AUSTRALIAN ENERGY REGULATOR

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9 July 2015

Mr John Pierce
Chairman
Australian Energy Markets Commission
PO BOX A2449
SYDNEY SOUTH, NSW 1235

Dear Mr Pierce

Re: Submission on demand management incentive scheme rule changes

Please find attached our submission regarding the AEMC's draft determination on the National Electricity Amendment (Demand Management Incentive Scheme) Rule 2015.

We would be pleased to provide further assistance to the Commission on this area of reform. If you would like to discuss any aspect of this submission, please contact Adam Petersen on (08) 8213 3458

Yours sincerely

Petersen

For Chris Pattas
General Manager
Network Investment and Pricing

Sent by email on: 09.07.2015

AER submission to the AEMC's demand management incentive scheme draft determination July 2015

Introduction

The AER welcomes the opportunity to respond to the AEMC's draft determination on changes proposed to the National Electricity Rules (NER) concerning the demand management incentive scheme and innovation allowance. We strongly support the goal of creating an environment where physical investments in distribution networks are made only because they are the most efficient, considering all alternatives. The promotion of efficient investment in and use of the network is at the core of the regulatory framework that we administer.

We support a principles based approach that is not overly prescriptive and provides the AER with flexibility. In particular we support:

- The principles based approach that provides flexibility in designing and applying the scheme and allowance to distribution businesses
- The timeframe in which to develop the scheme by 1 December 2016
- Not having to develop a separate guideline given the development of the scheme and innovation allowance under the distribution consultation procedures
- Reporting against the innovation allowance by the distribution businesses and the flexibility for us to determine the appropriate reporting arrangements.

Our submission focusses on the following aspects of the draft determination:

- Principle based approach to the development and application of the scheme and allowance, including market benefits and scheme rewards
- Role of the AER in assessing demand management proposals
- Commencement of the scheme and transitional provisions
- Guidelines and reporting.

Principles based approach to the development and application of the scheme and allowance

In our submission to the consultation paper we considered that a broader focus is required as to whether there are other relevant factors in achieving efficient investment. This included consideration of why pricing and other current measures alone might be insufficient and the potential for demand management to be provided on a competitive basis by other service providers.

As stated by the AEMC, the market is unlikely ever to reach the point where price signals mean there are no network constraints at peak times. We accept that, at the very least, the desired pricing outcomes will take time to be realised and at this early stage it is difficult to see with any certainty what impact this will have on the level of demand management.

The AER is supportive of the principles based approach to the development and application of the scheme and allowance. This will provide the flexibility required to ensure that the scheme can operate effectively in a rapidly changing environment for the provision of network and non-network services. Importantly, the scheme should encourage efficient decisions by distributors to utilise demand management options, including those provided by third parties.

Under this approach the AER will be able to take into consideration the regulatory objectives and incentives in deciding on the design of the scheme, which may vary between distributors and over time. This includes for example making sure efficient expenditure of network and non-network options are balanced and considering the value of demand management through the inclusion of the wider economic benefits of a non-network option that are delivered to those who produce, consumer and transport electricity.

Importantly, this will enable consideration of other complementary provisions in the regulatory framework that support efficient network and non-network options, such as pricing, the regulatory investment test for distribution and network planning requirements and other provisions, in deciding on how to apply the scheme to individual distribution businesses.

We support the ability to design the financial rewards under the scheme i.e. the value of the incentive, which will include the retention of market benefits (sharing ratio) and whether foregone revenue or foregone profit should be considered and under what circumstances, such as the nature of the price control mechanism. This is an appropriate recognition that incentive rewards can be designed in a number of ways, which may include consideration of the net economic benefits delivered across the supply chain.

Role of the AER in assessing demand management proposals

In our submission to the consultation paper we noted that the value proposition for demand management is also changing as demand becomes more uncertain. For example, as set out in our recent draft decision for Ausgrid, as overall demand and peak demand declines toward an uncertain point, compared to historical levels, demand management solutions might actually increase in their so called 'option value'[1]. However, our submission to the consultation paper did not outline the approach to assessing the demand management proposals for the NSW businesses.

The AEMC has suggested that to provide some certainty, there may be benefit in the AER explaining how it will assess the efficiency of demand management project expenditure as part of the regulatory determination process and this could be done in the expenditure forecast assessment guidelines.

The guideline outlines the types of assessments we undertake in determining expenditure allowances and the information we require from network service providers to facilitate those assessments. The guideline provides guidance to network service providers on how we are likely to assess their expenditure forecasts and the information we will require from them to do so (through specific information requirements contained in regulatory information notices).

Our assessment of demand management involves a review of the demand management project business cases and is not a unique assessment approach that requires special treatment over and above the assessment of other expenditure proposals. The assessment of specific cost categories such as vegetation management or demand management are not treated separately from the general approach outlined in the guideline.

[1] AER submission to AEMC consultation paper, March 2015, p. 8

However, we will further consider whether it is necessary to amend the expenditure forecast assessment guidelines or otherwise separately set out our assessment approach to demand management in more detail, in light of the application of new rules for demand management.

Commencement of the scheme - application mid-way through the regulatory control period

We agree with the AEMC that our current regulatory determinations have been made having regard to certain factors and with the aim of achieving certain outcomes. In making the regulatory determinations, we have considered the operating and capital expenditure factors, which includes whether expenditure is consistent with any incentive scheme or schemes that apply.

Under the regulatory framework contained in the NER, there are a number of interrelationships and financial incentives that are required to be considered and balanced in making the overall determination for an individual distribution business. This includes the application of various schemes, such as the efficiency benefit sharing scheme and the capital efficiency sharing scheme, the service target performance incentive scheme and other components including the form of control mechanism and the rate of return.

The application of the regulatory framework to an individual distribution business should be considered holistically, to enable the appropriate balancing of financial and service incentives and other interdependencies. The application of a revised scheme midway through the regulatory period may require a reopening of the current determination. If this was the case, there would be considerable costs on distribution businesses and us in introducing a new scheme and possibly recalibrating other measures or schemes. This would include a process for reopening the existing determinations and applying the scheme, which would in the normal course of events, occur through the Framework and Approach process. This also creates a degree of regulatory uncertainty for the distribution businesses.

We consider that the application of the scheme and allowance midway through a regulatory control period will create considerable costs and uncertainty, whereas the benefits are uncertain, and is not supported.

Guidelines and reporting

We support the decision not to require the making of a demand management guideline. A separate guideline document is unlikely to be necessary given that the scheme and allowance will be developed in accordance with the distribution consultation procedures. The scheme and allowance will be supported by a decision document and corresponding explanatory material on the scheme. This should provide stakeholders with sufficient guidance on how we designed the scheme and allowance and the reasons for doing so, including methodologies and calculations. Further, the application of the scheme to individual distributors will be consulted on through the Framework and Approach process. We consider that all relevant information will be included in these documents. Having said that, it is open to the AER to issue a guideline at any time if this was considered necessary.

We also support the need for the distribution businesses to report on demand management projects under the scheme and innovation allowance and the flexibility afforded to us in designing the reporting requirements.