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24 February 2017

Mr Warwick Anderson
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Mr Anderson

Essential Energy submission on the consultation paper for the demand management incentive scheme and innovation allowance mechanism

Essential Energy welcomes the opportunity to provide feedback on the consultation paper for the demand management incentive scheme (DMIS) and innovation allowance (DMIA) mechanism.

On the whole, we support the scope of the proposed scheme. The DMIS must be available to assist in funding the least cost demand management solution, whether the project is a:

- Distributor led installation, where the non-network assets are used solely to provide network support and funded by the DMIS; or
- Third party led installation where the network support benefits from the non-network asset can be acquired by the distributor under the DMIS.

We certainly see merit in formalising a net-market benefit sharing approach to ensure consistent treatment between distributors in considering the costs and benefits of potential projects. This approach should formalise the inclusion of any associated increase in customer prices arising from the implementation of a demand management measure for distributor's operating under a revenue cap in determining the net market benefit of the project.

We also see merit in the DMIS including a mechanism that targets improved network utilisation. Such an approach would better suit Essential Energy's voltage constrained network, as opposed to a capacity constrained network, by ensuring efficient and effective use of network assets.

Essential Energy sees potential overlap between the DMIS and Western Power's proposed rule change on alternatives to grid-supplied network services, where the investment in a stand-alone power systems benefits demand management.

In terms of the DMIA, we believe the existing mechanism works fairly well. On this basis, we support either the option of a minor extension to the status quo or the high cap allowance with ex-ante approval option. Both these options recognise that distributors are best placed to make demand management decisions concerning their network. They are also administratively less burdensome on both distributors and the AER. More importantly, they ensure that the long term interests of each distributor's customers are met, as project funding is both relevant to the distributor's circumstances and accurately reflected in customer prices.

We have provided answers to the questions raised in the consultation paper as an attachment to this letter. If you have any questions regarding our submission, please do not hesitate to contact Natalie Lindsay, Manager Network Regulation, on (02) 6589 8419.

Yours sincerely

Gary Humphreys
Deputy Chief Executive Officer

Attachment - Answers to questions posed in the consultation paper

1. Do stakeholders support our interpretation and proposed implementation of the new rules? If you have alternative views, please share these and provide supporting evidence.

The DMIS must be available to fund the least cost demand management solution, whether the project is a:

- Distributor led installation, where the non-network assets are used solely to provide network support and funded by the DMIS; or
- Third party led installation where the network support benefits from the non-network asset can be acquired by the distributor under the DMIS.

This is consistent with the view in the AER's ring-fencing guidelines which allow distributors to undertake non-network solutions where they are used solely for network support. It is only where alternative revenue streams are sought from a non-network asset that the services of a third party provider (which can be an appropriately ring-fenced affiliate) need be utilised.

On another note, we believe it is worth including a general statement in the introduction of the Guideline that demand reductions will not always equate to a net benefit for customers on voltage constrained networks. As the owner of a voltage constrained network, as opposed to a capacity constrained network, Essential Energy has an issue with the implication throughout the consultation paper that a reduction in demand will always equate to a benefit. This may well be the case for a thermally constrained network i.e. "strong" networks, where a reduction in demand has no negative consequences and augmentation related consequences are not incurred until the summated reduction is equal to the magnitude of the original demand (but of the opposite sign or direction).

On a voltage constrained network, however, increasing levels of distributed generation and/or a reduction to demand whilst maintaining peak load will often require augmentation to be undertaken at a cost to customers. Whilst distribution transformer tap settings are able to compensate for voltage sag along the length of a feeder, augmentation is required as voltage bandwidth increases. The increase in bandwidth (ignoring losses) is the same whether peak demand is increased, or minimum demand is reduced by the same amount.

2. Do you agree with our view on the main demand management incentives (or disincentives) provided under the regulatory framework and the potential issues associated with these incentives?

Please provide reasons to support any alternative views you may have.

It is worth noting that distributors operating under a revenue cap may still be somewhat disincentivised to reduce energy when such a reduction will necessarily equate to an increase in customer tariffs. Customer impacts are a key concern to distributors and, given stakeholder feedback largely informs regulatory submissions and tariff structure statements, there is increasing pressure to keep customer prices as low as possible. The associated increase in customer prices arising from the implementation of a DMIS measure should, therefore, be formalised as a cost inclusion in the DMIS cost-benefit analysis. This should be considered as part of the net market benefits approach raised in the paper and dealt with in question 3 below.

Given the relatively low levels of expenditure undertaken by distributors on demand management activities to date, Essential Energy disagrees with the comment in section 5.7.1 that there is a greater risk of setting a demand management target that is too high. We believe this is of less concern given the current state of the market and the AER's ability to alter targets as required.

3. Do you see value in exploring this option further, despite the difficulties associated with measuring net-market benefits? If yes, what detail of guidance should we provide on calculating market-wide costs and benefits? Should we (and if so, how should we) establish a method for valuing smaller demand management projects in a way that reduces the administrative burden of applying the Scheme to these projects?

Essential Energy sees value in exploring the net market benefit sharing option further. A consistent approach would ensure that all distributors consider both the potential up-stream and down-stream costs and benefits in undertaking a demand management project in the same manner, possibly resulting in more demand management projects being undertaken.

As outlined in our response to question 2 above, this analysis should include the resulting increase in customer tariffs arising from the application of a revenue cap form of price control as a cost of the scheme.

Smaller demand management projects would need a faster and less burdensome process than the current RIT-D. We are happy to work with the AER to develop such a process.

Calculating market benefits involves complexity and requires input and engagement with market participants and stakeholders. Essential Energy strongly encourages the AER to facilitate a cross industry perspective to calculating market-wide costs and benefits. Essential Energy would be pleased to be involved in establishing a guideline with the AER and other industry participants.

4. Since the RIT–D already requires distributors to select the option with the highest total market benefit, should we (and if so, how should we) treat RIT–D projects differently under this type of Scheme?

RIT-D projects should be treated the same as smaller demand management projects under this scheme. The main point is to ensure that the total market benefit is used to incentivise and determine the success or otherwise of the demand management decision.

5. How might we best combine the mechanisms discussed in section 6 above into an option that achieves the Scheme's objective?

If you prefer a mechanism that we did not discuss in in section 6, please provide details on this mechanism.

Essential Energy supports all of the mechanisms discussed in the consultation paper and would suggest the AER conduct a workshop with relevant parties in determining a final option.

Having said that, a mechanism that targeted improved network utilisation would better suit our voltage constrained network, by ensuring more efficient and effective use of our network assets. As outlined in our response to question 1, the consultation paper is currently geared only towards thermally constrained networks. There is a risk that on voltage constrained networks the incentive may provide perverse signals that result in augmentation expenditure.

6. If you have views against applying any of the particular mechanisms discussed in section 6, please provide reasons to support this view.

We do not have any issues with the mechanisms discussed in the consultation paper.

7. How we might best give effect to or enhance the information and reporting requirements discussed in section 6.5 above?

Essential Energy is happy to provide information and reports, however, it is important to appreciate that these activities are not costless exercises. As such, we would appreciate it if the requirements were not too onerous, nor duplicative of other existing (or soon to be in existence) regulatory requirements.

8. Which of the options discussed above in section 7 would best achieve the Allowance Mechanism's objective? Please provide reasons supporting your view.

If you prefer an Allowance Mechanism design that we did not discuss as an option in section 7, please provide details on this option.

Essential Energy believes option 1 - Minor extension to the status quo and option 2 - High cap allowance with ex-ante approval would best achieve the allowance mechanism's objective. We provide the following reasons to support this view:

- The distributor's own customers directly benefit from the distributor's expenditure, unlike option 3 – Bidding to encourage 'ground breaking' R&D;
- They provide greater flexibility as to whom (distributor or third party) performs the work, which is important in the more remote areas of Essential Energy's network area where third party participants are not active or where their travel costs may result in a higher cost solution;
- The distributor is best placed to understand the particular issues likely to be seen on its local network, assess the relative merits of competing projects for application to these issues and apply limited funding appropriately;
- Ground-breaking R&D (option 3) has a poor rate of success. Essential Energy planned to test promising products from two businesses with near commercial technologies who both went bankrupt, resulting in the loss of most of the intellectual property.
- Third-parties are already actively engaged to perform non-network solutions for distributors, especially given NSWs Accredited Service Provider (ASP) scheme – over 50 per cent of Essential Energy's expenditure has been paid to third parties. Option 4 seems to imply there is some sort of market failure, which is certainly not evident in NSW;
- They make better use of a distributor's limited staff resources and are administratively easier for both distributors and the AER. Option 3 requires the AER to run a bidding process and would result in unsuccessful bids being a waste of distributors' time and effort and option 4 requires the distributor to administer an auction process.

9. If you have views against applying any of the particular mechanisms discussed in section 7, please provide reasons to support this view.

As discussed in the second part of our answer to question 8 above, options 3 and 4 are less desirable for the reasons noted.

10. How we might best give effect to or enhance the information and reporting requirements discussed in section 7.5 above?

Essential Energy sees value in enhancing information and reporting requirements, however it is important that the level of information and reporting provided are commensurate with the value of the project. DMIA amounts are generally very small and in the interests of ensuring the efficient use of limited staff resources, information and reporting efforts should reflect this value and the overall risk to customers.

Thought should be given as to exactly what information and reporting is required by the market and brevity (for example bullet points) should be encouraged wherever possible.