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19 April 2017

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

Dear Warwick

Demand management incentive scheme and innovation allowance mechanism

We welcome the opportunity to make this further submission to the Australian Energy Regulator (AER) to assist it in developing its Demand management incentive scheme (Scheme) and innovation allowance mechanism (Allowance Mechanism). This submission supports our earlier submission of 24 February 2017, on the AER's "*Consultation paper: Demand management incentive scheme and innovation allowance mechanism*" (Consultation Paper), however it specifically addresses the issues raised by the AER in its 6 April Workshop.

As set out in our earlier submission, we support a Scheme that provides distributors with an incentive to invest in efficient demand management solutions. While we currently pursue both internally and externally provided demand management solutions where these provide an efficient alternative to traditional network investment, we recognise that the market for these solutions is not mature. Therefore, we strongly support a scheme that would encourage the development of a deeper, more mature market for these solutions.

To date, most of our demand management solutions have involved us making payments[1] to third parties – either to our customers to curtail demand or other third parties providing demand management solutions. Currently, there are no explicit financial incentives to pursue these solutions as we do not benefit from the positive externalities that arise from these projects, which can deliver lower overall market costs.

As set out in our earlier submission, we believe that a key consideration to driving the development of the demand management market involves allowing distributors to secure a fair portion of the benefits from these investments that arise across the supply chain.

The AER's Consultation paper recognises this limitation, stating[2] :

> *"…distributors will not necessarily be able to monetise benefits that their demand management projects bring to other parts of the electricity supply chain."*

The AER's Consultation Paper outlines an option for addressing this, referred to as net market benefit sharing mechanism (Option 2), whereby distributors are allowed to retain a portion of the non-distribution market benefits arising from demand management solutions.

[1] Operating expenditure (opex) payments
[2] AER Consultation paper Demand management incentive scheme and innovation allowance mechanism, January 2017, p.6-40

At its recent workshop, the AER flagged the difficulty associated with accurately estimating the value of the net market benefits arising from the demand management investments that occur at other parts of the supply chain.

We agree that valuing these benefits may not be straight forward. Our earlier submission requested that the AER provide:

> *clarity on how to calculate value of demand management in different levels of the electricity supply chain.*

While we continue to support an incentive mechanisms which share the non-distribution benefits between distributor and consumers, we recognise that developing a methodology for valuing these benefits is likely to be complex and costly for the AER to administer. Such an approach may therefore not support the "simple and administratively straightforward" criteria that that the AER must have regard for in developing the Scheme. It may also unduly hinder the introduction of a scheme to promote the overall objective of the scheme, being to:

> *provide Distribution Network Service Providers with an incentive to undertake efficient expenditure on relevant non-network options relating to demand management.*

To this end, we propose that for demand management solutions which take the form of opex, the weighted average cost of capital (WACC) may provide a reasonable incentive to distributors to further pursue these solutions. For example, if we were to undertake a demand management solution to the value of $2 million, then the market benefit that we would receive under this approach would be $127,400 (where the nominal vanilla WACC is 6.37 per cent).

We consider that the benefit of this approach is that it aligns the principle that the level of incentive should be reasonable considering the long term benefits of customers with the following key criteria:

- Transparent to apply – the AER determines the value of the WACC in its regulatory determinations for each distributor; and
- Simple and administratively straightforward - Allowing distributors to recover an uplift on any opex solution to the value of the AER's approved WACC, is a less accurate scheme than determining a share of the net market benefits, however it is a simpler more straightforward approach that will minimise administrative burden for the AER.

We further consider that this approach is consistent with a "totex" approach to expenditure. In particular, it complements the intent of the Capital Expenditure Sharing Scheme (CESS) and Efficiency Benefit Sharing Scheme (EBSS) to ensure that distributors are provided with balanced incentives to promote efficient spending decisions in terms of the timing, amount and type of expenditure.

We would welcome the opportunity to discuss this submission further with the AER.

Should you have any questions, please contact Stephanie McDougall, Price Review Manager, on (03) 8846 9538 or Stephanie.McDougall@ue.com.au.

Yours faithfully

Andrew Schille

General Manager – Regulatory and Corporate Affairs