EnerNOC Pty Ltd
ABN 49 104 710 278
Level 18, 535 Bourke Street
Melbourne, Victoria 3000

Tel: +61-3-8643-5900
www.enernoc.com.au
info@enernoc.com

Mr Warwick Anderson
General Manager
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Submitted by email to NSWACT@aer.gov.au

13 February 2015

Dear Mr Anderson,

Submission on 2015-19 draft decisions and revised proposals for NSW DNSPs

EnerNOC is grateful for this further opportunity to comment on the regulatory reset for the NSW distribution network businesses.

Our comments are mostly based on the draft decision and revised proposal for Ausgrid, but many of the same issues arise with Endeavour Energy and Essential Energy, and we would ask that you take these comments into account in their determinations as well.

We are, frankly, perplexed by the draft decisions.

In this submission, we go into detail on four issues with the draft decisions. Our hope is that the AER will make significant changes to its positions once it has considered these issues more thoroughly. Otherwise, the AER will clearly be harming the long-term interests of consumers, counter to the National Electricity Objective.

1 Actions that fail to match rhetoric

The first issue is an overarching one. The draft decisions contain some statements that seem to indicate that the AER understands the importance of demand management, such as:

> *"In this demand growth environment there is a stronger economic case for the use of demand management as investment in long-life network assets can be deferred until there is a more certain need, reducing the risk of stranded network assets. Further, the option value of demand management also increases."*[1]

> *"We acknowledge the need to reform the existing demand management incentive arrangements and the importance of demand management in*

[1] AER, Ausgrid draft decision, November 2014, Attachment 6, p.83.

deferring the need for network augmentation by alleviating network utilisation during peak usage periods."[2]

> *"Beyond increasing opportunities, we recognise the importance of strengthening demand management incentives in order to defer network augmentation. A benefit sharing scheme, such as that proposed by Ausgrid, could well be effective in strengthening incentives in this regard."*[3]

However, every single decision relating to demand management indicates that the AER believes that demand management is of no importance whatsoever.

We would expect the NSW network businesses – and their potential new owners – to plan on the basis of the regulator's actions, rather than its rhetoric.

If the approach set out in the draft decisions remains unchanged, then it would be quite rational for them to cease any real demand management activity whatsoever, disbanding the relevant teams and losing the know-how they have been accumulating. The RIT-D and other demand management obligations would then be treated as mere box-ticking compliance exercises – of no benefit to anyone – not part of their core business.

Such an outcome would cost consumers dearly in the long term, and, as such, would be counter to the National Electricity Objective. To avoid this, the AER must amend its decisions so that it takes actions on demand management to match its rhetoric.

2 Failure to provide an incentive scheme for demand management

The AER's Ausgrid draft decision notes that the submissions from the Consumer Challenge Panel, the Public Interest Advocacy Centre, and the Total Environment Centre all argue that incentives are needed to encourage demand management.[4]

Our previous submission did, too:

> *"Having identified the need for an effective demand management incentive scheme in 2012, it would be completely unacceptable to leave DNSPs without one until the next regulatory cycle starts in 2019."*[5]

More importantly, the AEMC has recommended that positive incentives are needed for demand management, and these recommendations have been endorsed by COAG and by the Productivity Commission.

The AER does not seem to dispute that it already has the power to introduce an effective incentive scheme. It just proposes to choose to fail to do so.

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2 AER, *Ausgrid draft decision*, November 2014, Attachment 12, p. 10.

3 *Loc. cit.*

4 *Loc. cit.*

5 EnerNOC, *Submission on NSW distributors' regulatory proposals for 2014-19*, August 2014, p. 4.

The AER's rationale for this failure is that it does not want to pre-empt the AEMC. While it is always nice to have a few additional rounds of public consultation, to fail to introduce a scheme now on this basis would be to prioritise process over outcomes.

The Productivity Commission is clear that an incentive scheme does not have to be perfect to be preferable to the status quo:

> *"[Although it may be more accurate to calculate benefits on a project-by-project basis,] … an alternative is for the AER to calculate the average spillover from a sample of demand management projects and use this as the basis for the incentive payment for all projects. While this might lead to less accurate estimates, it would improve the incentives to undertake demand management compared with the status quo … "*[6]

In our view, the AER would have to design an incentive scheme outstandingly badly for it to produce worse outcomes for consumers than having no incentive scheme at all. The scheme proposed by Ausgrid is good enough to serve as an interim scheme until it is replaced by an AEMC-consulted one for the next regulatory cycle.

If necessary, the AER could limit this interim incentive scheme to the NSW DNSPs, because they are the businesses which have historically had an incentive for demand management (the D-Factor). As Ausgrid notes:

> *"The loss of the incentive component of the D-Factor now means that this draft decision is less supportive of demand management than the previous AER decision."*[7]

Removing an existing incentive in NSW is likely to cause more harm than merely delaying the introduction of an incentive elsewhere. This is because the NSW DNSPs have developed demand management skills and capabilities that, without an incentive, they are likely to lose.

It is not too late to rectify this. National Electricity Rules clause 6.6.3(c) allows the AER to amend or replace a demand management incentive scheme at any time, and only 30 business days of public consultation are needed.[8]

3 Erroneous characterisation of the impact of pricing reforms

The AER's Ausgrid draft decision rejects Ausgrid's proposed broad-based demand management initiatives on the basis that "under new proposed rules, network tariffs will be based on the long run marginal cost of providing the service,"[9] and

6 Productivity Commission, *Electricity Network Regulation*, Final Report, p. 482.

7 Ausgrid, *Revised Regulatory Proposal*, Attachment 5.14, p. 7.

8 NER clause 6.16.

9 AER, *Ausgrid draft decision,* Attachment 7, p. 168.

the AER expects the resulting changes in tariffs to obviate broad-based demand management initiatives.

This position is mistaken in two ways:

1. Although network tariffs containing suitable price signals should alter consumption patterns favourably, they are no panacea. Even if new tariffs were implemented perfectly, a significant role would remain for broad-based demand management initiatives. For example, there is a limit to how strong a price signal can be provided in a tariff without consumers perceiving it as punitive. In contrast, if a programme is structured such that customers are paid for their participation (rather than penalised for not altering their behaviour), much sharper price signals can be provided. In addition, DNSPs are dependent on retailers to pass on tariff price signals to customers. This severely limits the number and complexity of tariffs that can be offered, whereas standalone demand management programmes can bypass the retailer and deal with the relevant customers directly – for example, targeting only those in areas which are likely to be constrained.

2. The AER asserts that "network tariffs based on long run marginal cost will already be in place" by 2019, and hence reduce the benefits of Ausgrid's proposed initiatives.[10] While new distribution pricing arrangements will be used to set network tariffs in NSW from 1 July 2017, tariffs will not become "cost-reflective" right away. The new arrangements require DNSPs to abide by a consumer impact pricing principle. This provides for a transition period over which more cost-reflective tariffs will be phased in, and explicitly states that this "may extend over more than one regulatory control period".[11] Jemena provide an example of how this principle may be applied: they plan to introduce new tariff structures incorporating maximum demand charges for small customers with effect from 2017. However, the price of the maximum demand component will initially be zero, and will be increased only gradually, reaching cost-reflectivity by 2030 – i.e. three regulatory cycles from now.[12]

In its revised proposal, Ausgrid has modelled the likely impact of tariff reform on the cost-effectiveness of its broad-based demand management initiatives, and concluded that it "would lead to only a 1-2 month delay in the project achieving a net positive NPV" – i.e. there is no material impact.[13]

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10 *Loc. cit.*

11 National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014 No. 9, clause 6.18.5(h)(1).

12 Jemena, *Proposed tariff structure changes over 2016-20 regulatory period,* presented at Jemena Pricing Workshop, 2 October 2014, slides 9-10 & 23-24.

13 Ausgrid, *op. cit.*, p. 4.

4 Apparent misunderstanding of capex-opex trade-offs

For a DNSP to carry out demand management activities, it has to spend money. This generally consists mainly of opex. If the demand management is efficient, then it will result in capex being avoided or deferred, such that the total costs are lower than they would have been otherwise.[14]

There are two internally-consistent ways in which DNSPs and the AER could treat this opex and capex:

- **Option A:** Make explicit allowance for the opex required for demand management, and reduce the capex allowance to reflect the resulting savings.
- **Option B:** Ignore the possibility of demand management when setting the opex and capex allowances, such that the DNSP will then fund demand management initiatives out of the money that the incentive framework allows it to keep for reducing capex.

Ausgrid are explicit that they are using Option A:

> *"Note also that we have retained the effect of the broad-based DM program in our demand forecasts, which has flowed through to our augmentation capital program."*[15]

However, in its draft decision, the AER appears to be using a hybrid of the two options: using the reduced capex that results from the demand management, per Option A, without providing any means to fund the demand management opex. This makes no sense.

If the AER does not want to include demand management costs in the opex allowance, then it must increase the capex allowance to the level that would be required if no demand management were to be carried out. The DNSP would then be able to fund demand management activities from capex savings, per Option B.[16]

As an alternative, Ausgrid proposes a variant on Option A: the demand management opex could be included in the DMIA, such that the funds are quarantined for demand management purposes. This seems a workable approach.

The draft decision also suggests that Ausgrid may be able to use demand management to achieve a greater level of capex deferral. It provides an estimate, based the previous regulatory cycle, that 9.2% of system capex should be deferrable.

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14 This is usually expressed on a net present value basis. To deal properly with the option value provided by demand management in the face of uncertain demand forecasts, it should really be on the basis of *expected* net present value.

15 Ausgrid, *op. cit.*, p. 2; The other NSW DNSPs make similar statements.

16 Note, however, that in the absence of a positive incentive scheme for demand management, the benefits that potential demand management initiatives provide in other parts of the value chain will be ignored, so the DNSP could only be expected to pursue demand management initiatives that will save it money, not all of those that would save consumers money.

As we stated in our previous submission, we believe that Ausgrid's proposals are unambitious, and more could be achieved. However, even we would question the appropriateness of simply removing 9.2% from the capex allowance on the assumption that it ought to be deferrable.[17] Somewhat greater rigour would be required in estimating the deferrable proportion. With this approach, if the AER's estimate were too high, the consequences for Ausgrid would be serious. However, 9.2% may well be an appropriate figure to use as a target in an incentive scheme.

I would be happy to provide further details on these comments, if that would be helpful.

Yours sincerely,

Dr Paul Troughton
Senior Director of Regulatory Affairs

[17] And, of course, adding a sufficient amount to the opex allowance to fund the demand management activities necessary to achieve this deferral.