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Mr Ben Davis, Acting Director
Australian Energy Market Commission
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20 March 2018

Implementation of Demand Management Incentive Scheme - ERC0230

Dear Mr Davis,

AGL Energy (**AGL**) welcomes the opportunity to make a submission in response to the Australian Energy Market Commission's (**AEMC**) Implementation of Demand Management Incentive Scheme (**DMIS**) Consultation Paper.

AGL is one of Australia's largest integrated energy companies and the largest ASX listed owner, operator and developer of renewable generation. Our diverse power generation portfolio includes base, peaking and intermediate generation plants, spread across traditional thermal generation as well as renewable sources. AGL is also a significant retailer of energy, providing energy solutions to around 3.5 million customers throughout eastern Australia.

In addition, AGL is continually innovating our suite of distributed energy services and solutions for customers of all sizes. These behind-the-meter energy solutions involve new and emerging technologies such as energy storage, electric vehicles, solar PV systems, digital meters, and home energy management services delivered through digital applications.

In 2015, the AEMC made the Demand Management Incentive Scheme (**Scheme**) rule change to help balance the incentives for distribution network service providers (**DNSP**) to undertake efficient demand management projects. The rule change included requirements on the AER to develop a Scheme, which was subsequently published in line with the Scheme objective on 14 December 2017.

The AER proposes to make a Rule that would allow eligible DNSPs to apply to the AER for approval to apply the new DMIS mid-way through an existing regulatory control period. The AER would then assess the proposal and decide on early application of the Scheme for a DNSP and the date from which it may apply.

AGL's position

AGL considers that if the DMIS is to be permitted, and implemented within an existing regulatory control period, the AER's ring fencing regime (in terms of enforcement and the exemptions process) must first be shown to be working effectively.

In AGL's view, this is not the case, and as such we oppose the Rule Change on the basis that appropriate enforcement frameworks are not currently in place to effectively manage the provision of services that should in principle be ring fenced.

In our view, to justify an early application of the Scheme, tighter controls must be placed on Rules relating to services that should be ring fenced, or greater direction should be provided in the Rules on the scope and extent of the enforcement regime, as ring fencing has not been shown to be operating within the principles of Rules that have previously been made by the AEMC. We therefore have no confidence that the DMIS



scheme will operate effectively within the same enforcement regime and operate effectively to meet the Scheme objective.

Customer objectives

AGL considers that demand management programs have a vital role in promoting the efficient utilisation of network infrastructure, and thereby minimising required network investment and operational expenditure and resultant costs to customers. The advent of a wave of new 'smarter' controllable demand side technologies present real opportunities to scale-up the use of demand management programs going forward.

Accordingly, an efficient deployment and use of DER and demand management related services will enable co-optimisation across these multiple uses and value streams. It will also recognise that it is ultimately a customer's choice as to how their BTM resources are deployed and what compensation or reward they expect for participating in different service markets (including providing network support).

AGL sees competition and innovation in technology and business models as the primary means for meeting this co-optimisation challenge and aligning the interests of energy service providers with those of the customers they serve. To enable efficient 'value stacking' requires the need for the location and size of grid support services and their value to the network to be made explicit, so that products and services can be designed by competing energy service providers to address these and build those values into the commercial model.

This will directly benefit customers investing in DER by ensuring the least cost deployment and highest value use of those assets are made, and by promoting the availability of a range of retail offers and bundled products to meet distinct customer preferences. Importantly, it will indirectly benefit all customers by ensuring investment in assets or services which support reliable network operation are efficient, thereby ensuring the efficiency of overall network costs.

The AEMC has previously explored these issues and agreed to these principles in their rule change regarding the contestability of energy services.¹

Operation of existing incentives framework

Within this context, the introduction and renewal of the Scheme and the associated demand management innovation allowance (**DMIA**) is justified only on the basis that there appears to remain a bias to network investment in capital expenditure programs. This is despite the current economic regulatory framework seeking to provide balanced incentives on distribution businesses to pursue the most efficient network investment and management pathway, whether this be a network or non-network solution.

There are a range of factors, with complex interactions, that lead to this outcome. These include the allowed rate of return, the long-term stability of returns on capital investments (particularly under a revenue cap), and comparatively less familiarity with demand management programs.

Although AGL strongly supports the principle of incentivising networks to provide standard control services as efficiently as possible, it believes the economic regulation of the networks as it stands is overly complicated and distorted by the multi-layered incentive schemes that are currently applied.

In our experience, these schemes have not encouraged more efficient capital and operating expenditure by networks but have simply resulted in questionable annual accounting practices, highly variable reported expenditures during regulatory periods, followed by tenuous expenditure proposals by networks in the subsequent period. These schemes are highly susceptible to gaming, very difficult for the regulator to critically

¹ AEMC, Rule Determination, National Electricity Amendment (Contestability of energy services) Rule 2017, available at: <https://www.aemc.gov.au/rule-changes/contestability-of-energy-services>



assess, and provide opportunity for underperforming networks to engineer their spending and accounts to mitigate inefficiencies into the future.

We note the AER's conclusions that on the face of evidence provided to it during the submission process, it is likely that distributors presently face incentives to prefer network options to non-network options relating to demand management.² Further, the treatment of capex can create an incentive for a distributor to prefer network solutions to non-network solutions in particular if the distributor and its investors prefer relatively stable long-term cash flows, receive an allowed rate or return on regulated capex that is above its actual cost of capital, or value the option to defer capex less than electricity consumers.³

These factors pose significant distortions in the efficient operation and investment in electricity networks, which must be redressed by significantly regulatory reform. Therefore, while AGL does not support the existence of the Scheme in principle, on the basis that it merely provides an additional financial windfall for networks to operate efficiently, we do support the AER's view that there is value in improving how it regulates networks.

We note the AER's description of the nature of the DMIS and DMIA as a 'bridge' between the current inefficient network pricing and incentive model and an optimal framework, and we would encourage the AER to therefore focus on the transition towards efficient network pricing, monitoring the effectiveness of recent regulatory reforms, progressing and supporting further regulatory reforms such as amendments to the RIT-D, and continuing to engage with stakeholders and contribute to rule change proposals and energy market reviews.

In this respect, it seems that while the AEMC and the AER have both agreed that the principles of the DMIS and DMIA are misplaced, they have conceded that a temporary mechanism is required while more principled regulatory reform occurs due to the inertia of the existing network model. We also agree with the view that the DMIS and DMIA are temporary mechanisms only that should not be expanded and should not defer the longer-term reform that needs to occur through the AER's Better Regulation reform process.

It is therefore absolutely critical that the DMIS and DMIA are enforced appropriately from a ring fencing perspective, so as not to erode important regulatory principles that have been set by the AEMC with regard to other determinations, such as the contestability of energy services.

Design of DMIS and DMIA

In AGL's view, it is critical that the DMIS is regulated and enforced in such a way as to build on the capacity of the competitive market to deliver demand management programs. Requiring network businesses to engage with competitive service providers in the delivery of demand management programs will better assure that such programs are efficient, lower-cost, innovative and have a strong customer focus.

New technologies are providing more advanced ways to deliver demand management programs. However, if network businesses bypass competitive providers when designing and implementing such programs, we are unlikely to see the realisation of potential available innovations, cost reductions and service outcomes from their competitive provision.

As a monopsony purchaser of such services, the ability for a DNSP to by-pass the competitive market will have profound implications for the potential for a strong market in demand management services to develop.

² AER, *Explanatory statement Draft demand management incentive scheme*, 28 August 2017, p.12

³ *Ibid*, p.12



The AER has stated that the Scheme is neutral towards whether a distributor provides the demand management component of an eligible project in-house, as long as the in-house option is:

- Permitted under other regulatory requirements. For instance, the national ring-fencing guideline requires distributors to implement ring fencing arrangements between direct control services and other (negotiated and unclassified/unregulated) distribution services;⁴ and
- Maximises the expected net benefit of the preferred option. In achieving this, the Scheme should promote efficient outcomes that reduce electricity prices in the long term, all else being equal.

Based on recent experience with ring fencing waiver applications, we are not as optimistic as the AER that the draft scheme will operate in a neutral manner towards DNSP's in-house suppliers. We anticipate that a careful monitoring of the tendering process as well as an assessment of the parties that are successful in the tender process should determine over time if there is a bias towards ring-fenced entities providing services to regulated parent DNSPs.

Indeed, there are a number of other reform processes currently underway which aim to increase the extent to which non-network solutions are considered and deployed in the place of traditional capital expenditure programs. These include the introduction of more cost-reflective network tariffs, modification to the Regulatory Investment Test via the AER's replacement expenditure rule change proposal, and the contestability of energy services rule change proposals launched by COAG Energy Council and the Australian Energy Council.

In AGL's view, to the extent a DMIS is introduced and applied, this should only be on a transitional basis to bridge the gap until these reforms are implemented and have a tangible impact on the market for demand management.

Rationale for early adoption

In its Rule Change proposal, the AER contends that projects that are eligible under the Scheme are those with the highest expected net benefits. Therefore, the AER do not consider the early implementation of the Scheme will increase the risk of greater financial leverage to distributors to award demand side contracts to their ring-fenced affiliates. The AER argue this will not occur because:

- Under the Scheme, distributors receive financial incentives regardless of the identity of the other party with whom they contract for demand management services. Thus, the Scheme itself does not provide any significant reason for a distributor to favour its affiliate's projects over those of third parties; and,
- The Ring-Fencing Guideline is designed to prevent the use of regulated income, either directly or indirectly, in contestable markets. Ring fencing compliance is designed to prevent, detect and deter cross-subsidies.⁵

In our view, the reliance on the ring fencing guideline in moderating this efficient outcome is critical. Reliance on the ring fencing process to ensure an efficient outcome for customers implies that the AER will have in place a robust enforcement and compliance mechanism to oversee effective ring fencing. We do not perceive this to be the case.

We consider that the recent operation of the ring fencing enforcement regime has shown to produce regulatory outcomes that would allow DNSPs to continue to use their regulated revenue for contestable

⁴ See clauses 3.1 and 4 of AER, *Ring-fencing guideline: Electricity distribution*, November 2016.

⁵ AER, *Request for Rule Change – Early Implementation of the Demand Management Incentive Scheme*, p8

services and also cross-subsidise their ring-fenced affiliates when those affiliates are participating across both the regulated and contestable sectors of the energy industry.

Network ring-fencing

Effective ring-fencing of regulated distribution monopolies from businesses providing competitive services in contestable markets is of fundamental importance to promoting the long-term interests of consumers. This principle has been made clear in a number of recent AEMC rule change determinations, and is a particularly salient point at a time when greater consumer participation and the proliferation of new distributed technologies are prompting the development of entirely new service offerings which have the potential to deliver value to a range of end-users.

The emergence of new technologies and business models requires the AER to give effect to the overarching principles that customer-led decision making will lead to the most efficient outcome for individual customers and the sector as a whole.

Following the AEMC, the AER has also made public comments to this effect. It has stated that ring-fencing facilitates competition in markets that are contestable and makes regulation more effective in markets that are not contestable.⁶ For example, in its decision to the review of the ring fencing guideline, it stated:

Without ring-fencing, there is a risk that a DNSP might cross-subsidise unregulated electricity services with revenue earned from provision of distribution (and transmission) services. There is also a risk that a DNSP might discriminate in favour of an affiliate that provides unregulated electricity services, potentially harming competition in contestable markets. Such outcomes could lead to less efficient prices for operation and use of both regulated and contestable electricity services and restrict the development of competition in contestable markets.⁷

The AER has also observed in its own report⁸ that “where a network business offers services in a contestable market, robust ring fencing should be in place to ensure the business does not unfairly deter new entrants”. Hence, as noted by the AEMC, ring fencing aims to prevent harm to consumers that would be likely to result from the following types of DNSP behaviours:

- cross-subsidising an affiliate’s services in contestable markets with revenue derived from its regulated services;
- discrimination in favour of a DNSP’s related electricity service provider operating in a contestable market;
- providing related electricity service providers with access to commercially sensitive information acquired through provision of regulated services; and
- restricting access of other participants in contestable markets to infrastructure services provided by the DNSP, or providing access on less favourable terms than to its related electricity service providers.

Exemptions and waivers

⁶ AER, *Electricity Distribution Ring-fencing Guideline Explanatory Statement*, November 2016, p1

⁷ AER, *DNSP applications for waivers from the Electricity Distribution Ring-fencing Guideline – Decision*, December 2017, p13

⁸ AER, *State of the Energy Market*, May 2017



In December 2017, the AER delivered final rulings on exemptions to applications for exemptions to network ring fencing obligations. Despite the AER's own guidance that waivers are likely to be granted as "an exceptional and temporary measure only"⁹, the majority of applications lodged by DNSPs were successful.

In granting the exemptions, the AER's view appears to be formed on a reluctance to impose a definite cost on consumers (the cost of compliance) to avoid an uncertain cost (the potential harms to competition). The preferred approach from the AER was therefore granting reclassification waivers that allow DNSPs to undertake their existing operations with minimal disruption. This is a significant departure from the prevailing view that these businesses should be ring fenced, in alignment with policy principles that were determined during the AEMC's rule change consultation.

In order for end-users to benefit from services that are capable of dynamic competitive offerings, it is essential that there is non-discriminatory access to these markets. In our view, the nature of the services for which DNSPs have sought waivers are unlikely to ever be regulated services or services that would not benefit from a competitive market, and so the AER's rationale is heavily flawed.

Adherence by the AER to the principles set out in the ring fencing guideline play a crucial role in this regard. The decision to grant waivers is likely to further engrain services that can be competitively provided into existing DNSP costs, leading to inflated costs for customers.

There is no evidence that the significant market advantages that DNSPs hold by not structurally separating the provision of these services does not result in cheaper prices for customers. Indeed, as has been noted many times by the AER and AEMC, the lack of a competitive market for these services means that costs for these services are likely to be severely inflated.

We therefore seek further information from the AEMC and the AER on the application of waivers and the diversion from previously stated principles regarding ring fencing. In our view, both the AEMC and AER have made clear that the default position must be compliance with the Guideline as a rule—not the exception.

In our view, an applicant for waiver must put forward a reasoned basis for the waiver to be granted, that should at its basis be formed on a rationale of promoting competition for services, increased choice for customers, and reduced cost through competitive market forces. Issues of convenience or protecting access to economies of scale and scope are not reasons for a waiver to be granted.

We are concerned that the AER appears to have taken an inverse approach that all ring fencing waiver applications are to be accepted unless they are considered unnecessary or can be specifically proven to be detrimental. The AER has stated in their decision that the networks would normally be expected to comply with the ring fencing Guideline, but that temporary waivers are necessary in this instance to accommodate a transition to full compliance in the long-term.

In conclusion

In our view, these views are not an acceptable application of the relevant regulation and do not promote the temporary objectives of the DMIS. This application of the ring fencing guidelines must be equally applicable to the principles of the DMIS and DMIA, and appropriate enforcement and setting of any exemptions must be established prior to allowing the scheme to be brought forward.

We consider it is not sufficient for the AER to claim that there is an appropriate ring fencing guideline in place that acts as a sufficient security for the activities of DNSPs and their ring fenced affiliates, when the AER has departed so significantly from ring fencing principles in its determination so far.

⁹ AER, *DNSP applications for waivers from the Electricity Distribution Ring-fencing Guideline – Decision*, December 2017



We consider that the AER's approach provides market participants with little confidence in the efficacy of the ring fencing guideline. The ability of the AER to enforce the National Electricity Rules that are set by the AEMC is not merely a minor comment of the separation of market bodies that are responsible for different aspects of the regulatory process.

Rather, the AEMC must consider in making a Rule, whether or not that Rule will have the intended consequences and can be adhered with by participants and enforced appropriately. In our view, the AEMC should address this matter in their determination, and, if necessary, provide greater clarity as the how ring fencing in particular should be adhered to in meeting the objectives of the Rule.

Should you have any questions in relation to this submission, please contact Aleks Smits, Manager Policy & Research, on 03 8633 7146, or myself on 03 8633 6836.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Stephanie Bashir', is written over a faint, light blue circular watermark or stamp.

Stephanie Bashir

Senior Director Public Policy