28 February 2017

Mr Warwick Anderson
General Manager, Network Regulation
Australian Energy Regulator
GPO Box 3131
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Email: DM@aer.gov.au

Dear Mr Anderson

RE: DEMAND MANAGEMENT INCENTIVE SCHEME CONSULTATION PAPER

Origin Energy (Origin) appreciates the opportunity to provide input to the Australian Energy Regulator's (AER) demand management incentive scheme and innovation allowance mechanism consultation paper.

Origin supports the AER's ongoing reforms to promote more efficient network expenditure outcomes and specifically how distribution businesses should undertake investments that deliver net benefits to consumers.

The Power of Choice Review set out a market-wide reform program to give electricity consumers more opportunities to understand and take control of their electricity use and associated costs. In relation to distribution networks, the reform program included a number of key Rule changes. With respect to demand management these included the obligation on the AER to develop and apply a demand management incentive scheme and innovation allowance mechanism to help balance the incentives on distribution businesses to make efficient expenditure decisions.

The current regulatory framework places an obligation on distribution businesses to consider non-network options as alternatives to network investment in certain circumstances though their annual network planning and specifically the regulatory investment test for distribution (RIT-D). The purpose of the RIT-D is to ensure that distribution businesses consider all credible options (both network and non-network) when choosing how to address a constraint on the distribution network. In other words, only the most efficient solution to a network problem is approved for recovery in regulated revenues.

On this basis, if a demand side management project is the most efficient solution over the life of the asset taking into account avoided or deferred expenditure, it should be identified in the distribution network's investment assessment as such. If the uptake is low, this implies that either: 1) demand side management projects are less efficient than traditional solutions; 2) the current planning framework is not operating as intended; or 3) the financial incentives in the regulatory framework are biased in favour of certain types of investment.

We believe a key reason for the relative low uptake of demand side management projects are the investment incentives between opex and capex. Specifically, we consider the existing framework incentivises distribution business to pursue capex solutions due to the higher return on expenditure over the life of the asset. Furthermore, we consider that a threshold of $5M for the RiT-D does not promote a sufficiently transparent project appraisal framework to demonstrate how all credible options have been considered and costed, including the treatment of avoided future costs.

For these reasons, we believe that it is necessary for the AER to critically assess whether additional incentives are in fact needed or whether the impediments to the uptake of demand management can

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be resolved by modifying the current framework. In undertaking this assessment, we also believe that the AER needs to fully take into account the number of ongoing reforms, notably network tariff reform and the distribution market model which we believe are likely to encourage the uptake of demand management activities.

Origin's responses to specific issues raised by the AER with respect to the schemes design and allowance mechanism options are set out below.

Type 1: Mechanisms to target potential disincentives

The current regulatory framework consists of multiple mechanisms that interact with one another and are collectively critical to providing incentives and signals. It is imperative that all mechanisms operate in tandem and as intended to ensure the completeness of the regulatory framework. When aspects of any of these mechanisms are modified to accommodate or promote a particular investment over others there is a risk of unintended consequences.

Therefore the role of the regulatory framework should be to establish a framework that incentivises a network to pursue the most efficient solution and to penalise the business for inefficient investments.

For these reasons, we believe that the AER needs to exercise caution in modifying any of its existing schemes. For example, a customer's price reflects a particular level of service and security of supply. When a network fails to deliver the level of service commensurate with its regulated revenue allowance it is penalised. If demand management projects are afforded lower performance thresholds this suggests that customers may receive a lower level of reliability than what they are paying for.

For these reasons, we do not agree with compromising the STPIS or other schemes to lessen the performance obligation on the network to promote demand management. We believe this would be both inefficient and inequitable. We believe providing distribution businesses confidence in the robustness of demand side management and behind the meter solutions can be best resolved through better signalling of network constraints as discussed below.

However, this is not to suggest that certain incentives within the current regime should not be adjusted, provided they retain the objective of promoting efficient outcomes. As Origin understands, the current framework requires that the AER must accept the forecast of required expenditure if the AER is satisfied that the total of the forecast expenditure reasonably reflects the efficient costs of achieving the expenditure objectives.

In deciding whether or not it is satisfied, the AER must have regard to, among other matters: the substitution possibilities between operating and capital expenditure; whether the capital expenditure forecast is consistent with any incentive scheme or schemes that apply to a distribution business; and the extent a distribution business has considered, and made provision for, efficient and prudent non-network options.

However, we believe that there is an incentive for a distribution business to prefer capital expenditure. The reason being is that operating costs are expensed and recovered within the regulatory year that they are incurred. They are effectively a pass-through; notwithstanding a distribution business can achieve some efficiency rewards from outperforming their benchmark allowance.

Capital expenditure on the other hand attracts both a return on debt and a return on equity. Shareholders achieve a return on their investment based on the return on equity component. Therefore, the incentive for shareholders is to maximise the capital investment. We believe this produces a perverse incentive towards capital solutions and acts as an impediment to the uptake of demand side management and other non-capital solutions. To resolve this, the AER should examine how the savings from non-network solutions that accrue from deferred or avoided capital spend are allocated between consumers and the distribution businesses.

Furthermore, we consider that greater scrutiny around the project appraisal framework including greater obligations on distribution businesses to provide information around network constraints and the estimated timing of the system limitation is necessary. This in turn will provide markets participants with information that would assist in developing the market for behind the meter storage availability and provide the distribution businesses more confident around the firmness of the non-network offer. The information presented by the AER in section 5.5 of its paper represents an appropriate set of information in this regard. While this type of information disclosure is necessary it is not sufficient. We also believe that the current RiT-D threshold is too high and does not allow transparency and scrutiny around distribution business decision making. We believe this threshold should be lowered. In lowering this threshold, there will be a trade-off between administrative burden and greater transparency of information. Notwithstanding, we believe an optimal balance can be achieved between cost and market benefits from greater disclosure. We also recognise that this is the subject of a Rule change request submitted by the Australian Energy Council.

Type 2: Net-market benefit sharing

Origin recognises that in some cases demand management projects may deliver benefits that extend beyond the distribution network. The AER suggest that a benefit sharing mechanism could result in a network receiving a financial benefit based on a proportion of the market benefits and avoided or deferred network costs as well as compensation for any foregone profit due to a reduction in throughput volumes.

We consider that the AER needs to exercise caution in examining a market benefit scheme. We support examination of how avoided or deferred network costs and foregone profit should be allocated; the data for which should be relatively accessible. However, the calculation of market benefits will be more contentious with potentially unreliable data and what constitutes a benefit or a negative outcomes across the supply chain open to dispute. Furthermore, it is not clear how a market benefit payment would be funded and how material this could be over time.

We are concerned that a net-market benefit sharing scheme would be administratively complex, could generate uncertain long-term outcomes and create uncertainty in the market regarding the treatment and definition of market benefits and costs.

Type 3: Mechanisms to promote competition

We strongly support mechanisms that promote competition and the involvement of third party providers.

We believe a market-driven investment environment is the best means to provide long-term efficient price signals and investment. We consider that the importance of market-driven price discovery should not be underestimated. Where competition is weak, access to information and contracts (or their equivalent) typically become more sensitive. This is of particular relevance when there is a dominant participant in the market, such as a monopoly network.

For these reasons we support a model where networks disclose to the market information around emerging constraints and system limitation in advance. We also believe this model needs to be supported with a lower threshold for the RiT-D.

We believe that a lower RiT-D and an evolving market in distributed energy will promote the uptake of demand management. Where non-network parties are in control of the supply of behind the meter storage this will promote different service offerings reflecting the value the market places on this service, which in turn drives efficient investment. The critical role of the distribution business in this market is making available information necessary for informed decision making that fairly coordinates this transaction. As mentioned above, the AER has identified examples of such information in its paper.

For this reason, the planning framework should signal to the market in a transparent and accessible format where behind the meter storage may be a practicable solution in specific geographic locations and over what time period.

Type 4: Targets for demand management deployment

We do not support a regime where a network would receive rewards if it achieves pre-determined non-network targets based on identified constraints. As stated above, we believe a market-driven investment environment is the best means to provide long-term efficient price signals and investment. Otherwise there is a risk that pre-determined targets could create perverse investment signals that generate inefficient investment outcomes.

Demand Management Innovation Allowance Mechanism

As stated above, Origin strongly supports market based outcomes. We believe that distribution networks should be encouraged to pursue research and development to drive efficiency and innovation, as occurs in competitive markets.

The Rules state that the objective of the demand management innovation allowance mechanism is to provide network businesses with funding for research and development in demand management projects that have the potential to reduce long term network costs. We agree with the AER that in light of complementary reforms that a conservative approach should be taken in terms of the value of the allowance. We also support an approach where distribution businesses are encouraged to partner with third parties. In this regard we consider the option where a pool of funds is made available to the most promising projects warrants further consideration.

Closing

The regulatory framework should promote the lowest cost combination of demand and supply side options to deliver services that are in the long term interests of consumers. We believe there are impediments within the existing regulatory framework that if removed could promote greater uptake of efficient non-network solutions.

For these reasons, we do not consider that an incentive scheme is necessarily required to balance outcomes, rather that the elements of the existing framework that are contributing to this imbalance are addressed. These include the investment incentives between opex and capex and the existing distribution planning and RiT-D process.

In undertaking its analysis, we also believe that the AER needs to fully take into account the number of ongoing reforms, notably network tariff reform and the distribution market model which we believe are likely to encourage the uptake of demand management activities.

We would welcome the opportunity to discuss our view further with the AER. If you have any questions regarding this submission please contact Sean Greenup in the first instance on (07) 3867 0620.

Yours sincerely

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