21 April 2016

Mr Warwick Anderson
General Manager
Australian Energy Regulator
By email: DM@aer.gov.au

Dear Mr Anderson

Additional note on AER demand management workshop

SA Power Networks welcomes the opportunity to provide additional comments on the Australian Energy Regulator's **(AER)** development of a new demand management incentive scheme **(scheme)** and innovation allowance mechanism **(innovation allowance).**

Our detailed responses to the AER's consultation paper are covered in our submission of 24 February 2017. However, we wish to comment on key issues the AER raised at its workshop of 6 April 2017.

Scheme considerations:

- Need and purpose: We believe the AER should develop a new and 'higher–powered' scheme, targeting key underlying issues affecting the relative merit for distribution network service providers (Distributors) in pursuing demand management compared to traditional options such as building poles, wires and other traditional assets:
  - A Distributor's main consideration is whether to pursue capital expenditure (capex) or operating expenditure (opex) options in delivering the monopoly service of providing a distribution network.[1] The scheme's focus should therefore be on matters influencing capex and opex trade–offs. **To this end, we support the direct approach identified in the AER's consultation paper of a simple incentive uplift added to any efficient demand management opex incurred.**
  - Incentives tied to Distributors running bidding processes or designing standard–form contracts represent unnecessary levels of micro–management that could distort and constrain the emerging demand management market rather than enable it. Distributors are incentivised to seek out efficient options including via outsourcing, and contract design will evolve over time as technology matures and alternative providers emerge in greater number and with greater corporate stability.
- Neutrality: A new scheme must be neutral between a Distributor's in–house option versus outsourcing decisions, in keeping with the fundamental intent of the regulatory framework.
- Coverage: A new scheme must apply to all approaches by which demand on networks can be managed, and **not be limited to managing peak demand** by virtue of any incentive bonus being linked to peak demand reductions:
  - Peak demand is unlikely to be the primary overall focus for Distributors based on most available and acceptable demand forecasts; and
  - There are greater concerns going forward in needing to manage the challenges of significantly increasing volumes of Distributed Energy Resources (DER) being connected to networks, including managing minimum or negative demand and associated technical conditions (e.g. network voltage, system frequency and other technical parameters). These challenges will present key opportunities for DER technologies and providers of these technologies.

1 This is, by assessing the net present value of capex or opex options.

- Simplicity and transparency: A new scheme must be simple to apply, administer and verify for resulting benefits. Any demand management scheme will present verification challenges and this is not avoided by focussing solely on peak demand. To avoid burden on Distributors and the AER, the simplest approach is to not tie the scheme to a rigid measure such as a demand reduction or some measure relating to voltage parameters. The scheme should instead apply a simple notional bonus amount (i.e. a percentage) onto any demand management opex spent / incurred, with the efficiency of these spends determined in line with the AER's existing approaches to assess and incentivise regulatory expenditures, as follows:[2]
  - *Expenditure included in five–yearly regulatory proposals:* demand management expenditures Distributors are able to forecast[3] in their regulatory proposals can be assessed at that time by the AER much like any other expenditure.
  - *Expenditure undertaken during a regulatory control period*:
    - Any demand management expenditure actually incurred, including on projects unforeseen at the time of the regulatory proposal would be deemed as efficient expenditure. This keeps with the premise of the ex–ante incentive framework. Within this framework, the AER does not approve specific project expenditure but rather, overall allowances, leaving capex, opex and service performance incentives to guide decisions on the most efficient and prudent activities to undertake given prevailing conditions as the regulatory period proceeds.
    - Distributors would only incur demand management opex if it generates other capex and opex savings, as by incurring demand management opex, a Distributor will risk either facing a penalty or a smaller benefit under the Efficiency Benefits Sharing Scheme (EBSS).
    - Major projects would, and currently are, subject to public transparency and consideration of alternatives (including those provided by third–parties) via the Regulatory Investment Test.
    - If further information is required, Distributors could report on demand management opex similar to how we already report annual use of the current innovation allowance. This could include specifying what the demand management opex was used for, for example: if the expenditure was on customer rebates, contracts with external service providers for demand / voltage response, opex to maintain a Distributor's battery storage or generator or other purposes.
- Regulatory framework interactions: the AER must clarify key regulatory interactions, including:
  - Its intended treatment of demand management opex if included in Distributors' five–yearly regulatory proposals. While unrequired by the National Electricity Rules, the AER's last regulatory determinations took a strict approach to assessing forecast opex that is unsuitable to demand management. Demand management opex might not be revealed in base–year expenditure as it might not be recurrent. It might also not be accepted as a step change, as the AER has taken a view that these should be limited to permanent opex increases driven by regulatory obligation changes, which demand management might not be; and
  - If demand management opex will be excluded from EBSS calculations so as to avoid Distributors' being penalised (or benefiting less) for undertaking efficient demand management opex.

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2 In this way, the scheme's application is likely to progress incrementally, driven only by actual efficient expenditure. This allows the AER to review the scheme's effectiveness on a gradual basis without potentially having locked in large incentive bonuses, which is a risk that could be presented by target or other schemes.

3 We note it might not always be possible to forecast all required demand management too far in advance of being required.

Innovation allowance

- Need for innovation allowance: in a changing energy market the need for an effective innovation allowance remains. That is, as a means for Distributors to trial (either alone or in partnership with other providers as Distributors deem most efficient and prudent) innovative approaches by which to derive future efficiencies and manage challenges. However, the level of the current allowance is insufficient in many cases to enable significant research and development projects.
- Transparency and efficiency: the use to which an innovation allowance is put and the learnings derived should continue to be made public, and we support sensible measures to ensure that innovation projects are demonstrably adding to the pool of knowledge and not duplicating research undertaken by other parties. This consideration could be included within any ex–ante or ex–post approval process the AER decides to adopt.
- Simplicity: We support an allowance process that is administratively simple and cost effective, so as to not deter Distributors accessing the allowance. This should be a simple extension to the status quo, supplementing the current modest allowance with a more substantial allowance. If greater forward visibility is required, this allowance could be accessed via an ex–ante approval process through the regulatory determination. More complex measures involving bidding systems, or rules compelling Distributors to seek outsourced solutions even when not most efficient, would reduce the effectiveness of the innovation allowance, distort emerging markets and drive unnecessary administrative overhead costs.

If you wish to discuss any of our comments further, please contact Bruno Coelho on 08 8404 5676.

Yours sincerely,

Richard Sibly
A / Head of Regulation