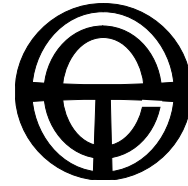


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SUBMISSION

to

Australian Energy Regulator

**Demand management incentives for Energex,
Ergon Energy and ETSA Utilities for 2010-2015**

Proposals and frameworks

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AER Proposals and frameworks

1. Introduction

1.1 Demand management incentives for DNSPs

Total Environment Centre (TEC) welcomes another opportunity for input to discussions about demand management (DM) incentive schemes for distribution network service providers (DNSPs). We are pleased that the Australian Energy Regulator (AER) is devoting attention to the overall concept of DM incentives and support the overall approach, but consider that the schemes devised for each DNSP fall well short of an appropriate environment for promotion of the uptake of DM techniques by these businesses.

This submission is a combined response to four papers from the AER:

- Explanatory statement and proposed demand management incentive scheme to apply to Energex, Ergon Energy and ETSA Utilities over the 2010-2015 regulatory control period.
- Proposed demand management incentive scheme for Energex, Ergon Energy and ETSA Utilities for the 2010-2015 regulatory control period.
- Preliminary positions: Framework and approach paper, Application of schemes – Energex and Ergon Energy 2010-2015.
- Preliminary positions: Framework and approach paper – ETSA Utilities 2010-2015.

Our main recommendations in this submission are:

- TEC supports the development of a national DM incentive scheme for DNSPs.
- TEC supports the development and application of innovation allowances for Energex, Ergon Energy and ETSA Utilities.
- The innovation allowance should be set at 5% of the projected network capital expenditure for each DNSP – the amounts set are far too low to promote extensive DM projects.
- DM targets should be set for each DNSP.
- The D-factor method should be applied to ETSA Utilities for the 2010-2015 regulatory period.
- The AER should undertake a benchmark investigation of DM actions by all DNSPs to date; and this should be published for easy access by all businesses engaged in the electricity sector. This would serve both as provision of examples for businesses to assess; and as a performance indicator. The database could then be expanded as the AER collects more information from the annual reports.
- The AER should ensure that, where there is conflict between incentive schemes, DM is not disadvantaged but rather given priority.
- So far the DM incentive planning is proceeding in a piecemeal fashion and the AER should investigate the potential for further incentives in terms of a whole of industry scenario.

- The Rules should refer to a Demand Management (DM) Code of Practice for distribution networks, with the NSW or SA model to be adopted as a minimum; networks should be obligated to **implement** non-network solutions where they are cost-effective.
- A revenue cap should be applied to distribution networks since they essentially form geographic monopolies and a revenue cap embodies a least-worst scenario for DM.

The discussion in the AER's set of papers begs a number of questions:

1. Has the AER allowed for the possibility of increasing the innovation allowances before the next regulatory period for each DNSP?
2. What other models are being used in other jurisdictions to promote DM (or energy efficiency); and how could they be adapted here?
3. How much DM is actually being done in Australia by DNSPs?
4. What approaches would DNSPs themselves choose as an encouragement to expand their DM programs?
5. What other potential does the AER see in its role for the reduction of greenhouse gas emissions within the NEM? The electricity sector does not operate in a vacuum. Addressing climate change can in fact lead to greater efficiency – there is not necessarily an inherent conflict.
6. What potential does the AER see for DM incentives across the whole electricity industry? This question is raised in the papers but no solution is proffered. Although the types of business are ring-fenced, the system itself is not, therefore this issue warrants further investigation.

TEC encourages the AER to investigate these questions in its development of a national approach to DM incentives for DNSPs. The issues should be approached on the basis of the underlying principles that DM actions can bring a wide range of relevant benefits, and that there has been insufficient consideration of non-network solutions by DNSPs to date.

1.2 Demand management and the NEM

We reiterate from our previous submissions: demand management (DM¹) in all its forms must be recognised as a viable alternative to current attitudes and actions throughout the NEM because of the benefits that it delivers to consumers and the wider market. The NEL Objective is set up to cater for "the long term interests of consumers"; without effective DM this is not being achieved.

There is a distinct lack of conviction displayed in these latest papers by the AER as to the necessity for DM incentives. The purpose of such schemes is not argued strongly and there is repetition of the spurious and unsubstantiated notion that if DM actions were efficient then the businesses would already have been doing them. This is couched in terms of the Rules allowing for cost recovery of DM expenditure that defers capex, the

¹ DM in this submission can be read to include 'demand response', 'demand side management', 'demand side response', 'energy efficiency' and 'non-network solutions'. In general, DM can include both the management of peak loads and energy efficiency as a way of meeting capacity requirements most cost effectively. It includes a diverse array of activities that meet energy needs, including cogeneration, standby generation, power factor correction, fuel switching, interruptible customer contracts, and other load shifting mechanisms.

NEL Objective of promotion of efficiency (if DM spending were efficient it would be allowed) and the reliance on the good sense of a business to undertake proper fiscal behaviour. For instance, in discussing ETSA Utilities, the AER stated that it, "considers it appropriate that the primary source of funding for demand management ... should be the forecast opex and capex allowances approved in the distribution determination."²

These assumptions completely neglect the fact that DNSPs have undertaken very little demand management action to date – which itself is acknowledged in the AER review. On the one hand the AER is arguing that DM has been limited so far across the NEM but it clearly can bring many benefits (including economic efficiency), therefore an incentive scheme would be useful; on the other it is arguing that DM must not be efficient since businesses are adopting so few non-network solutions. This position relies on faulty internal logic.

A prime example of the failings of the status quo is the current determination for the NSW DNSPs. TEC's submission³ noted: "Energy Australia's (EA's) proposal stands out for its excessive claim for \$8.6 billion of capex compared to a mere \$23 million, or 0.26%, for DM. Even if one compares solely the proposed peak-demand related claim for \$2.5 billion to proposed DM (p. 55), the proportion is still vastly inappropriate, at a mere 0.9% of total peak-demand driven spending. [and] Integral Energy's and Country Energy's proposals have failed to even provide projected expenditure on DM ..." (p. 2). These do not represent efficient approaches to DM.

It is all very well to say there are incentives in theory (such as business efficiency); but the fact is that DNSPs are **not** doing very much at all. The Rules contain disincentives; and where non-network solutions are mentioned there they are very lacklustre indeed (which is why TEC has gone to the effort of submitting a Rule change package on the subject to the AEMC).

Moreover, the AER has made no attempt to set out precisely what actions DNSPs have taken so far. There does not seem to have been a rigorous assessment of this and the presentation of the current position relies on a hazy presentation of the status quo based primarily on assumptions only. TEC would agree that little has been done (as was presented in the ISF/TEC paper *Win, Win, Win*⁴, which we have forwarded to the AER), but the AER does not seem to have done sufficient investigation itself and the discussion is only in principle. We would urge the AER to do some thorough research in its development of a national approach.

There is also regular reference to the proposal for innovation allowances being a "modest scheme". It is not clear why the AER feels the need for it to be modest – the majority of stakeholder responses within the review were in favour of a DM incentive scheme, and a

² Australian Energy Regulator (2008) *Preliminary positions: Framework and approach paper, Application of schemes – Energex and Ergon Energy 2010-2015*. June 2008, p. 96.

³ Total Environment Centre (2008). *Submission to AER – NSW Distribution Network Service Providers proposals: 2009-2014*, August 2008.

⁴ Institute for Sustainable Futures (2008) *Win, win, win: Regulating electricity distribution networks for reliability, consumers and the environment – Review of the NSW D-Factor and alternative mechanisms to encourage demand management*. Report prepared for Total Environment Centre, January 2008.

number noted that the allowances set by the AER for NSW had been too small. The AER has thus been given the go-ahead by stakeholders to take a bolder approach than it has displayed in this phase; a modest scheme now means that precious time is being lost until the next determination (seven years away).

1.3 Scope of this submission

We have addressed a number of other issues in the rest of this submission:

- DM innovation allowance
- DM Code of Practice
- D-factor method
- Other models of DM incentives
- Intersection with other incentive schemes
- DM allowance – ETSA Utilities, Energex and Ergon Energy.

2. DM innovation allowance

TEC fully supports the development of DM innovation allowance schemes. They have been insufficiently applied in Australia – SA so far is the only example – and we consider they are well worth testing. Once again, however, like the allocations for NSW and the ACT, the amounts allocated are disappointingly small. We would also emphasise that other stakeholders are of the same opinion, as the AER itself points out in the papers.

As far as the details of the innovation allowance are concerned, TEC supports the major features presented in the papers. We are particularly pleased with the approach of the sum being applied across the whole regulatory period with an associated carryover mechanism (for under/over spends in the regulatory period); this is in effect a bonus/penalty technique that will enhance the use it or lose it approach.

We also support:

- The ex ante (for the whole period) + ex post (annual) approach as it will result in greater accuracy and transparency in decision making by the businesses and the AER, while not being too onerous in terms of administration.
- Compilation and publication by the AER of DM expenditure by the DNSPs.
- The use it or lose it approach.

3. DM Code of Practice

It is curious that the AER has so far apparently not seen fit to investigate the potential for a national DM Code of Practice, since this was a partner method to the D-factor technique in NSW. This Code set out many details concerning proper investigation of DM by DNSPs, and the businesses are required to follow the Code as part of their licensing conditions. SA also has a Code of sorts – Guideline No 12 – which also sets out requirements for DM obligations under the licensing system.

TEC therefore urges the AER to develop a DM Code of Practice for application at a national level. The NSW and SA versions, though containing some flaws, at least would serve as a starting point for such a national code. We note that DNSPs will no longer be

licensed in the form that is now current, but a way could be found around this such as the design of NE Rules that oblige DNSPs to follow the Code.

Such a Code would not only set out requirements that DNSPs must follow, but would serve as guidelines for them to remove uncertainty. For instance, it allows for definition of terminology that the AER would follow in consideration of allowed expenditure. A definition of “innovative” action, for instance, would be helpful along with clear examples, if this is to be one of the criteria the AER will apply (as referred to in the papers).

4. D-factor method

Where a price cap is in place, generous incentives should be developed to encourage DM since this control method contains an inherent incentive to expand the network and increase consumption of electricity by consumers. An innovation allowance is not sufficient in itself and other mechanisms need to be established as well. The D-factor method – where the DNSP must demonstrate that its DM implementation costs are less or equal to the avoided distribution costs before it can pass through any costs to customers – at least has been tested in Australia and found to have some beneficial effect.

The AER decision on the use of the D-factor for the SA DNSP (ETSA Utilities) is a curious one. It has been determined that the D-factor should continue to be applied to the NSW DNSPs, as a continued trial of the method, but not to ETSA Utilities. It is self-evident to TEC that application of the method in SA would constitute a perfect opportunity for a further trial – the AER presents this as a drawback to its application, that is, that it has not been properly tested – particularly since it would allow further testing in a different jurisdiction. The decision is even more peculiar since ETSA Utilities itself supported the idea of its use in SA in its submission (as noted by the AER).

The AER response is another manifestation of the hesitance with which they seem to view DM incentive schemes. TEC acknowledges that the D-factor method has led to only small increases in DM uptake in NSW; nonetheless, it has been in existence for a short time only and changes in approach and internal culture of businesses can require longer timelines than has so far been the case. It also did in fact contribute to some increase in DM, particularly by Energy Australia.

We strongly recommend application of the D-factor method to ETSA Utilities for the next regulatory period. If it continues to result in only minimal uptake of DM in NSW and SA, the situation can be revisited at the time of the next determinations for those states. It seems especially short-sighted to avoid its use at this point when the AER has not yet undertaken a proper assessment of DM incentives at a national level.

5. Other models of DM incentives

From research undertaken to date by the AER and others, it would appear that there is unlikely to be one single model applied in any electricity sector that could be directly transferred to the Australian situation. This research, however, has been far from rigorous and more work should be done by the AER in looking at alternative scenarios. Despite the differences across policy and regulatory environments, there is the potential for some salient features to be useful.

TEC raised the example of the California method in our last submission and a report prepared for TEC by Headberry/Lim⁵ presents a longer discussion of this (on pp. 39-41) than we were able to do – we refer the AER to that report (we have previously forwarded it to the AER). We are not satisfied with the AER's response that this approach has no utility here. We consider the arguments presented as superficial and it would seem there has been no real attempt to consider if any parts of the California model could be applied.

6. Intersection with other incentive schemes

The Headberry/Lim report⁶ also considers the impact on DM of an efficiency benefit sharing scheme (EBSS) (pp. 14-15). They noted that, "The EBSS therefore creates a disincentive for DM by encouraging NSPs to exchange potential DM programs funded by opex for capex programs where profits are greater." (p. 15) The AER has included a provision in the EBSS to exclude opex spent on DM – we support this provision in principle and hope that the AER will make clear to DNSPs the details of that provision and will assess future application of the EBSS to ensure that it is genuinely not operating in conflict with spending on DM. We also support the AER's intent to examine in the future a similar adjustment for delayed capex (as suggested by ETSA Utilities).

The service target performance incentive scheme (STPIS) is addressed in the Headberry/Lim report as well in terms of potential conflict with DM incentives (pp. 13-14). Their conclusion was that, "Thus a side-effect of the performance incentive scheme is to discourage DM solutions by actively encouraging the approach that is perceived to be more reliable: ie by the use of network approaches." (p. 14) Unlike the EBSS, the AER has not found any kind of solution to this problem within the STPIS, but asserts it will give the issue greater consideration in the future. We would urge the AER to ensure that it does further investigation on potential conflict and make certain that DM is endorsed as the primary matter of importance.

In summary, the AER should ensure that, where there is conflict between incentive schemes, DM is not disadvantaged but rather is given priority. We are not fully satisfied that these conflicts have been thoroughly resolved.

7. DM allowance – ETSA Utilities, Energex and Ergon Energy

The AER has set a sum of \$3 million for ETSA Utilities for the whole regulatory period (\$600,000 per year) as a DM innovation allowance. As with the NSW DNSPs, this is a minute sum in relation to ETSA's overall spending and is symptomatic of the apparent conflict suffered by the AER in supporting the principle of DM incentives. It is particularly disappointing considering that ESCOSA set a sum of \$20.4 million as a DM opex allowance for ETSA for the previous regulatory period (2005-2010). Moreover, the AER has given no justification for the sum it has allocated, apart from the fact that it is "modest" – which of course is the problem with it.

⁵ Headberry Partners/Bob Lim & Co (2008) *Does current electricity network regulation actively minimise demand side responsiveness in the NEM?* Report prepared for Total Environment Centre, June 2008.

⁶ Headberry Partners/Bob Lim & Co (2008) *Does current electricity network regulation actively minimise demand side responsiveness in the NEM?* Report prepared for Total Environment Centre, June 2008.

Similarly, the allowance has been set at \$5 million each for Energex and Ergon Energy for the period 2010-2015 – again this could be seen as a purely token gesture.

If the AER seriously supports the concept of an innovation allowance, then it must set serious sums to support the intention. These amounts are minute in relation to a DNSP's annual expenditure. Moreover, the majority of stakeholders who have made comment on the process so far would agree that a demand management incentive scheme is worthwhile, and that the sums allocated should be greatly increased.