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Mr Richard Owens
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Lodged online at www.aemc.gov.au

Dear Mr Owens

Demand Management Incentive Scheme -Ref ERC0177

GDF Suez Australian Energy (GDFSAE) welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC) Demand Management Incentive Scheme rule proposal (the proposed rule).

Demand management incentives in context

The existing market design is premised on competition, customer choice and decentralised decision making. This, in turn, requires effective price signalling to customers to foster informed decision and enable behavioural changes in end-use energy consumption. These price signals need to be effectively structured to signal energy and network usage costs.

Energy prices are already provided by competitive spot and contract markets, however, networks remain regulated monopoly businesses and existing network charges to small customers are not cost reflective. High priced energy events typically do not coincide with high network demand and separate signals need to reflect the appropriate dynamics. Network capacity requirements are a function of geography and coincident demand.

The current structure of network pricing to small consumers doesn't value capacity as distinct from energy. The result is mispriced energy and cross subsidy between customers depending on their energy usage and load factors (ie high energy with low demand versus low energy and high demand). Typically the high energy users will subsidise the low energy but high demand customers (eg household with PVs and air-conditioning). A move towards cost reflective network pricing is a positive step but will take time to implement and deliver customer benefits.

Historically, network demand has monotonically increased. The rate of return regulation has incentivised network businesses to grow their business by investing in new assets, rather than looking for competing non-network solutions. In this paradigm, for a network business to be revenue neutral, the net present value of a competing project would need to be equivalent to that of a network project and would not necessarily benefit the customer.

With sharp increases in network costs and decreasing demand on some networks, political pressure is increasing to reduce electricity costs to consumers. Some customers are avoiding network charges by installing rooftop solar and/or improving efficiency to reduce energy imports from the grid. However these

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customers benefit from security of supply and backup generation which is subsidised by other network users.

In addition, self-generation and potential disconnection from the grid raises the spectre of stranded network assets. Technology is likely to accelerate such trends and make the current pricing to consumers unsustainable, as it places the cost burden of the network on a smaller number of consumers.

In summary, network businesses are now faced with a combination of political pressures, uncertainty over future network demand, low interest rates (WACC), and continuing growth of embedded rooftop solar generation, and therefore network businesses are looking at other ways of growing their revenue.

Under the current market model, their offerings must be bundled by a retailer to ensure that a complete product offer is made.

The new focus of delivering savings in network is misplaced

The focus on network driven initiatives to reduce network expenditure, and hence lower the cost to consumers, is a flawed concept as the customer utility function is omitted from network decision-making. Network incentives, if successful and by themselves, may deliver sub-optimal outcomes, but alternatively could increase costs to consumers as a result of split incentives (between customers, networks and retailers).

Networks should not be placed in a position to second guess customer choices and behaviours or to assume that an “efficient use of networks” is synonymous with providing value to customers. Customers will place value on using energy when they choose in accordance with their needs and preferences and not when the network chooses to provide it based on policy driven incentives.

The primary function of networks should be to provide efficiently priced network services so that customers have choice. Such customer choice will, over time drive network investment which may possibly be higher or lower than present based on those preferences. So long as network pricing is cost-reflective, customer choices will be efficient and reflect a desire to utilise more or less of network services. Recent history would suggest customers may ideally consume less network services when faced with cost-reflective prices but these preferences into the future are unknown. Therefore, creating policy interventions for the myopic objective of reducing network investment at all costs is short-sighted and inefficient.

In the event that incentives are warranted as part of a transitional arrangement to curb overinvestment in networks, these should be retailer driven (incentivised) from the customer end, and not the network end. This is because the trade-off for consumers reflects consumption and not regulatory incentives.

Elements of efficiently priced supply

There are a number of categories to efficiently priced supply to consumers. In the context of this discussion the following are considered most relevant:

- Energy prices reflective of the supply/demand balance as close to real time as possible (which should not be confused with existing time of use pricing which is not cost reflective);
- Cost reflective network charge – fixed charges, demand related charges and energy usage charge (very small component based on network losses);
- Competitively priced and offered energy services (which may include demand management, local voltage control etc.); and

- Economically efficient pricing of micro-generation exports to the grid (energy and network benefits/costs; additional charges for localised ancillary services where applicable).

From a small customer's perspective an arrangement based on these categories represents a major change from the status quo and may require a transitional period. However transitional policies should encourage cost-reflective price signals and not operate in isolation to favour topical or preferred outcomes in one segment of the market.

The demand management incentive scheme does not support efficient outcomes as it undermines customer choice and provides questionable customer benefits. It can thus be argued that it is inconsistent with NEO. Therefore it should be either abandoned or drastically modified to enable it to be retailer led (Notwithstanding retailers are already pursuing similar outcomes in the competitive market without policy settings of this type. This undermines the very need for the DMIS in any case).

Issue 1 Issues this rule change is seeking to address

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?

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 incentives structure currently applied to the networks is sufficient to incentivise them to pursue demand management projects over network building and there is no current gap in the framework that would require the addition of a DMIS.

In terms of capital expenditure, there are two offsetting incentives that aim to encourage the networks to move toward an efficient expenditure decision:

First is the value of the weighted average cost of capital (WACC) that provides the networks with a return on an investment in the network. The WACC provides an incentive to spend capital on augmenting the network because the network earns the return on this capital invested.

Offsetting the incentive of the WACC is the Efficiency Benefits Sharing Scheme (EBSS). The EBSS provides the networks with an incentive to not spend capital on augmenting the network because the networks keep any underspend for a period longer than the regulatory period. The intention of the EBSS is to balance the incentive of the WACC and force the networks to make a trade-off between spending a higher amount augmenting the network and earn the WACC, or spend a smaller amount on a demand management arrangement and keep the additional return provided by the EBSS.

If the networks are choosing to build network over spending money on demand management projects, then this would suggest that there is an imbalance between the two incentives, and this is not a surprising outcome given that the value of the WACC has been overstated for many years.

In GDF's view, providing the networks with an opportunity to earn an even higher return on top of an over-valued WACC by allowing them an additional avenue for raising revenue is not in the long term interests of customers. The incentive framework that is already in place is more than sufficient to compensate them for their investment decisions, and we would prefer to see greater focus on a re-valuation of the WACC so that the EBSS acts as a greater offset to capital spending than is currently the situation.

There are sufficient measures in place already to assist demand side response as follows:

- Large customers can enter into direct negotiations over supply arrangements

- Aggregators can enable wider participation of smaller loads with variable demand side potential
- Cost reflective network pricing (if allowed to work efficiently) can incentivise changes in customer behaviours and network usage patterns

No additional measures to support demand side response are needed in the NER and attention should be given to the successful and timely implementation of the CRNP.

Issue 2 Proposed DMEGCIS

1. In making its decision on the network regulation rule change request, the AEMC considered how much prescription the NER should include. In this context, we welcome the views of stakeholders on the appropriate level of prescription to include in the NER to enable the AER to develop and apply an effective DMEGCIS. In particular:

(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?

(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?

2. Having regard to recent changes made by the AEMC to Chapter 5 and 5A of the NER in relation to the arrangements for connecting embedded generators, are additional financial incentives for innovation in the connection of embedded generators through the DMEGCIS required?

Networks have a narrow focus and the contemplated “innovation incentives” mechanisms represent a poor surrogate for customer benefits. Even if networks were successful in improving load factors which would improve economic efficiency from their perspective, this is unlikely to coincide with best value for customers.

It is difficult to see how networks could be sufficiently incentivised to look at least cost investment and operation without paying the “shadow price” of the network projects forgone (as outlined under issue 1). In such a case there would be either significantly eroded benefits, or no benefits to consumers.

Efficient signals should be provided to customers so that they can choose the best value proposition from their perspective. This is in an environment where monopoly networks are regulated to provide efficiently priced network services. For example, they may choose to increase their demand and pay the cost-reflective network price (CRNP) or to manage their demand and reduce their network costs. This value proposition must be assessed from the customer’s unique perspective.

The best way to achieve this is to foster customer centric decisions in the competitive market; mainly through retailers and alternative energy sellers, to drive initiatives.

In the overall market context, the DMEGCIS initiative appears ineffective. It may well be increasing costs in excess of benefits as it undermines customer choice and provides questionable customer benefits. Therefore it should be either abandoned or drastically modified. It does not represent a best case policy outcome and ignores the fact that market derived led initiatives are engaging consumers to make more informed choices about their network and energy consumption.

In case DMEGCIS continues to be pursued in some form, it should at least be sponsored by customers or retailers to support overall economic efficiency and enable customer choice / power of choice.

Issue 3 Demand management innovation allowance

- 1. Given that the proposed amendments in relation to the innovation allowance are largely reflective of existing AER practice, what additional benefits are likely to be gained by codifying these in the NER?*
- 2. What impact, if any, will the proposed amendments have on distribution businesses incentives to utilise a greater proportion of their allocated allowances on innovative demand management projects, relative to current practice? For example, would greater certainty increase the likelihood of distribution businesses participating in this scheme?*
- 3. Are the proposed amendments likely to address concerns raised by stakeholders around the size of the innovation allowances allocated by the AER to the distribution businesses (noting that, to date, these amounts have been considered to be modest)?*
- 4. Given the new DAPR and DSES arrangements are now in place, what additional benefits will the proposed annual reporting requirements deliver to the market? Is there a risk of duplication in reporting for the distribution businesses?*
- 5. Should the innovation allowance be a time-limited measure? If so, should the AER be given the flexibility and discretion to determine the appropriate timeframe?*

Having reviewed AER reports on innovation expenditure by networks, there appears to be a large overlap with customer and retailer initiatives. As such, the innovation allowance is misdirected, doesn't represent a value proposition to the consumer and cuts across retailer relationships.

The AEMC needs to give an authoritative account of why market lead initiatives cannot be relied upon to deliver the best environment for consumers to make informed choices about their consumption patterns and preferences. The question is not how to better design an unnecessary scheme.

Under no circumstances should market benefits be included to further distort the scheme. Customer choice and a retailer led approach as outlined previously is the effective and economically efficient way forward.

Furthermore, retailers and alternative energy providers are already well placed to offer integrated products and incorporate network, energy and energy services. There is little evidence to suggest networks should be receiving payments to compete in an already crowded space.

Issue 4 Demand management incentive scheme

- 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?*
- 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?*
- 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?*

For the reasons outline in this submission, these initiatives should be abandoned as they are inconsistent with a market based approach and customer choice. Networks must not be incentivised in any way by second guessing customer or energy market benefits. Customer choice must be front and centre of any effective arrangement.

GDFSAE trusts that the comments provided in this response are of assistance to the AEMC in its deliberations. Should you wish to discuss any aspects of this submission, please do not hesitate to contact David Hoch on, telephone, 03 5135 5363.

Yours sincerely,

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