PO Box 4136
East Richmond VIC 3121
T 131 806
F 1300 661 086
W redenergy.com.au

PO Box 4136
East Richmond VIC 3121
T 1300 115 866
F 1300 136 891
W lumoenergy.com.au

17 March 2022

Mr Sebastian Roberts
General Manager, Network Expenditure
Australian Energy Regulator
GPO Box 3131
Canberra, ACT, 3001

Submitted electronically: incentivereview@aer.gov.au

Dear Mr Roberts,

Re: Review of incentive schemes for networks: Discussion paper

Red Energy and Lumo Energy (Red and Lumo) welcome the opportunity to make a submission to the Australian Energy Regulator's (AER) Discussion paper on the review of incentive schemes for networks.

In its discussion paper, the AER undertakes a review of the incentive schemes that have been applied to networks in the National Electricity Market (NEM) over time to determine how to improve them to ensure that they remain fit for purpose and continue to provide long term benefits to consumers.

As retailers, we support incentive regulation only where it incentivises networks to operate their business efficiently and reduce their costs which are paid for by consumers.

We recommend that the AER must continue to refine the incentive schemes so that they only reward genuine efficiency gains and limit the pass throughs available to networks. Absent these adjustments, networks will recover efficiency gains that are not genuine and continue to apply for cost pass-throughs undermining the incentive schemes making it more like rate of return regulation. Incentive regulation works in tandem with penalty payments that are required to be made to customers where standards are not met, such as Guaranteed Service Level (GSL) payments. In our view, the right to recover the costs of a GSL payment via a pass through clearly undermines the incentive scheme approach.

Therefore, it is imperative for the AER to continue to refine the manner in which it applies incentive regulation to ensure it delivers outcomes consistent with the long term interests of consumers.

Below, we have included some suggestions that should improve the application of incentive regulation to networks.

Review and abolishment of the DMIS & DMIA

The discussion paper does not review all incentive schemes, and we firmly recommend that the demand management incentive scheme (DMIS) and demand management incentive allowance (DMIA) should be reviewed and abolished. Based on our understanding, the AER introduced the DMIS and DMIA to provide a greater financial incentive for networks to undertake demand side options compared to the traditional option of building out the network. This is no longer required, as the power of choice changes along with the post-2025 market design work that continues to enact changes that drive demand side participation. In addition, the DMIS and DMIA are no longer necessary as:

- With interest rates at historical lows, the regulated rate of return (WACC) has reduced from 6% to 3% in real terms diminishing any potential bias towards capex meaning the DMIS and DMIA are not required.
- Demand side investment opportunities will progressively become more attractive as renewables grow, especially distributed energy resources (DER).
- Under the efficiency benefit sharing scheme (EBSS), networks already have a financial incentive to invest in demand side options by underspending relative to their benchmark allowance and sharing any efficiency gains with consumers.

Linking service performance to incentive scheme but with broader service parameters

Without a service performance scheme, networks could potentially reduce the service reliability on the network for financial gain. As such, we strongly support linking a service performance scheme to incentive regulation.

However, service parameters that are linked to the service performance scheme should be broadened. For example, for electricity networks the previous customer service component of the Service Target Performance Incentive Scheme (STPIS) was equal to 0.5% of a network's regulated revenue and the AER amended this as it was not particularly challenging for the networks to obtain. In July 2020, the AER introduced the Customer Service Incentive Scheme (CSIS) that incentivises networks to comply with a wider range of customer service performance parameters. This scheme replaced the previous customer service complement of the STPIS. This requires networks to comply with a wider range of meaningful performance parameters to obtain its incentive payment. In this regard, our expectation would be that any adjustments to service performance schemes in the future will be broadened, which is consistent with the

strategic plan of the AER and other market bodies, to place consumer experience and outcome at the centre of the energy market transition.

Over forecasting must be adjusted otherwise incentive scheme should not be applied

Inflated expenditure forecasts approved by the AER allow networks to underspend relative to their approved benchmarks, which artificially increase the size of any efficiency gain. In order to rectify this, greater transparency in the manner that penalties and rewards are applied by the AER under incentive regulation would be required. In addition, providing the AER with stronger investigative powers would allow for corrections to over forecasting of expenditures to be addressed.

Without the required changes to mitigate expenditure over forecasting, then the incentive scheme itself should not be applied. In the end, if incentive regulation is going to be applied to networks it must only ever reward genuine efficiency gains.

AER must prevent strategic spending patterns to reward true efficiency gains

Importantly, the AER must only reward spending behaviours in response to incentive schemes that reflect genuine attempts to underspend relative to benchmark expenditure forecasts rather than any attempts to game the rules for financial reward. This is not in the long term interests of consumers.

Over time, the expenditure patterns of some networks have appeared to indicate a less than convincing attempt to legitimately respond to incentives. For example, some networks:

1. Appeared to significantly underspend capex in the first 3 - 4 years of the regulatory period while spending closer to the benchmark allowances in the last 2 years.

2. Underspent capex during a regulatory period to maximise the efficiency carry over while subsequently proposing significant capex forecast in the following regulatory periods.

Pass throughs to be employed sparingly

While the National Electricity Rules (Rules) provide networks with a broad range of pass throughs under clause 6.6.1, we prefer that they are used sparingly under the following conditions including:

1. The pass through event was beyond the control of management

2. The financial impact of the event was largely beyond the management's control

3. The magnitude of the event was pronounced to prevent excessive regulatory proceedings.

The inclusion of pass throughs for a limited set of important exogenous factors can capture some of the benefits of rate of return but they should nonetheless be extremely limited. By excluding pass-throughs for most or all exogenous factors, like most commercial businesses, networks are forced to become accustomed to the realities of the market.

About Red and Lumo

We are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria, New South Wales, Queensland, South Australia and in the ACT to over 1.1 million customers.

Red and Lumo thank the AER for the opportunity to respond to this consultation. Should you wish to discuss aspects or have any further enquiries regarding this submission, please call

Yours sincerely,

Stefanie Monaco
Manager - Regulatory Affairs
Red Energy Pty Ltd
Lumo Energy (Australia) Pty Ltd