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Mr Warwick Anderson
General Manager, Network Regulation
Australian Energy Regulator
Submitted by email: DM@aer.gov.au

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Dear Mr Anderson,

Draft demand management incentive scheme and innovation allowance mechanism

AGL welcomes the opportunity to respond to the Australian Energy Regulator's (AER) draft Demand management incentive scheme and innovation allowance mechanism (**Draft Decisions**).

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 3.5 million customer accounts throughout eastern Australia.

In addition, AGL is continually innovating our suite of distributed energy services and solutions for customers of all sizes (residential, business and networks). These 'behind the meter' (**BTM**) energy solutions involve new and emerging technologies such as energy storage, electric vehicles, solar PV systems, digital meters, and home energy management services delivered through digital applications.

Australia's electricity system is undergoing a significant transformation. At the transmission level, variable renewable generation is increasingly replacing older thermal generation plant. At the distribution level, penetration of small-scale generation is proliferating as households and businesses across the country take up distributed energy resources and become both consumers and producers of electricity. The once linear supply chain - where electricity generated by large power stations is transported across the high-voltage transmission network and through the low-voltage distribution network and into homes and businesses - is becoming increasingly decentralised and bi-directional. There are both opportunities and challenges associated with this inexorable transition.

Customer preferences

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.

We note that network support or grid stability service might only be required on a limited number of occasions per year, and this is similarly the case with demand response to meet a wholesale supply constraint. The remainder and majority of the time, customer-owned Distributed Energy Resources (**DER**)



installed behind-the-meter is likely to be employed directly for meeting the comfort and consumption needs of the customer.

Accordingly, an efficient deployment and use of DER and demand management related services will enable co-optimisation across these multiple uses and value streams. It will also recognise that it is ultimately a customer's choice as to how their BTM resources are deployed and what compensation or reward they expect for participating in different service markets (including providing network support).

AGL sees competition and innovation in technology and business models as the primary means for meeting this co-optimisation challenge and aligning the interests of energy service providers with those of the customers they serve. To enable efficient 'value stacking' requires the need for the location and size of grid support services and their value to the network to be made explicit, so that products and services can be designed by competing energy service providers to address these and build those values into the commercial model.

This will directly benefit customers investing in DER by ensuring the least cost deployment and highest value use of those assets are made, and by promoting the availability of a range of retail offers and bundled products to meet distinct customer preferences. Importantly, it will indirectly benefit all customers by ensuring investment in assets or services which support reliable network operation are efficient, thereby ensuring the efficiency of overall network costs.

Operation of existing incentives framework

Within this context, the introduction and renewal of the demand management incentive scheme (**DMIS**) and demand management innovation allowance (**DMIA**) is justified only on the basis that there appears to remain a bias to network investment in 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 Draft Decisions note 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 examining the outcomes of these schemes and the benefits which flow to customers given material information asymmetries between the regulated businesses and their regulator, as well as a lack of information for public bodies or research institutions that could provide useful analysis on these matters.

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.

We note the AER's conclusion in its Draft Decisions that on the face of evidence provided to it during the submission process, it is likely that distributors presently face incentives to prefer networks options to non-network options relating to demand management.¹ Further, the treatment of capex can create an incentive for a distributor to prefer network solutions to non-network solutions in particular if the distributor and its investors prefer relatively stable long-term cash flows, receive an allowed rate or return on regulated capex that is above its actual cost of capital, or value the option to defer capex less than electricity consumers.²

AGL supports this position and the AER's subsequent conclusion that there is value in improving how it regulates to encourage distributors to better utilise efficient demand management in managing their networks. There is some acceptance that the DMIA or DMIS is not a perfect mechanism; however, it is a necessary incentive to overcome existing biases in the regulatory pricing framework. With this in mind, we would encourage the AER to continue to transition towards efficient network pricing, monitor the effectiveness of recent regulatory reforms, progress and support further regulatory reforms such as amendments to the RIT-D, and continue to engage with stakeholders and contribute to rule change proposals and energy market reviews.

We note the AER's description of the nature of the DMIS and DMIA as a 'bridge' between the current inefficient network pricing and incentive model and an optimal framework. While we agree that the scheme and mechanism can provide some useful incentive to DNSPs in the short term, the existence of the scheme should not impede more significant reform to enable more natural incentives for DNSPs to operate efficiently.

In this respect, it seems as though the AER has agreed that the principles of the DMIS and DMIA are misplaced, but that more principled regulatory reform on a large scale will take time due to the inertia of the existing network model. We support these conclusions and agree that the DMIS and DMIA are temporary mechanisms that should not be expanded and should not defer the longer-term reform that needs to occur through the AER's Better Regulation reform process.

Interaction with contestability of energy services rule change

AGL notes that AEMC has recently published a draft rule and draft determination on the contestability of energy services, as a result of two rule change requests that is received earlier in 2017. The draft rule, while limited to the activities behind the meter, makes a number of key determinations regarding the role of distributors in providing certain services to the market. In summary, the draft determination:

- Introduces restrictions on DNSPs earning a regulated return on assets located behind the meter
- Introduces provisions that improve the distribution service classification framework's ability to respond to technology changes
- Introduces a requirement for the AER to develop and publish guidelines that set out the AER's approach to classifying distribution service.

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,

¹ AER, *Explanatory statement Draft demand management incentive scheme*, 28 August 2017, p.12

² *Ibid*, p.12



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.

Although the AEMC's determination is still in draft, the commentary accompanying the draft rule makes it clear that while non-network solutions may often be the most cost effective method of network augmentation, the way that these solutions are implemented and incentivised needs to be carefully structured.

The AEMC's determination makes it clear that DNSPs should not be able to control assets behind the meter that can provide contestable energy services,³ and that the starting point for any exemption to this framework would be that the restriction applies to all assets on the customer's side of the connection point. We strongly support the conclusions that the AEMC reached in their determination, which must naturally flow through to any determination the AER makes regarding DMIS and DMIA eligibility. On this basis, we consider that despite the principles of the incentive scheme, it is clear that demand management projects cannot occur behind the meter.

Furthermore, we consider that projects occurring at the network level should also consider some of the arguments regarding contestability services and value-stacking that were examined more broadly by the AEMC in their discussion paper, including the requirement not to erode other value streams that can be supported through competitive markets through the use of regulated funding.

We reiterate, network support or grid stability service might only be required on a limited number of occasions per year, and this is similarly the case with demand response to meet a wholesale supply constraint. The remainder and majority of the time, customer-owned DER installed behind-the-meter is likely to be employed directly for meeting the comfort and consumption needs of the customer. Accordingly, an efficient deployment and use of DER and demand management related services, will enable co-optimisation across these multiple uses and value streams.

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 the format of the DMIS and DMIA as described in the Draft Decisions will promote the operation of a scheme and allowance that address some of the barriers to greater deployment of demand management programs:

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. 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

³ AEMC, *Contestability of energy services*, Draft determination, 29 August 2017, Sydney, Chapter 3

the competitive market will have profound implications for the potential for a strong market in demand management services to develop.

In its Draft Decision, the AER stated that the draft Scheme is neutral towards whether a distributor provides the demand management component of an eligible project in-house, as long as the in-house option is both:

- Permitted under other regulatory requirements. For instance, the national ring-fencing guideline requires distributors to implement ring fencing arrangements between direct control services and other (negotiated and unclassified/unregulated) distribution services.⁴
- Maximising the expected net benefit of the preferred option. In achieving this, the Scheme should promote efficient outcomes that reduce electricity prices in the long term, all else being equal.

We are not as optimistic as the AER that the draft scheme will operate in a neutral manner towards DNSP's in-house suppliers. We anticipate that a careful monitoring of the tendering process as well as an assessment of the parties that are successful in the tender process should determine over time if there is a bias towards ring-fenced entities providing services to regulated parent DNSPs.

As is noted in the Draft Decisions, 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 Aleks Smits, Manager Policy and Research, on 03 8633 7146 or myself on 03 8633 6836.

Yours sincerely,



Stephanie Bashir

Senior Director Public Policy

⁴ See clauses 3.1 and 4 of AER, *Ring-fencing guideline: Electricity distribution*, November 2016.