and use of, electricity services for the long-term interests of consumers…"*.

The EEC is extremely concerned that the AER appears to be considering only modest strengthening of the existing Scheme. If the AER fails to put in place a material Scheme there is a high likelihood that several States and Territories will introduce their own mechanisms to force or encourage Network Service Providers (NSPs) to invest in demand management.

There is widespread concern among governments, experts and consumers that NSPs have overinvested in network infrastructure and underinvested in non-network solutions, and this has contributed to rapid escalation in network prices. Network prices have increased rapidly in Australia – in real terms by 120 per cent in NSW and 140 per cent in Queensland between 1997 and 2013[1]. International research by UBS found that, between 2007 and 2013, network costs rose faster in Australia than any other country they examined[2].

During the AER's forum on the Scheme and Allowance Mechanism on 6 April 2017, there were a number of arguments expressed for only weakly enhancing the current Scheme, which could be summarised as:

- The regulatory problems around NSPs have either already been addressed or will be shortly addressed (e.g. shifting to a Total Expenditure (TotEx) model); and
- Concerns that a strong Scheme will result in overinvestment in demand management.

[1] EY 2014, *Electricity network services: Long-term trends in prices and costs*.

[2] UBS 2014, *Global Power Utilities - Rising power tariffs create a risk of regulatory intervention*

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The EEC strongly rejects both of these arguments, and believes that a strong Scheme and Allowance Mechanism are essential.

Regulatory Problems

It is clearly incorrect to suggest that there are either no regulatory problems that encourage NSPs to underinvest in demand management, or that these problems have already been addressed. Extensive reviews by the Australian Energy Market Commission, Productivity Commission and several Senate Committees have identified major distortions in the regulatory system, and the majority of these distortions have yet to be addressed.

Given the pace of reform in energy regulation, it is also highly unlikely that the many problems in the economic regulation of NSP will be resolved in the near future.

Furthermore, even if the suite of policies that are being considered are introduced, this will not resolve all the distortions that lead to overinvestment in network infrastructure and underinvestment in non-network solutions. For example, the EEC supports the introduction of more cost-reflective network tariffs, but the introduction of nodal pricing is highly unlikely and, even with genuinely cost-reflective tariffs, without an incentive for action by NSPs, it would be almost impossible for consumers to independently coordinate demand management activities to avoid or defer network investment.

Risk of over-incentivising demand management

Given most NSPs' cultural bias against demand management, the risk of NSPs undertaking too much demand management is negligible.

More critically, the AER will assess NSPs' demand management proposals to determine whether they are cost-effective at meeting consumers' needs. If the AER's processes are appropriate, this will ensure that only cost-effective demand management projects proceed, and should mitigate the risk that NSPs overinvest in demand management.

The remaining concern is whether NSPs will be over-rewarded for undertaking demand management. This issue can be effectively dealt with in the Scheme design, and the level of reward for demand management is likely to be non-material for consumers' bills in comparison to the level that NSPs have been excessively rewarded for investment in network infrastructure. Therefore, applying extreme caution to the level of incentive for demand-management would be a case of misguided priorities.

Design of the Scheme and Innovation Allowance

A strong Scheme and Innovation Allowance are required to address three separate issues:

1. Correcting of distortions in the current rules and regulations that make it more attractive for NSPs to invest in networks infrastructure than demand management
2. Rewarding networks for the externality benefits of demand-management (e.g. reduced wholesale electricity prices)
3. Reforming NSPs' cultures and capabilities, which encourage investment in network infrastructure over demand management.

While ideally regulatory distortions would be addressed through correction of the rules, and externalities would be addressed through the development of healthy markets for those services, in practice both of these will take years to implement and develop.

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Therefore, the EEC supports the development of a Demand Management Incentive Scheme. There is no single tool that can perfectly address the three issues identified. Therefore, the EEC recommends that the Scheme include:

- A price signal to:
    - Overcome the distortions that favour expenditure on network infrastructure over expenditure on demand management; and
    - Reward NSPs and third parties for non-network benefits.

  This incentive would ideally be based on outcomes delivered (e.g. peak demand reduction) rather than output (e.g. size of investment).
- Minimum targets for demand management activity by NSPs, in addition to a requirement for NSPs to report demand management metrics.

The EEC does not have detailed recommendations on the level of incentive or size of the target at this time, and looks forward to reviewing a proposal from the AER.

The EEC provided recommendations on the Innovation Allowance in its last submission.

Within these broad boundaries, we note that there is a significant risk of the 'perfect being the enemy of the good'. Most developed jurisdictions in the world have mechanisms that require NSPs to invest in demand management when it is more cost effective than building network assets. While some of these mechanisms are crude, they have resulted in a more cost-effective mixture of demand-side and supply-side investment, reducing costs for consumers.

The absence of an effective Demand Management Incentive Scheme has driven up electricity costs for consumers. Continuing to delay the introduction of an effective Scheme will result in further inefficient investment and higher costs for consumers.

Summary

The EEC recommends that the AER introduce a strong, material Demand Management Investment Scheme and Innovation Allowance as soon as practicable. If the AER does not introduce an effective scheme it will likely contribute to the further fracturing of a national approach to electricity regulation.

We look forward to being involved in this process as it proceeds. Your office can contact me on 0414 065 556 or via rob.murray-leach@eec.org.au.

Yours sincerely

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