

24 February 2016

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Sent via email to: [DM@aer.gov.au](mailto:DM@aer.gov.au)

Dear Mr Anderson

## Demand management incentive scheme and innovation allowance

SA Power Networks welcomes the opportunity to comment on the Australian Energy Regulator's consultation paper on the demand management incentive scheme and demand management innovation allowance mechanism.

We support the development of revised approaches applying to demand management. However, we raise a number of factors that should be considered to ensure that any new incentives and innovation allowances are consistent with the broader regulatory framework within which they would operate. Our submission comments on the following matters:

- The application and coverage of demand management incentives and innovation allowances, including:
  - the objectives and principles that should be applied in developing new incentives;
  - the scope of demand management activities that should be captured; and
  - the barriers to efficient demand management.
- Initial views on the specific incentive and innovation allowance mechanism options proposed by the AER in its consultation paper.

We would be happy to discuss our submission further. If you have questions on any matter we raise, please contact Bruno Coelho on 08 8404 5676.

Yours sincerely



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SA Power Networks



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# Submission to AER consultation paper

Demand management incentive scheme and  
innovation allowance mechanism

24 February 2017

**SA Power Networks**

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## Executive summary

SA Power Networks supports revising the demand management incentive scheme and innovation allowance applying to electricity distribution network service providers (DNSPs). We refer to these as, the ‘incentives’ or ‘innovation allowance’. These are to further promote efficient DNSP decisions on inputs we select in delivering our monopoly service—to be neutral to new and innovative ways of managing demand, compared to building poles, wires and other traditional assets.

Competition in demand management is an often misunderstood issue, occurring not at the service level (the monopoly service of providing a distribution network) but at the input level. For inputs, the regulatory framework affords DNSPs discretion in choosing between outsourcing or in-house investment. Discretion accompanies regulatory measures that guide DNSPs to efficient and safe input choices and in so doing, to consider if any input (including demand management) might involve other parties. Measures include an objective and incentives for efficiency, AER and stakeholder scrutiny on investment plans and requirements to not discriminate against unrelated parties. Where inputs involve other service providers, responsibility for network operation and performance still rests with DNSPs.

Revised incentives and innovation allowances must complement the regulatory framework by:

- Being neutral—not biasing in favour of a DNSP’s outsourcing as compared to in-house investments (e.g. owning demand management related assets), or any co-investment partnerships with other providers. Neutrality is consistent with incentive regulation’s premise and other incentives on capital and operating expenditures and service performance targets.
- Working with the regulatory determinations and Regulatory Investment Test rather than separately assessing project merit. Rewards should apply to projects DNSPs deem efficient, subject to scrutiny through these processes, and provide a continuous incentive for demand management or other efficiency opportunities during a regulatory period.
- Not excluding underperforming demand management from the Service Target Performance Incentive Scheme—this would conflict with the premise of operating networks to agreed performance standards. Underperformance risks are best managed by DNSPs having discretion and not being incentivised against assessing which activities to undertake themselves or which can be safely and efficiently procured from other parties.

Revised incentives and innovation allowances must also apply in a way that is not overly restrictive by:

- Allowing demand management solutions beyond just lowering or shifting demand to manage peaks. Demand is increasingly a two-way energy flow. In addition to managing peak demand, DNSPs need solutions to manage minimum (or negative) demand conditions caused by technologies such as batteries or solar generators. Managing both issues could avoid needing to build more poles, wires and other traditional assets, and recognises that demand must be managed with respect to the safety, reliability, quality, or security of supply. Further, the solutions to both issues could overlap (e.g. managing voltage by reducing demand could also manage peak demand and vice-versa).
- Being sufficiently flexible on what is considered an innovative trial or research, and not excluding from incentives, measures that involve tariffs or other payments / rebates.

Of the options proposed by the AER, our initial views are that:

- For incentives, the ‘operating expenditure uplift’ seems most consistent with the framework providing it does not favour outsourcing. This option would reward demand management only where efficient, contrasting to targets which might over or under promote demand management. We also support add-on options for more specific goals, including rewards to internalise market benefits and option value arising from demand management (if calculation is made simple) and rewards for DNSPs to actively pursue opportunities to share assets (e.g. batteries) with other parties who would be allowed to use these assets for services DNSPs are not allowed to provide.
- For innovation allowances, we favour increasing available funding given that there remains an unproven nature to some demand management. The idea of a national fund pool is worth exploring.

# 1. Application and coverage

## Objectives

**Demand management is not a service but one of many inputs DNSPs can choose from in delivering the monopoly service of providing a distribution network. The role of demand management incentives is to encourage efficient input decisions—specifically, encouraging consideration of demand management.**

The distinction between a service versus an input to a service is often confused.<sup>1</sup> This is particularly evident in debates on how to treat cases where DNSPs directly invest (to own) or co-invest in (and co-own) technologies such as Distributed Energy Resources (DER)<sup>2</sup>, and specifically, invest to manage network demand.<sup>3</sup> The AER's consultation paper is also somewhat unclear, appearing to suggest that these investments by DNSPs would comprise services.<sup>4</sup> Under the regulatory framework, activities undertaken by DNSPs to manage network demand by wholly investing, co-investing, or to outsource / procure the use of underlying assets such as DER, are not services but inputs to a monopoly service:

- The monopoly service in question is the act of providing an electricity network, or distribution system in the case of DNSPs, and so is classified as a Direct Control Service (DCS). The regulatory framework reflected in the National Electricity Law (NEL) and the National Electricity Rules (NER) only directs the AER to classify services—activities delivered to electricity customers.<sup>5</sup> Services are the acts of: generating electricity into the wholesale market; selling / retailing electricity; and providing an electricity network.<sup>6</sup> Some additional activities have been classified by the AER that might otherwise not be considered services but rather inputs, such as metering and connection services. However, these examples all had the common characteristic of being delivered to customers.<sup>7</sup>
- Economic regulation and regulatory incentives are only applied to monopoly services (those subsequently classified as DCS). Therefore, it is unclear what is intended by the AER's consultation paper stating that demand management incentives could apply to a DNSP's unclassified (unregulated) distribution services<sup>8</sup>, which are not monopoly services.
- The monopoly service of providing an electricity network or distribution system comprises many inputs, by way of individual activities and assets / technologies. The regulatory framework affords DNSPs discretion in choosing inputs, which complements the other fundamental feature of the regulatory framework, being incentives. The regulatory framework has a number of incentive properties and their role is to motivate DNSPs to choose inputs that are most efficient.<sup>9</sup>
- Demand management incentives serve a more specific role of encouraging DNSPs to make efficient decisions for a subset of inputs—between inputs that serve to manage demand by means other than building poles, wires and other traditional assets / solutions.

<sup>1</sup> This was recently noted by the AEMC with respect to the service contestability rule changes.

<sup>2</sup> This term generally includes devices / assets such as local generators, energy storage / batteries, and smart devices. They cover devices that are capable of responding in automated ways to signals of when to consume, export or cease using electricity.

<sup>3</sup> Investment or co-investment refers to capital expenditures on assets that would be included in the regulated asset base (RAB). AER, *Consultation paper—Demand management incentive scheme and innovation allowance mechanism*, pp.21–22.

<sup>4</sup> Customers include: a 'customer' as set out in the NER, being a person such as, a retailer or individual that purchases electricity in the wholesale market; or, 'retail customer' as set out in the NEL, being customers who purchase electricity from retailers.

<sup>5</sup> Part 1 of the NEL defines these as: "services that are necessary or incidental to the supply of electricity to customers of electricity, including—(a) the generation of electricity; (b) electricity network services; (c) the sale of electricity."

<sup>6</sup> The AEMC made the same observation in its recent consultation paper on the service contestability rule changes. AEMC, *Consultation paper—National Electricity Amendment (Contestability of energy services) Rule 2016*, p.16.

<sup>7</sup> AER, *Consultation paper—Demand management incentive scheme and innovation allowance mechanism*, January 2017, p.22.

<sup>8</sup> Incentives are not to motivate DNSPs to choose to undertake one service over another, but to pursue efficiency in choosing inputs to the monopoly service.

## Incentive and allowance assessment principles

**Demand management incentives and allowances must not prescribe or bias toward encouraging specific inputs over others. To be consistent with the regulatory framework, these need to be neutral, recognising that DNSPs are afforded discretion on all input choices (demand management or otherwise) and which inputs to invest in-house or which to outsource from other parties where efficient and safe to do so.**

The AER seeks to add to the NER assessment principles. Administrative simplicity and transparency on realised benefits are supportable principles. However, we disagree with the description of a principle of enhancing competition / building contestable market capacity, described as meaning only that a DNSP's outsourcing decisions in this regard should be rewarded.<sup>10</sup> This conflicts with the regulatory framework and is a biased call on how competition should occur. Incentives and innovation allowances must apply neutrally between a DNSP's in-house investments, co-investments or outsourcing decisions:

- Many inputs within the monopoly network service have always had contestable characteristics so this is not unique to demand management inputs. For inputs such as installing a new sub-station, vegetation management or corporate services, DNSPs already decide whether to invest in-house or outsource and procure from other parties. This is also the case with demand management inputs, with SA Power Networks having to date both procured generator capacity from other parties, and alternatively invested in-house where it was more efficient in the circumstances.<sup>11</sup>
- The regulatory framework avoids pre-emptively 'picking winners' as to whether in-house investment, co-investment or outsourcing for a DNSP's inputs is most efficient, with DNSPs having discretion to make efficient choices. The point of incentive regulation is to complement discretion. This recognises that the micro-level decisions on technologies and approaches constantly evolve and are best made by network businesses, not regulators. All other regulatory incentives do not distinguish in favour of outsourcing over in-house investments (i.e. incentives to find capital and operating expenditure efficiencies,<sup>12</sup> and incentives to maintain service performance).
- While the monopoly service of providing a distribution network is by definition not contestable, the regulatory framework provides an indirect link to competition issues. There are avenues for other parties to present alternatives to DNSPs on their inputs. The framework's objective is to promote efficiency, via incentives. As noted by the AEMC in its final determination on the demand management rule changes, if outsourcing proves more efficient, DNSPs are rewarded for doing so.<sup>13</sup> DNSPs are required to demonstrate efficiency and consideration of alternatives (including those involving other parties), to the AER and stakeholders, via regulatory determinations and RIT-Ds. DNSPs are also required to not discriminate against unrelated parties.
- While regulation should not pick winners, there is also no evidence to presume as the AER suggests<sup>14</sup>, that outsourcing will always be more efficient than in-house investments. There might also be a myriad of ways DNSPs could partner with other parties to co-invest in demand management inputs. Partnerships could allow other parties to share assets with DNSPs to deliver services that DNSPs are not allowed to provide (e.g. selling into the wholesale market). These decisions might depend on factors such as:

<sup>10</sup> This is reflected in the AER proposed incentive and innovation allowance options that aim to enhance competition.

<sup>11</sup> For example, SA Power Networks has both paid to procure generator capacity from third parties for network needs in Bordertown and Cowell, and invested directly in owning generators to back up larger regions such as Kangaroo Island.

<sup>12</sup> That is, the Capital Efficiency Sharing Scheme (CESS) and Efficiency Benefits Sharing Scheme (EBSS) and the STPIS.

<sup>13</sup> This nuanced perspective on competition was outlined by the AEMC in its final determination on the demand management rule changes where it stated: "...the framework in the rules encourage DNSPs to identify and pursue the most efficient (or least cost) solution, irrespective of whether that solution is a network or non-network option, or in the case of the latter, whether it is provided by the DNSP in-house, or by a third party through a competitive tender". The AEMC also stated: "...if a non-network option is the more efficient solution, the party who provides the service should be the party that can provide it at lowest cost. In this way, the Commission considers that the final rule may encourage growth in the competitive market for demand management services". AEMC, Rule determination—Demand Management Incentive Scheme, Rule 2015, August 2015, pp.21-22.

<sup>14</sup> AER, Consultation paper—Demand management incentive scheme and innovation allowance mechanism, January 2017, p.18.

- the nature of the underlying asset—if it (e.g. a battery) can be productively used solely for demand management on the network or have other uses (by other parties);
- risks of demand management assets underperforming—whether the risk is better managed in some cases by DNSPs investing to have some control of an asset’s maintenance and performance, or by outsourcing if contracts are not too costly to establish, enforce and monitor<sup>15</sup>, and if other parties are willing and able to take on risks of underperformance; and
- the availability of other parties with sufficient corporate experience and stability, and parties with sufficient concentration of demand response loads in areas where network constraints could arise. The latter is also relevant to remote areas.

Disallowing DNSPs investing in-house or co-investing in demand management would lessen competition, removing dynamic drivers from competition between in-house versus outsourcing possibilities.<sup>16</sup> To consider that demand management incentives should only apply to outsourcing to promote competition among input providers, would be akin to designing electricity regulatory incentives to boost competition amongst law firms—legal services being another of the inputs DNSPs choose whether to invest in-house or outsource. With legal services, like other inputs, the possibility of DNSPs employing their own lawyers drives law firms to improve their value proposition to DNSPs.

### Nature of input expenditures to reward

**Incentives and innovation allowances must cover all demand management that can efficiently avoid poles, wires and other traditional investments—this extends beyond simply managing peak demand to also include managing technical conditions associated with what is increasingly becoming two-way demand, such as minimum (or negative) demand conditions.**

The NER provide that demand management incentives and innovation allowances are to reward expenditure on non-network options. The AER seeks to further define eligible options to incentivise, as not including those requiring expenditure on network assets alone, and not involving assets used to convey or control the conveyance of electricity to customers.<sup>17</sup> We accept the need to define the expenditures to be rewarded (regardless of whether they involve outsourcing). Basically, distinction is needed between expenditure on poles and wires (and other traditional assets such as transformers etc), as opposed to options that seek to manage demand by altering the timing, size and nature of demand (i.e. technical conditions imposed). However, we disagree with the AER’s distinction, as it excludes relevant demand management activities.

#### *Linking demand management to asset definitions*

The link between demand management and assets termed ‘network’ or ‘non-network’ is not as clear as the AER suggests, and needs further consideration. For example:

- SA Power Networks’ assets described as ‘non-network’, are all unrelated to demand management (e.g. motor vehicles, information technology systems).
- Conversely, assets directly related to demand management might be deemed to be ‘network’ assets. For example, not all of SA Power Networks’ network assets, much like other DNSPs, pertain solely to poles and wires. The local generators that we own (capable of being used for demand management) are included as network assets.<sup>18</sup> This was also noted by the AEMC in an earlier consultation paper

<sup>15</sup> This relates to the economic concept of ‘transaction costs’. Transaction costs that might be involved in designing and monitoring detailed contracts with what could be many small individual providers could be significant, ultimately being borne by customers. The significance of transaction costs should not be discounted, with studies in other industries showing these to be material components of business costs. For example, see Furubotn & Richter, *Institutions and economic theory – Contribution of the new institutional economics*, 2000. P.51.

<sup>16</sup> This issue was also recently further discussed by Energy Networks Australia (ENA) in their submission to the AEMC’s consultation paper on service contestability rule changes. ENA, *Contestability of energy services Response to AEMC*, February, p.9.

<sup>17</sup> AER, *Consultation paper—Demand management incentive scheme & innovation allowance mechanism*, January 2017, pp.20-21.

<sup>18</sup> This is with respect to our internal accounts and how we report expenditures to the AER for its regulatory processes.

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on energy storage, where it outlined that if a DNSP owns a storage device, for example, that this might be considered to be a distribution asset.<sup>19</sup>

- It might also be inaccurate for the AER to say that demand management–related assets are not used to convey or control electricity conveyance. Many demand management activities might involve load control or other devices that switch off, and/or cycle appliances—these might relate to controlling the conveyance of electricity (and therefore be part of the distribution system).

#### *Demand management's scope*

While the new demand management rules refer to non–network options, we disagree with the AER that eligible projects were intended to be limited to lowering, shifting or deferring demand to manage network peaks. The AEMC's determination did not identify any such intent. This would also be impractical and unreasonable:

- Demand management has applications beyond just simply reducing peak demand. A key challenge facing networks as identified in work by the ENA<sup>20</sup> and the AEMC<sup>21</sup>, is that there are increasing levels of DER connecting to networks, driving two–way energy flows and challenging balances of technical parameters (e.g. voltage etc.). This represents a step change in the nature of network demand. DNSPs increasingly require, for example, solutions to manage minimum (or negative) demand conditions caused by local solar generation, as well as peak demand. Demand management includes any alternative to investing in the network to accommodate demand and means managing demand with respect to the safety, reliability, quality and security of supply. Demand management solutions could be deployed by DNSPs for a range of purposes:
  1. Capacity management: Reducing customer demand or increasing local generation to 'fit' within network capacity;
  2. Voltage management: reducing or increasing traditional demand (real power) or reducing or increasing reactive power, and / or introducing more complex control systems to maintain voltage levels in the network to within prescribed standards;
  3. Reliability management: utilising embedded generation or storage (customer or DNSP owned) to provide an alternative source of supply (N–1) rather than providing alternative supply using network infrastructure (e.g. back–up feeders); and
  4. Managing excess solar energy: shifting load into times of peak solar output to keep reverse energy flows within local network capacity.
- Further, in practice, some of the solutions listed above might be inseparable from others. For example, measures designed to manage voltage (e.g. by installing devices or paying customers or their agents to manage voltage etc) might also manage peak demand capacity.

We also disagree with excluding approaches that are tariff based or involve tariffs:

- For incentives—demand management options might involve rebates or payments to customers either alone or accompanying the installation of a device enabling demand response. It is unclear if the AER envisages these as tariff–based. Further, for tariffs listed in a Tariff Structure Statement, DNSPs should be rewarded for approaches to actively encourage take up of tariffs that significantly reflect peak demand and go beyond general expectations for network tariffs.
- With respect to the innovation allowance, funds should be available to trial innovative approaches either to tariffs or approaches that involve rebates / payments or combine these measures with demand response devices.

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<sup>19</sup> AEMC, *Integration of Energy Storage Regulatory Implications—Discussion paper*, p.40.

<sup>20</sup> This topic is covered in the ENA's Network Transformation Roadmap, accessible on: [<http://www.energynetworks.com.au>]

<sup>21</sup> This was set out in the AEMC's consultation paper on their Distribution Market Model work in which it set out the range of possible challenges and opportunities that DER will present to electricity networks and how approaches to these challenges might interact with each other. AEMC, *Distribution Market Model—Approach Paper*, December 2016, pp.21-25



## Barriers to efficient levels of demand management

Demand management deployment is affected by regulatory uncertainty on the ability of DNSPs to undertake in-house investments, and by risks of service underperformance given the unproven nature of some demand management. Service underperformance risks are best managed by DNSPs maintaining discretion to choose their inputs, and which to outsource when efficient and safe to do so.

The AER's consultation paper sets out its view on barriers to efficient levels of demand management, and options designed to target these barriers. In our view:

- As discussed, we disagree with how the AER described the issue of the need to build capacity in contestable markets and how this has been taken to mean only rewarding a DNSP's outsourcing.
- A barrier not mentioned by the AER is that DNSPs continue to face a degree of regulatory uncertainty on the treatment of such investments. For example, we note that while DNSPs are now considering needs for their next regulatory determinations, the AEMC is consulting on rule change proposals from retailers and generators that would fundamentally alter and undermine the regulatory framework—potentially prescribing that DNSPs no longer decide their inputs. We also note the AER's consultation paper is somewhat unclear on whether DNSP investment in demand management-related assets would somehow be captured by ring-fencing.
- Service performance risks are legitimate issues to consider in deciding whether demand management can be deployed. However, it appears at odds with the regulatory framework to allow exclusions for under-performing demand management from STPIS penalties. Service performance risks should instead be managed flexibly by DNSPs, by maintaining their option to weigh up not only the costs, but also the service performance risks of demand management options that either involve just the DNSP, partnerships, or outsourcing, depending on prevailing circumstances:
  - maintaining service performance is core to the regulatory framework and the standard to which networks are built. Excluding some inputs from service targets would be akin to running two regulatory frameworks at the same time, passing on service unreliability risks to customers; and
  - it might be that the risks of service underperformance could diminish gradually over time as new parties emerge and build corporate experience and stability. However, DNSPs should be allowed to determine if it would be less risky to invest in a device itself and have greater control over its performance and maintenance. This could be where:
    - > the risks of service underperformance are too great, due to the nature of a third party's technology or that party's corporate stability and experience;
    - > the costs of specifying, monitoring and enforcing contracts with other parties to pass on risk of service underperformance, is deemed too costly—i.e. the transaction costs are too high; or
    - > third parties are unwilling or unable to agree to take on risk of under-performing demand management, either because markets for such insurance are illiquid / immature or the costs of insurance render their demand management options unviable.

## 2. Incentive scheme options

Of the AER’s options, the ‘operating expenditure uplift’ appears most consistent with the regulatory framework (if it doesn’t bias toward outsourcing) and likely to reward efficient demand management. Rewards to internalise broader market benefits and option value arising from DNSP demand management appear good accompanying options to target more specific goals.

The AER’s consultation paper sets out several incentive mechanism options. Some could form the core of the incentive scheme, while others might be accompanying options serving narrower purposes. In their current form, we do not support any of the options presented as they have not been described consistent with the principle of neutrality between in-house investments, co-investments and outsourcing. Our views on the proposed options are set out below.

### Potential core mechanism

The ‘opex uplift’ option appears to best meet the NER and AER principles. This is providing that the option can be amended to remove the bias in favour of outsourcing.

**Table 1: ‘opex uplift’**

| NER & AER principles   | SA Power Networks’ comments  |
|--|--|
| Accounts for interactions with other aspects of the regulatory framework | <p>For consistency with the regulatory framework, incentives must be neutral to a DNSP’s in-house investments, co-investments or outsourcing. Neutrality is also consistent with the EBSS, CESS and STPIS.</p> <p>If (as we propose) the mechanism applies neutrally, in-house investments will involve greater capex and less opex relative to outsourcing. However, incentives applying to opex are still relevant to in-house investments. For example:</p>   |
| Incentives beyond the regulatory control period                          | <ul style="list-style-type: none"> <li>• a DNSP’s in-house demand management might involve not only assets (or a notional share of those assets as being owned by the DNSP, where the asset is shared with another party) but accompanying payments / rebates to customers;</li> <li>• there could be opex in maintaining a DNSP’s demand management related assets; and</li> <li>• some DNSP in-house demand management might not involve other parties nor capex, but could solely involve opex and payments to customers.</li> </ul>  |
| AER: enhancing contestable markets.                                      | <p>The mechanism is also consistent with other parts of the regulatory framework by:</p> <ul style="list-style-type: none"> <li>• not affecting how service underperformance is treated;</li> <li>• applying an on-going incentive during the regulatory control period for DNSPs to seek out efficiencies, consistent with the intent of the CESS and EBSS; and</li> <li>• working with AER regulatory determination and RIT-D processes—not needing separate assessment to identify efficient demand management. Rewards apply to projects deemed efficient by the AER in regulatory determinations, in RIT-Ds, or projects which are otherwise efficient ways of achieving lower than allowed expenditure.</li> </ul> |

|   |  |
|---|--|
| Reward DNSPs for options with net cost savings to customers | Demand management would only be rewarded where efficient, required and delivers net cost savings to customers. DNSPs would determine (subject to AER and stakeholder scrutiny via regulatory determination and RIT-D processes) where demand management is efficient. Compared to other possible options, this would:  |
| AER: Transparent costs and benefits                         | <ul style="list-style-type: none"> <li>• apply to actual efficiently delivered demand management rather than needing ex-ante notional identification of the demand management that might be delivered; and</li> <li>• contrasting to target based options, not risk rewarding inefficient demand management or activities unrelated to demand management, such as changes in demand driven by external factors. It would also not require the same intensity of data reporting and debate on the demand normalisation factors to apply.</li> </ul> |
| Balance network v non-network incentive                     |  |
| Reasonable incentive level                                  | At this stage we do not yet have a view on the magnitude or calculation of the 'uplift'.   |
| AER: Administrative simplicity                              | Mechanism appears the most administratively simple, relying on the same data used for AER regulatory determinations and annual reports, and for conducting RIT-Ds.   |

### Accompanying options

The following mechanisms to target specific issues are supported and worth exploring further:

- Rewards to encourage DNSPs to seek out joint activities with parties in other parts of the value chain. Under current new ring-fencing requirements DNSPs are prevented from using assets such as DER to provide services that are not network services (e.g. selling into wholesale markets). However, DNSPs might partner with other parties to agree to share and co-fund DER assets with other parties who would be able to use DER to sell into wholesale markets. In this way, the use of the assets could be optimised across prevailing network and wholesale market conditions.
- Rewards to internalise externalities by allowing DNSPs to capture a share of broader market benefits resulting from their demand management activities, and rewards to allow DNSPs to monetise the option value of demand management. As the AER outlines, these are legitimate benefits of demand management that are not captured under the current regulatory framework. It is worth exploring how approaches to target these issues might be applied in an administratively simple way. This might entail estimating a broad benefit recovery rate incentive, to be applied to all demand management activity that is undertaken, as per the Network Capability Improvement Incentive Scheme example noted by the AER, allowing DNSPs to receive \$1.5 in incentives for every \$1 spent on demand management.

### Options not supported

- As set out in section 1, we disagree with how the AER described possible incentives for running competitive bidding processes that presume that only outsourcing is efficient and to be rewarded:
  - Any competitive bidding process dis-allowing DNSPs from presenting their own or partnered options in any open bidding process would represent a fundamentally biased perspective on competition that is inconsistent with the regulatory framework.
  - Further it is unclear why the scheme would implement a bidding process when DNSPs are already incentivised to undertake competitive tendering and actively do so, with respect to all input decisions not just those pertaining to demand management. The AER's consultation paper does

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not set out evidence why DNSP's current approaches to testing different options including in-house versus outsourcing are not working so as to need such micro-management.

- As also set out in section 1, excluding demand management underperformance from the operation of the STPIS appears to not represent a good outcome for customers. Instead, service underperformance risks should be left with DNSPs to manage flexibly depending on the prevailing circumstance—this might be by investing in demand management assets, co-investing, or establishing contracts to pass on risks to third party providers where possible and practical.
- Target based schemes are too administratively complex and present far too much risk for customers by potentially rewarding demand management where it is not required.

### **3. Innovation allowance mechanism options**

The AER's consultation paper set out options for innovation allowance mechanisms. These need to:

- Be flexible on what is considered innovative. An approach applied elsewhere might still be worth trialling with respect to the unique demand characteristics within a DNSP's network. There might also be a variant on the approach. For example, a DNSP might trial a battery (already used in another country), but with different asset sharing or rebate arrangements with other parties.
- Be neutral—not presuming only outsourcing is efficient. We do not support bidding options that disallow DNSPs undertaking research and development or that otherwise require DNSPs to partner with other parties. Partnerships might well evolve but should not be presumed by regulation.
- Increase funds available relative to modest historical allowances, recognising that there are legitimate risks of underperformance in demand management given the unproven nature of some approaches. With respect to the source of funding, a whole of NEM funds pool might present some concerns as customers in a given jurisdiction would be contributing funds that might be awarded to a DNSP (and their customers) in a separate jurisdiction. However, this idea is still worth further exploring with stakeholders, if it can increase the size of available funds and drive efficiencies across DNSPs. However, focus must be on the merit of the proposed innovation rather than the size of the potential network constraint that might be facing a particular network. Even relatively efficient DNSPs might still have localised network areas where demand management might be efficient.