11 July 2019

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235
Reference: ERC0266

Lodged electronically: www.aemc.gov.au

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AEMC consultation paper - demand management incentives for transmission businesses – 23 May 2019

EnergyAustralia is one of Australia's largest energy companies with around 2.6 million electricity and gas accounts across eastern Australia. We also own, operate and contract an energy generation portfolio across Australia, including coal, gas, battery storage, demand response, wind and solar assets, with control of over 4,500MW of generation capacity.

EnergyAustralia supports the ongoing consideration of incentives on network service providers (NSPs) to deliver efficient outcomes, including via non-network options relating to demand management. The costs incurred directly by regulated NSPs contribute roughly 40 per cent to residential customer bills. While transmission costs are a small part of this, the AEMC's latest residential price trends report suggests the transmission component of bills will increase by 6 per cent to 2021, which is more than double the increase in other regulated network costs.[1] Wholesale costs contribute a further 30 to 40 percent to bills and are materially affected by the decisions of transmission network service providers (TNSPs). Minimising these costs through more efficient network investment and operation is therefore important to us in driving down prices for our customers.

We consider there is likely to be a sound case for improving the rules and the associated decisions of the AER to ensure incentives on TNSPs are appropriately calibrated. We therefore support the AEMC's decision to consider Energy Networks Australia's (ENA) rule change proposal in tandem with its economic regulatory framework review.

It may be the case that the amount of demand management currently deployed by TNSPs is lower than its efficient level, which is central to the ENA's rule change proposal, and this may require targeted demand management incentives. The AEMC has asked appropriate questions in its consultation paper to gather evidence on this, and we note the ENA's proposal identifies examples of TNSPs already adopting non-network solutions which can be explored further.

Our detailed comments on the ENA's rule change proposal are below.

There are theoretical grounds for specific demand management incentives

NSPs may not adequately consider benefits across the whole value chain for electricity when making investment decisions and therefore undervalue non-network solutions. In our view, the capturing of these broader market benefits was the key justification for introducing demand management incentives for distribution network service providers (DNSPs)[2] and the calculation of net market benefits forms an essential part of the AER's Demand Management Incentive Scheme (DMIS). The AEMC should investigate the extent to which TNSPs overlook market-wide benefits in practice and not rely solely on a first principles analysis. Whilst we do not have

[1] AEMC, *2018 Residential Electricity Price Trends*, Final report, 21 December 2018.
[2] AEMC, *Demand Management Incentive Scheme*, Rule Determination, 20 August 2015, p. i.

strong views on or evidence of the practice of TNSPs, the market structure makes it difficult to stack value available to demand management service providers through combining spot (energy) and locational network prices.

A separate justification for introducing demand management incentives is to provide what would essentially be subsidies to accelerate and enable demand management deployment, similar to how ARENA's demand response program is intended to support provision of Reliability and Emergency Reserve Trader services to AEMO. Any such subsidy would be time-limited and exist for the purposes of overcoming deployment barriers such as high cost or risks to the TNSP, rather than correcting incentive issues. For example, the ENA's proposal suggests that demand management introduces reputational and compliance risks that may stem from counterparties in a market that is apparently still developing.[3] Again we encourage the AEMC to investigate instances where TNSPs have genuinely sought and failed to procure network support, and the reasons for this, including insufficient scale, lack of diversity or solvency of counterparties.

Pass throughs of network support may need revision

The examples at Appendix A of the ENA's proposal illustrate how non-network expenditures are treated under the current regulatory framework. They suggest TNSPs face no positive financial incentive in the following circumstances:

- where non-network options are factored into approved expenditure allowances
- where a non-network option is deployed to defer or avoid capex that was not factored into regulatory allowances
- where non-network expenditure is incurred to defer a contingent project (i.e. again where capex was not included in regulatory allowances).

In each of these examples, the TNSP seeks a pass through of any actual network support payments that differ from forecast amounts. These expenditures are therefore not subject to the ex ante incentive arrangements under the National Electricity Rules (NER) and in this sense do not result in positive (or negative) financial incentives.

Pass-through arrangements reflect a relaxation of the ex ante incentive framework. As such, they exist by exception, with scrutiny on ensuring trigger events and associated costs are genuinely beyond the control of the NSP. TNSPs face some incentive to act efficiently when incurring network support costs as clause 6A.7.2 of the NER requires the AER to conduct an ex post assessment, including of the efficiency of the TNSP's decisions, when approving pass through applications. We agree with the ENA's statement that the risk of the AER not approving these applications is insubstantial.[4] Network support pass through applications typically focus on verifying the costs incurred rather than efficiency considerations.

The ENA is correct in noting TNSPs enjoy no explicit financial gain from network support pass through arrangements. They do, however, shield the TNSP from volatility in costs. In this way, pass throughs lower risk for the TNSP which should have some effect on the TNSP's rate of return. Whether this results in any incentive depends on how the AER accounts for pass throughs when setting regulated rates of return.

The ENA's proposal argues for additional incentives to pursue demand management however underlines the uncertain nature of network support payments, and states that these pass

[3] ENA, *Demand Management Incentive Scheme and Demand Management Innovation Allowance – Rule Change Request*, February 2019, p.8.
[4] ENA, p. 33.

throughs are "still required".[5] It would be useful to explore whether TNSPs currently view network support as purely a reactive activity or would act differently, including through pro-active procurement, if incentivised to so do. In our view, it would be unusual (and potentially result in windfall gains and losses) to apply incentives to activities where the event trigger and associated expenditures are mostly beyond the NSP's control. To the extent they are controllable, the AEMC may wish to explore how network support could be subjected to broader ex ante expenditure incentives, without the need for pass throughs or ad hoc demand management incentives.

The ENA's proposal highlights broader framework issues

The ENA highlights potential barriers to pursuing non-network solutions however in some cases these reflect imbalances between incentives for capital and operating expenditures.[6] These imbalances would not be effectively addressed through demand management incentives.

The ENA also discusses demand management as an example of innovative activities. The concern here again is not limited to incentives and reflects potential biases in NER and AER assessments. For example, the assessment of expenditures may need to better recognise economic benefits that span multiple regulatory periods, including the role of option value in economic evaluations. Like other innovative solutions, non-network options may appear expensive in the short-term but can provide significant additional value to consumers as they de-risk uncertainty about the future. This value may be significant in the current environment of large expected increases in transmission network spending and the uncertain outlook of the NEM.

The AEMC has already explored some of these issues in its regulatory frameworks reviews and we support concurrent consideration of the ENA's proposal with its 2019 review report. The ENA usefully points out that Ofgem's RIIO framework has specific demand management and innovation incentives[7], which have been applied under a totex incentive framework, alongside specific innovation requirements including collaboration between networks and external parties. We encourage further discussion of this framework in its entirety.

Aside from the calibration of incentives and potential biases against innovative spending, the AEMC should also explore in more detail the claim from the ENA that NSPs have a "cultural" bias against non-network solutions. Knowing the root cause of this bias is important in designing an effective solution, and could be one or a combination of:

- unusual counter-party risk or the market for non-network services being immature
- a general reluctance of some TNSPs to partner with non-network service providers
- poor valuation of non-network alternatives based on a cost of capital approach, rather than present value of avoided network costs over the life of the assets being deferred
- shortcomings in consultation processes that prevent proponents from being appropriately engaged (e.g. regulatory investment tests, transmission determinations etc).

We consider there is scope for TNSPs to improve how they describe the problem they are addressing in RIT-T proposals (energy at risk, frequency and magnitude of constraints, likelihood of events, underlying weather and market conditions, etc) and in providing more information to proponents in the market to improve this assessment. This is potentially

[5] ENA, p. 10-11.
[6] See for example ENA, pp. 30, 34.
[7] ENA, p. 27.

something the industry can address in jointly determining what system support services are needed, including in the Integrated System Plan and in other planning documents and working groups. Improvements in TNSP planning, investment and operation will become increasingly important as the complexity of constraints and range of service procured by NSPs changes to accommodate increasingly intermittent supply, and more flexible demand that is enabled by advances in systems and technology. Caution should be taken to ensure that network options are not seen as the only solution to these challenges. For example, generators are also able to provide some of these services (through a non-network option), providing AEMO and NSPs with tools to manage both system security and reliability.

The justifications for demand management incentives for DNSPs may not apply

The ENA's proposal indicates that the AEMC, ACCC and AER have favoured the introduction of demand management incentives for DNSPs, and notes that similar issues are at play for TNSPs. As the AEMC would be aware, DNSPs face different circumstances that may have provided a greater justification for these incentives:

- DNSPs spend much more on network solutions, therefore the opportunity for efficiency is higher when the demand side is more integrated into decision making
- DNSP initiatives can be carried up the supply side to also support regional or broader transmission constraints
- DNSPs can face non-revenue cap forms of control, e.g. price caps, meaning that demand management has a direct and negative impact on revenues
- there may be higher administrative costs associated with coordinated demand reduction or load shifting for DNSPs i.e. large number of smaller customers, than compared to TNSPs
- similarly there may be higher administrative costs in promoting the visibility of distribution projects, which have shorter lead times, that reduce the opportunity for service providers to propose alternative solutions in public consultation processes
- the diversity of projects on distribution networks may mean that there are less individual commercial-scale demand management opportunities for DNSPs than TNSPs.

Demand management incentives should be accompanied by further requirements

If there is merit in introducing new incentives for TNSPs, the corresponding obligations that exist for DNSPs should also be introduced in terms of reporting requirements and producing demand side engagement strategies. Some of these requirements ensure that learnings are shared and incorporated into business as usual planning and operations.

Critically, we consider the AER's regulatory oversight of allowances and projects would need to ensure incentive payments genuinely encourage new solutions rather than simply provide additional revenue for works TNSPs would have undertaken anyway. This may be more of an issue for the AER's discretion, however any rule changes could include some guiding principle that incentives only be implemented subject to TNSP justification and provided by exception, rather than as a matter of course. Stakeholders are likely to expect any DMIS and DMIA for transmission will mirror those already developed by the AER for DNSPs, and it may be useful to explore possible and desirable differences as part of the AEMC's rule change consultation.

While the ENA suggests potential additional revenue streams under the DMIS and DMIA may be modest[8], we are still cautious in how incentive payments are administered. As per our previous comments on introducing demand management incentives for DNSPs[9]:

- we would have some concerns where the NSP is the party that is procuring services, responsible for furnishing bidders with information, and also competing for the provision of that service
- there should be a requirement on NSPs to test the competitive market for non-network solutions
- consideration should be given to whether NSPs are prevented from providing non-network solutions to itself and otherwise appropriate ring-fencing arrangements must be in place (and enforced).

These requirements would also address the ENA's concerns about addressing market maturity as well as encourage broader innovation and efficiency in service delivery.

If you would like to discuss this submission, please contact Lawrence Irlam on 03 8628 1655 or Lawrence.irlam@energyaustralia.com.au.

Yours sincerely

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[8] ENA p. 20.
[9] https://www.aemc.gov.au/sites/default/files/content/5b11e59f-b1af-43e8-a61a-6fd4b3df8657/RuleChange-Submission-ERC0177-EnergyAustralia-150714.PDF