



Mr Warwick Anderson
General Manager, Network Regulation
Australian Energy Regulator

Submitted by email: DM@aer.gov.au

27 February 2017

Dear Mr Anderson,

**Demand management incentive scheme and innovation allowance mechanism –
Consultation Paper**

AGL welcomes the opportunity to respond to the Australian Energy Regulator's (**AER**) *Demand management incentive scheme and innovation allowance mechanism, Consultation Paper (Consultation Paper)*, January 2017.

AGL is one of Australia's largest integrated energy companies and the largest ASX listed owner, operator and developer of renewable generation. Our diverse power generation portfolio includes base, peaking and intermediate generation plants, spread across traditional thermal generation as well as renewable sources. AGL is also a significant retailer of energy, providing energy solutions to around 3.7 million customer accounts throughout eastern Australia. In 2015, AGL established a New Energy Services division, with a dedicated focus on distributed energy services and solutions.

AGL considers that demand management programs have a vital role in promoting the efficient utilisation of network infrastructure, and thereby minimising required network investment and operational expenditure and resultant costs to customers. The advent of a wave of new 'smarter' controllable demand side technologies present real opportunities to scale-up the use of demand management programs going forward.

Operation of existing incentives framework

The introduction and renewal of the demand management incentive scheme (**DMIS**) and demand management innovation allowance (**DMIA**) are justified on the basis that there appears to remain a bias to capital expenditure programs. This is despite the current economic regulatory framework seeking to provide balanced incentives on distribution businesses to pursue the most efficient network investment and management pathway, whether this be a network or non-network solution.

As the Consultation Paper notes there are a range of factors, with complex interactions, that lead to this outcome. These include the allowed rate of return, the long term stability of returns on capital investments (particularly under a revenue cap), and comparatively less familiarity with demand management programs. Although there are schemes in place intended to neutralise biases between opex and capex (such as, the Capital Expenditure Sharing Scheme (**CESS**) and the Efficiency Benefit Sharing Scheme (**EBSS**)), there are inherent difficulties in forensically examining the outcomes of these schemes and the benefits which flow to customers given material information asymmetries between the regulated businesses and their regulator.

Although AGL strongly supports the principle of incentivising networks to provide standard control services as efficiently as possible, it believes the economic regulation of the networks as it stands is overly complicated and distorted by the multi-layered incentive schemes that are currently applied. In our experience, these schemes have not encouraged more efficient capital and operating expenditure by networks but have simply resulted in questionable annual accounting practices, highly variable reported expenditures during regulatory periods, followed by tenuous expenditure proposals by networks in the subsequent period. These schemes are highly susceptible to gaming, very difficult for the regulator to critically assess, and provide opportunity for underperforming networks to engineer their spending and accounts to mitigate inefficiencies into the future.

AGL is very supportive of the benchmarking processes used by the AER in its recent determinations that reward highly efficient networks whilst requiring those that are not to improve their productivity. Under this framework, a network that is more efficient than its peers will accrue additional revenue in the current period due to this performance and should continue to do so for so long as it outperforms its peers. With a benchmarking framework in place, it is unnecessary to provide additional incentives for network performance (such as the CESS and EBSS).

Contestability of energy services

AGL notes that two rule change proposals are currently being consulted on by the Australian Energy Market Commission related to the contestability of energy services. These rule change proposals seek to ensure that non-network solutions are considered for the widest practicable range of investment decisions and that these solutions are procured from contestable markets where possible. In this way, the objective of the rule change proposal is aligned with the DMIS objective, namely to encourage distribution businesses to undertake efficient expenditure on relevant non-network solutions related to demand management. However, the departure point between the two approaches is that the rule change proposal is not premised on an acceptance that distribution businesses need yet another incentive overlay to undertake projects that should, where most efficient, be being pursued as a matter of course.

Form of control

There is some emphasis in the Consultation Paper on the deliberate choice of revenue cap as form of control to ensure that distribution businesses are not deterred from actions which lead to a reduction in network throughput. However, it is important to note that demand management is targeted at efficient network utilisation. Programs that seek to shift load or avoid sharp, but narrow, demand peaks are not about reducing network use but improving utilisation factors and making network use more efficient. This is the same rationale for introducing more cost-reflective network tariffs.

Accordingly, AGL counsels against conflating revenue cap regulation with encouraging demand management programs. The prevalence of revenue cap regulation is counter intuitive in an environment where under-utilisation of networks is becoming a significant issue. Disassociating usage and throughput from networks' capital expenditure decisions is nonsensical. Linking revenue to utilisation is more likely to encourage networks to competitively price access to their networks and to introduce tariff innovations (such as rewarding distributed generation exported during network peaks, or 'by-pass' pricing customers for whom it would be economically feasible to go fully off-grid).

Design of DMIS and DMIA

Despite AGL's misgivings about the overall economic framework within which the DMIS and DMIA are being introduced, we consider that certain of the options being canvassed in the Consultation Paper will promote the operation of a scheme and allowance that avoid some of the pitfalls of other schemes, and address some of the barriers to greater deployment of demand management programs:

- **Competitive markets**

In AGL's view, it is critical that the DMIS be designed in such a way as to build on the capacity of the competitive market to deliver demand management programs. As such, we support the AER's proposal to include 'enhances competition' as a key assessment criterion. Requiring network businesses to engage with competitive service providers in the delivery of demand management programs will better assure that such programs are efficient, lower-cost, innovative and have a strong customer focus.

New technologies are providing more advanced ways to deliver demand management programs. However, if network businesses bypass competitive providers when designing and implementing such programs, we are unlikely to see the realisation of potential available innovations, cost reductions and service outcomes from their competitive provision. Further, as a monopsony purchaser of such services, the ability to by-pass the competitive market will have profound implications for the potential for a strong market in demand management services to develop.

Net-market benefits

Competitive service providers can optimise their demand management programs to both meet network needs and address other available value pools (such as energy market values). Co-optimisation of these different potential values promotes the efficient deployment of distributed energy technologies and allows competitive service providers to bid in their demand management programs to network businesses at a lower cost. In AGL's view, this is a better mechanism for ensuring that other potential values are taken into account when weighing potential options than pursuing a 'net-market benefit test' and the associated difficulties in making such an assessment.

Information

AGL agrees that having access to the kinds of information set out on in section 5.5.1 of the Consultation Paper (perhaps with the exception of information on customer appliance stock) is important if competitive providers are to construct realistic and cost-effective proposals. In a competitive process, lack of information generally leads to overpricing bids to allow some contingency to deal with unknown risks and circumstances. Therefore, more effective information sharing can lead to more competitively priced (cost effective) demand management programs.

There currently exists some disparity between different distribution businesses in the provision of information that is necessary to underpin a realistic and effective demand management proposal. However, rather than further rewarding those businesses who already perform well on this metric, the 'targets and benchmarking' process (discussed below) may be a better means of achieving the right level of information provision. An aspirational target for the deployment of demand management programs and scrutiny for underperformance, coupled with a requirement to utilise competitive energy service providers in the design and delivery of such programs, would necessitate improvements in information sharing by those underperforming distribution businesses.

Bidding mechanism and contract templates

AGL considers it essential that distribution businesses be required to procure demand management from the competitive market. However, we consider that for the time being a tendering process will provide a sufficient procedural framework in which this can occur. An externally administered platform may only add cost at this early stage of the developing market in demand management.

There may be some value in developing a template contract for the procurement of demand management programs. Distribution businesses (and indeed the market) are

currently more familiar with contracts for network support that comprise the dispatch of mid-scale distribution-connected generation. These are quite different to demand management programs that can take a variety of forms and may comprise a number of different components, technologies and approaches.

If developed by an independent party with appropriate expertise, a template contract could offer a useful starting point in negotiations on demand management programs, including a reasonable basis for managing and apportioning risk as between the different parties involved. However, counterparties should not be restricted from departing from the template as necessary to reflect the specifics of a particular project, including by making relative risk adjustments.

- **Targets, benchmarking and transparency**

AGL considers that aspirational targets for demand management programs would be a valuable way to underpin the scheme. These could be constructed by reference to the amount of capital expenditure anticipated to be required by distribution businesses to address identified network constraints over the forthcoming period. The aspirational target might be that, say, 50% of this amount be spent on non-network solutions / demand management. This target could ratchet-up over time.

At the end of each year or regulatory period, distribution business performance against the achievement of their aspirational target should be reported on. Rather than imposing penalties for non-achievement of the target, reporting would be used to allow benchmarking of performance across the sector. Reporting should also focus on questions such as the underlying causes of any underperformance, including engagement processes, information sharing and quality of proposals from demand management providers.

AGL supports the AER's inclusion of 'transparent to apply' as a key criterion in the design and implementation of both the DMIS and DMIA. As customers ultimately bear the cost of network spending, it is critical that it be made transparent what demand management programs distribution businesses are deploying, at what cost and what the outcomes of those programs are, including benefits to the distribution business in terms of avoidance or deferral of network augmentation. As suggested in the Consultation Paper, this will require both 'pre-project' and 'post-project' data and reporting.

- **Option value**

AGL agrees that distribution business valuation frameworks tend to be skewed towards capital expenditure programs because insufficient weight is placed on the option value of non-network solutions. The most effective means of addressing this issue would be to require distribution businesses to bear the risk of future asset underutilisation. With a real imperative to avoid asset stranding, distribution businesses would be more likely to properly weight the option value of non-network solutions.

- **STPIS**

AGL agrees that unfamiliarity with and lack of confidence in the performance of demand management programs may deter distribution businesses from procuring demand management in place of traditional 'poles and wires' solutions. Accordingly, there may be value in further exploring the possibility of permitting some leniency in the achievement of STPIS targets where these stem from the unexpected under-performance of a demand management program.

However, as this would effectively result in a transfer of risk from distribution businesses to customers, leniency in these cases should be limited to unexpected or unforeseeable events that impact the performance of the demand management program. It should not allow distribution businesses (or contracted demand management providers) to be absolved from genuine reliability issues with certain demand management solutions that should have been foreseen. Furthermore, if pursued, such a measure should operate on a transitional basis only until the market has greater experience with the performance of demand management solutions.

- **Scope**

We note that the AER has interpreted the revised DMIS as applying more narrowly than its earlier iteration – namely, to encompass only programs which manage demand on the network and not those non-network solutions that assist in the management of network quality issues (voltage, frequency). AGL supports a broader interpretation of the scheme to also include latter type of program as new distributed energy technologies can also be applied to manage such issues. These alternatives should be compared alongside network solutions when a distribution business is determining how to address these issues.

- **Innovation Allowance**

AGL supports the framework set out in section 7 of the Consultation Paper for assessing the relative merits of alternative mechanisms for structuring the innovation allowance.

In AGL's view, the innovation allowance must:

- involve ex-ante approval of, and public consultation on, all spending proposals on a project by project basis. As the Consultation Paper notes, this approach reduces the risk that a distributor spends a large sum of money that they are unable to recover or that customers bear the cost of R&D projects in which they see little value;
- limit spending approvals to genuinely novel applications of particular technologies or demand management approaches. This would limit the potential for a number of distribution businesses to receive funding to trial the same or very similar technology applications or demand management approaches. Option 3 (bidding to encourage 'ground breaking' R&D) could be an effective way of facilitating this;
- require the involvement of a third party competitive service provider in the design and delivery of innovation allowance projects. This will better ensure that the project is firmly framed around potential real-world applications and deployment models as these might be delivered by the competitive market; and
- require detailed reporting and knowledge sharing on the findings of projects implemented under the allowance. The approach of the Australian Renewable Energy Agency may provide a useful template for such knowledge sharing requirements and activities.

As is noted in the Consultation Paper, there are a number of other reform processes currently underway which aim to increase the extent to which non-network solutions are considered and deployed in the place of traditional capital expenditure programs. These include the introduction of more cost-reflective network tariffs, modification to the Regulatory Investment Test via the AER's replacement expenditure rule change proposal, and the contestability of energy services rule change proposals launched by COAG Energy Council and the Australian Energy Council. In AGL's view, to the extent a DMIS is introduced and applied, this should

only be on a transitional basis to bridge the gap until these reforms are implemented and have a tangible impact on the market for demand management.

Should you have any questions in relation to this submission, please contact Eleanor McCracken-Hewson, Manager Policy and Research, on 03 8633 7252 or myself on 03 8633 6836.

Yours sincerely,



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