



Mr John Mackay
Australian Energy Market Commission
Level 6, 201 Elizabeth Street
Sydney NSW 2000

20 June 2019

Dear Mr Mackay

RE: Demand management incentive scheme and innovation allowance for TNSPs Consultation Paper ERC0266

ENGIE Australia & New Zealand (ENGIE) appreciates the opportunity to respond to the consultation paper on the Demand management incentive scheme and innovation allowance for TNSPs (“the Consultation”) as submitted by the Energy Networks Australia (ENA).

ENGIE is part of a global energy group operating in the businesses of electricity, natural gas and energy services. In Australia, ENGIE has interests in generation, renewable energy development, and energy services. ENGIE also owns Simply Energy which provides electricity and gas to more than 700,000 retail customer accounts across Victoria, South Australia, New South Wales, Queensland, and Western Australia.

Conflation of two issues

The ENA’s rule change proposal is to implement a Demand Management Incentive Scheme (DMIS) and a Demand Management Innovation Allowance (DMIA) to apply to transmission network service providers (TNSPs) along the same lines as those introduced for distribution network service providers (DNSPs) in 2015.

It is claimed this rule change “will promote innovation in non-network solutions¹” and that it will address both “the absence of positive financial incentives to adopt efficient non-network solutions”² and “overcomes the current disincentive on TNSPs in the regulatory regime to incur expenditure on research and development that will only provide benefits in the longer term”³. ENGIE notes that the change proposal is thus purporting to address two different issues:

¹ Demand Management incentive scheme and demand management innovation allowance- rule change request, ENA, February 2019, p3

² ENA, op. cit., p4

³ Ibid.





- A concern that current regulatory settings promote capital expenditure (capex) over operating expenditure (opex)
- Whether an incentive based regulatory framework that promotes cost efficiency and allows service providers limited retention of benefits is capable of supporting innovation that may only pay off over the long term

The relevance of this proposal to each issue is discussed below.

Capex and opex trade-offs

Formally, the goal of the regulatory framework is to incentivise the lowest cost solutions to the TNSP's requirements. In many cases, not all of which relate to demand management, the TNSP faces a choice between a capex solution and an opex solution. Consumer representatives have made the argument over many years that networks exhibit a strong capex bias, and this is often explained by the regulatory WACC exceeding the network's actual cost of capital⁴. It seems unlikely that the ENA is trying to make quite this point, nor that the AER would support a regulatory decision based on the premise that it was systematically over-estimating the WACC.

Indeed, the AEMC regularly reviews such issues in its annual review of network regulatory frameworks. In the 2018 report, the AEMC observed that its analysis showed that "while the existing framework does not create systematic bias for either capital or operating expenditure, the financial incentives for NSPs are nevertheless not aligned as they vary depending on circumstances..., the potential for bias is low and the current regulatory framework provides appropriate incentives for efficient investment decisions"⁵. In its current review, the AEMC is exploring totex approaches to mitigate any bias. This appears a more holistic approach to expenditure bias than a specific incentive aimed at a subset of expenditure decisions.

The issue then seems to come down to the lack of a *positive* incentive to undertake non-network option, with the implication being that TNSPs will hesitate to undertake non-network options, even when they are cheaper, because of their unfamiliarity with such options and therefore how they will work out. This creates something of a regulatory conundrum – there is under the current framework a clear financial incentive to choose the cheaper option because the TNSP retains a share of the savings. This line of argument seems to claim such incentives are not effective. It's not clear then, that an additional incentive is the best solution to such an issue.

Businesses under the pressure of competitive forces frequently have to adapt their operations in order to reduce their costs or improve their product or service. To the extent that they are trying out approaches that are new to them, this could be considered in the broadest sense "innovation" but is also a normal part of business. Unlike competitive businesses, TNSPs have some scope to mitigate cost risks as they can pass through network support costs. In any case, the regulatory framework is not predicated on fully derisking TNSPs – otherwise they could be

⁴ See for example, *The Winners and Losers of the Monopoly Game*, Hugh Grant, 2018

⁵ *Promoting efficient investment in the grid of the future*, AEMC, 2018



financed on fully risk-free terms. Accordingly, the simple decision between a more familiar capex solution and a less familiar but potentially cheaper opex solution should not warrant an additional incentive.

Supporting innovation for the longer term

To the extent that TNSPs need to carry out specific “research and development” activities (as opposed to merely being prepared to adapt to previously unfamiliar ways of doing business) in order to be able to substitute in non-network options for network options, then the case for some regulatory support is stronger. In Great Britain, where the CPI-X style regulatory framework has been applied for longer than in Australia, it was observed some time ago that the framework was good at driving efficiency, including certain types of innovation that typically resulted in a clear payoff over a short time frame, but inhibited research and development into longer-term issues where the chance of success of any given project was lower, and the network’s opportunity to retain the benefits of success was curtailed.

The British regulator Ofgem has implemented multiple iterations of innovation allowances and incentives, evolving their approach as they observe what is effective. They have been broader in scope – rewarding innovation across a range of criteria/network activity rather than simply demand management. They have included a competitive component, driving the networks to ensure they have developed the most worthwhile projects for funding. They have required a collaborative approach, with the networks expected to collaborate with each other and other parties. and required to develop a Collaboration Portal, which directs potential collaborators to network innovation resources, documents, and contacts within the network companies for potential partners to submit project ideas⁶.

The advantages of collaboration and the creation of an ecosystem of innovation are widely acknowledged. In their book *the smartest places on Earth*, Antoine van Agtmael and Fred Bakker describe this approach as “brainsharing” and document how value chains depend on different parts of the supply chain acting as research-and-development partners⁷.

ENGIE recommends that if the AEMC determines that the introduction of a DMIS and DMIA for TNSPs is warranted, that the incentives are conditional on TNSPs engaging other parties, including customers, generators and retailers in developing and implementing the projects that are funded in this way. This does not seem to have been a key criterion for the DNSP DMIS and DMIA.

Conclusion

ENGIE considers that the introduction of a DMIS/DMIA incentive scheme for TNSPs is not warranted purely on the basis of attempting to align capex and opex incentives. To the extent such a scheme is required to address disincentives for research and development type expenditure that may be required in order to support greater

⁶ Innovation and regulation, Ofgem, 2016

⁷ The smartest places on earth: Why rustbelts are the emerging hotspots of global innovation, Agtmael and Baker, 2016



use of non-network options, then ENGIE recommends such a scheme be designed to promote collaboration across the electricity value chain.

While the AEMC may wish to observe this working in practice before extending this approach to the DNSP version of the scheme, this would be a logical next step. There may also be merit in broadening the scope of such an incentive to cover a wider range of TNSP activity, though this does not necessarily require an increase in the quantum of the allowance.

Should you have any queries in relation to the attached proposal please do not hesitate to contact me on (03) 9617 8415.

Yours sincerely,

A handwritten signature in blue ink, appearing to read "Jamie Lowe".

Jamie Lowe
Head of Regulation