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

Submitted via www.aemc.gov.au

19 March 2015

Dear Mr Pierce,

Submission on demand management incentive scheme rule change (ERC0177)

EnerNOC is grateful for the opportunity to comment on this important – and long overdue – rule change request. In this submission, we have followed the structure of the consultation paper.

Issue 1 Issues this rule change is seeking to address

Q1.1 Having regard to current and potential future market conditions, and in light of recent changes to the regulatory framework for distribution businesses, is there a gap in the current framework which may be discouraging distribution businesses from pursuing demand management projects as an efficient alternative to network investment?

Yes. The reforms mentioned – the distribution annual planning report, the demand-side engagement strategy, the RIT-D, and the distribution network pricing arrangements – impose obligations on network businesses to provide information and to consider options. However, they do nothing to motivate the businesses to pursue demand-side options.

Unfortunately, network investment decisions are rarely so clear-cut that the range of plausible options, and the expected costs and benefits of each, can be determined completely objectively. In practice, a degree of subjective judgement is needed both in forecasting the usage of the network (complete with probability distributions to account for uncertainty, which is often substantial), and in specifying the various competing options. The specifications are particularly important for demand management options, because changes in key parameters such as lead time or maximum annual hours can render an otherwise low-cost option prohibitively expensive.

This unavoidable subjectivity means that in practice network businesses have considerable freedom to choose whichever option suits their preferences, regardless of whether it is really the most efficient option: it would be almost impossible for any other party, including the AER, to prove that a particular decision was actually inappropriate.

As a result, incentives matter. We should expect efficient businesses to pursue the most profitable option. The role of the incentive scheme is to nudge the network business towards favouring demand management options when they are the most efficient, by making such a course the most profitable one.

Q1.2 If a gap does exist, where does it lie? Is it a product of the provisions in the NER or a result of the current design of the DMEGCIS applied by the AER?

The gap is in the current design of the DMEGCIS, as applied by the AER. As noted in the consultation paper,[1] it does not provide network businesses with an opportunity to make profits on demand management projects, and, as such, is not a true incentive scheme: it does not reward a business for delivering defined goals.

For the many reasons identified in the rule change proposals and in the consultation paper, network businesses have a preference for solutions involving network infrastructure. An effective incentive scheme would reward network businesses that overcame this tendency.

There may be another gap, relating to transmission networks. In the AEMC's 2012 Power of Choice review, there was broad agreement amongst stakeholders that similar demand management incentive schemes should be apply to both distribution and transmission network businesses. In its final report, the AEMC recommended against this, but the rationale for this recommendation was simply that:

> *"The incentive regulation framework for transmission business is subject to change under the network regulation rule change plus the AEMC Transmission Frameworks Review is looking at the issue of transmission incentives generally."*[2]

The Transmission Frameworks Review has since been completed, and has not addressed the issue of incentives for demand management.[3] What's more, the

[1] Consultation paper, pp. 10, 25.

[2] AEMC, *Power of choice review - giving consumers options in the way they use electricity*, Final Report, 30 November 2012, p. 214.

[3] AEMC, *Transmission Frameworks Review*, Final Report, 11 April 2013 has no mention of demand management.

AEMC has subsequently made a draft recommendation against implementing Optional Firm Access, the core recommendation of the review.[4] In the light of this lack of progress, we recommend that the rule should be extended to cover transmission network businesses as well as distribution network businesses.

Issue 2 Proposed DMEGCIS

Q2.1(a) Having regard to the level of flexibility and discretion afforded to the AER in designing and applying other incentive schemes under Chapter 6 of the NER, is the level of flexibility and discretion currently afforded to the AER in relation to the DMEGCIS appropriate?

No. Despite already having the power to introduce an effective incentive scheme, the AER has chosen – for reasons that have never been satisfactorily explained – not to do so. More prescription is therefore required.

Q2.1(b) If there is benefit in providing more prescription in the NER, is the level proposed by the COAG Energy Council and the TEC in their rule change requests appropriate?

The two rule change requests may still leave too much discretion to the AER, in that they still propose giving the AER the ability to impose an ineffective incentive scheme – for example, by setting the network business's share of the benefits to zero.

Issue 4 Demand management incentive scheme

Q4.1 If distribution businesses are able to receive a payment based on a proportion of the market benefits produced by a demand management project, is this likely to increase investment in projects that will deliver broader market benefits that are in the long term interests of consumers?

Yes. Since there will be some reward for the network business, it is better than the status quo.

This method of formulating the reward, although very conservative, means that there is no possibility of the available incentive causing a network business to pursue a demand management project that does not further the long-term interests of consumers.

[4] AEMC, *Optional Firm Access, Design and Testing*, Draft Report, 12 March 2015.

The comment in the COAG Energy Council rule change request that setting a cap on the share of the market benefits that the network can retain "has the benefit of promoting certainty for DNSPs about the returns available for implementing demand management projects"[5] is curious. A **floor** would give a network business such certainty; a cap does not do so at all. We would support a 30% floor.

The consultation paper comments[6] that the RIT-D was also intended to ensure that efficient non-network solutions are identified. As discussed in our comments on Issue 1, an obligation by itself cannot bring about the necessary behavioural change; an effective incentive is also needed.

The provision of this reward will require collection of data about the level of demand management activity, its costs, and the avoided costs. To quote the AEMC, "an incentive scheme is only effective if it changes a business's behaviour and results in a net cost saving to consumers."[7] The data that is collected should be used to judge the effectiveness of the DMIS and to calculate metrics that can be used to benchmark the network businesses' demand management activities. The AER should then use these benchmarks to inform their assessment of network businesses' expenditure proposals.

Q4.2 *Given that the majority of distribution businesses are expected to be regulated under a revenue cap in the near future, is there value in amending the rules to explicitly require the inclusion of a payment for any foregone revenue resulting from implementing a demand management project approved under the innovation allowance? Should the AER retain discretion as to whether this component is appropriate?*

If any business remains under some form of price cap, then it will need to be compensated for foregone revenue. Businesses under a revenue cap do not need such compensation. There does not seem to be any room or need for discretion here. Ideally, all network businesses would have their revenues fully decoupled from throughput, so the issue would not arise.

Q4.3 *In light of the recent changes to the distribution network pricing arrangements, what are the potential benefits of requiring that the DMEGCIS include tariff based demand management options, in addition to non tariff based options?*

It is straightforward to determine the effectiveness of non-tariff-based demand management schemes, because customers are explicitly enrolled for the scheme, and their performance must be assessed because it affects their payments. In contrast, assessment of tariff-based schemes is much harder, requiring a great

5 COAG Energy Council, rule change request, p. 6.

6 Consultation paper, p. 28.

7 AEMC, *Power of choice review - giving consumers options in the way they use electricity*, Final Report, 30 November 2012, Sydney, p. 207; also quoted in the consultation paper, p. 26.

deal of inference about participation and performance. Unless some fairly objective measure of the effects of a tariff-based scheme can be devised, we are inclined to agree with the COAG Energy Council that the risks of including them in the incentive scheme are too great.

I would be happy to provide further detail on these comments, if that would be helpful.

Yours sincerely,

Dr Paul Troughton
Senior Director of Regulatory Affairs