Locked Bag 14051
Melbourne City Mail Centre
Victoria 8001 Australia
T: 1300 360 795
www.ausnetservices.com.au

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Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney NSW 1235

Lodged online: www.aemc.gov.au

Dear John

National Electricity Amendment (Demand Management Incentive Scheme) Draft Rule 2015

AusNet Services welcomes the opportunity to provide a response to the Australian Energy Market Commission's (AEMC) draft rule determination with respect to the Demand Management Incentive Scheme (DMIS).

AusNet Services supports the introduction of an explicit Demand Management Incentive Scheme (DMIS) which will financially reward businesses for implementing efficient non-network solutions and share in their value to the market. The separation of this financial incentive from the cost-recovery mechanism in the Demand Management Innovation Allowance (DMIA) is appropriate as these two mechanisms address two different objectives.

This submission responds to matters raised in the draft determination in relation to the DMIS.

AusNet Services would be pleased to discuss the attached submission in further detail with you at your convenience. Please contact me on 03 9695 6627 or anh.mai@ausnertservices.com.au if you have any questions in relation to this submission.

Sincerely,

Anh Mai
Manager Economic Regulation
AusNet Services

The need to provide an incentive

AusNet Services favours non-network solutions where they are able to efficiently substitute network solutions and provide value for consumers. While the current regulatory framework leaves us largely indifferent to which solution is taken, the only benefits which distributors derive from implementing non-network solutions stem from the costs savings from avoided network expenditure. Therefore, challenges exist where:

- A non-network option that delivers net benefit to the market may not be adopted because we cannot access the cost-offsetting value of those benefits because they do not accrue to the network. This has also been described as a 'split incentives' problem.

- Connected to this, other market participants such as transmission businesses can benefit from demand reductions resulting from a non-network solution implemented by the distributor but do not share in the costs of these works, effectively 'free riding' off the investment.

In light of this, an incentive scheme which enables distributors to earn an appropriate financial reward and share in the broader market benefits resulting from their non-network solution would encourage the adoption of efficient non-network options. It is consistent with good incentive-based regulation and would contribute to the achievement of the National Electricity Objective (NEO). Further, it would be effective in driving network businesses towards maturity in integrating non-network solutions in network planning and investment decision-making. While some progress has been made in recent years, the application of a DMIS which will reward businesses for delivering non-network solutions can only accelerate this progress.

Further, the DMIS will play a crucial role in preparing networks and the market for the future where non-network options will become increasingly important as new technology and better affordability make them suitable substitutes for network solutions.

It is expected that over time, the need to provide an incentive for demand management should diminish as the understanding and adoption on non-network options becomes fully mature.

Scope of the incentive

The Draft Determination sets out that the DMIS should only apply to non-tariff demand management because recent rule changes require distributors to introduce cost-reflective tariffs and the scheme should not reward firms for doing what the rules require them to do. The AEMC's expectation is that cost-reflective pricing will deliver clearer price signals to remote parts of a distribution network.

However our customers' sensitivity to energy price rises and its impact on their cost of living mean there is no intention to apply locational pricing in AusNet Services' network at this stage. As such, there may be a need to provide an incentive for tariff-based demand management where it meets the objective of the scheme.

Providing consistent incentives across the distribution sector

An effective regulatory framework provides consistent incentives across the regulated sector. It is, therefore, important that the incentives for implementing non-network solutions should be the same for all businesses.

As the DMIS will form an important component of the incentive-based regulatory framework, similar to service performance incentives and efficiency incentives, there should be a presumption in the Rules that the scheme applies. This is currently the case for all regulatory incentive schemes as their existence indicates a general need for them to drive particular outcomes. However, the draft determination describes the DMIS as optional:

> The optional application of the scheme and allowance promotes flexibility and adaptability in regulatory arrangements. It reflects the intent of the scheme and allowance as tools which are available to the AER to help it balance the incentives between network and non-network investment.[1]

Beyond requiring the AER to publish a scheme by December 2016, the draft rule leaves it open to the AER to apply the scheme as it deems necessary, which creates a level of regulatory uncertainty.

Furthermore, leaving the AER with the flexibility to apply the scheme on a case by case basis without guidance could potentially result in a perverse outcome where businesses might avoid pursuing non-network options so that they may be provided an incentive (and rewarded) for undertaking them. In this situation, businesses which have responsibly implemented a number of efficient non-network options to date would be excluded from the incentive and effectively punished for their lack of bias.

Given the above, it would be useful for the Rules to set out criteria in relation to how the AER would assess whether the scheme would be applicable for individual businesses. Further, as there appears to be a temporary nature to the DMIS which will see it operate until such time as non-network solutions become business as usual for networks, considerations for the AER in deciding when and why it would decide to close out the scheme for a business would be similarly useful.

It would be reasonable for this decision to be made as part of a business's regulatory review process (presumably at the Framework and Approach stage).

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[1] AEMC, Draft Determination (Demand Management Incentive Scheme), May 2015, p 37

Participation in non-networks market by network businesses

AusNet Services supports the Draft Determination's conclusion that distributors have a role to play in demand management and that the DMIS does not pose a threat to the competitive provision of demand management services.

Networks are obliged under the regulatory framework to provide customers with the most cost effective and economic solutions over the long term, irrespective of who provides those solutions. It does not matter whether they are provided by a distributor or a third party provider.

Furthermore, the modernization of the energy market and the availability of new technology means that in the future networks will need to be able to provide services through a range of solutions and not just limited to traditional network services. The DMIS will therefore play a critical role in pushing distributors to build capability to meet the needs of their customers in the future.

Expanding the scope of the RIT-D to replacement

While the RIT-D and the current distribution planning arrangements are beyond the scope of this rule change, the draft determination invites stakeholders to consider the possibility of expanding the scope of the RIT-D to include replacement and refurbishment as this was raised in submissions. The view is this might be an effective way to strengthen the current regulatory obligations on distributors to consider options in a balanced fashion.

However, AusNet Services would caution against such a step given:

- The current distribution planning arrangements which took over 5 years to develop and only began operation last year should be provided a reasonable opportunity to establish themselves and deliver expected improvements in planning and investment decision-making.
- The proposed DMIS will work in combination with the current distribution planning framework and RIT-D to ensure the consideration and implementation of non-network options.
- The regulatory cost and burden of applying the RIT-D and its associated consultation process to replacement projects would be immense. The volume and breadth of asset replacement programs in distribution would mean that the cost of administering the RIT-D process for many hundreds of replacement projects across the sector would be unlikely to be outweighed by any marginal benefit. Regulatory settings must provide for the effective assessment of investment options whilst ensuring cost-efficient planning process and reasonable regulatory burden.
- Replacement of assets is necessary when there is unacceptable risk that assets can no longer safely serve their function. The application of the RIT-D to asset replacement planning would therefore contemplate that these assets be removed from service, and potentially replaced by off-network solutions. It is unclear how the broader regulatory framework would currently provide for distribution businesses to initiate the removal of network services, and for them to replace these with non-network services. Therefore consideration of

expanding the RIT-D to asset replacement should form part of a wider review of the role and responsibilities of distributors in these types of situations.

An appreciation of the above issues leads AusNet Services to conclude that re-opening the scope of the RIT-D and current planning arrangements at this time is unnecessary and a disproportionate response to the issue it is seeking to address.