Major Energy Users Inc.

19 March 2015

The Commissioners
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Sent by: online lodgement

Dear Sirs

CONSULTATION PAPER
National Electricity Amendment (Demand Management Incentive Scheme) Rule 2015
Rule change proposal ERC0177

Major Energy Users Inc (MEU) has reviewed the AEMC Consultation Paper addressing the rule changes on incentivising demand management (DM) in the electricity market proposed by Total Environment Centre and the CoAG Energy Council.

The MEU considers that the current electricity rules are biased towards encouraging supply side actions to ensure that the electricity market is reliable. At the same time, the MEU considers that the current rules limit the ability of the demand side of the market to take an active part in ensuring that the market is as competitive as is needed to ensure that electricity prices are the result of strong competition. With this in mind, the MEU welcomes the proposals to increase the potential for demand side activity to reduce market costs and, more particularly, network costs.

MEU members have introduced practices that implement DM under the current rules but, despite this, it is clear that their ability to interact within the electricity market is somewhat constrained by the structure of the market and its rules; certainly consumers are not provided with the same incentives and benefits that the supply side is provided with.

MEU members have reported that in the implementation of their embedded generation projects, the benefits that the additional generation to the market provides is not recognised by networks and networks still seek for the embedded generator to be liable for considerable costs that the networks advise they are exposed to manage the introduction of the embedded generator.

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Overall, the MEU considers that consumers seeking to provide DM in the electricity market face considerable barriers and need to be encouraged by changing the rules.

One of the key aspects where MEU members (and others) have reported facing significant barriers is with their interface with the networks - both transmission and distribution. The MEU notes that the two rule changes proposed are about reducing the barriers raised by distribution networks to DM responses by providing incentives to networks to embrace DM proposals; this is in contrast to networks addressing congestion by implementing network augmentations.

The MEU sees the problem lies with the networks being monopolies under regulation to provide a surrogate to competition. The MEU considers that the solution needs to reflect what would occur if there was real competition to the monopoly provider. In a competitive environment a seller, all other things being equal, will seek to reduce its prices to increase its market share. A seller will undertake R&D at its own cost to reduce its cost structure (and therefore its prices) and it should benefit from the lower cost structure for a period of time before its competitors implement their own cost reductions to reduce their prices; at this point the market then rebalances with a lower price structure. It is very unusual for a buyer to provide a seller with any support to implement cost reductions.

In the case of the Demand Management and Embedded Generation Connection Incentive Scheme (DMEGCIS) and Demand Management Incentive Scheme (DMIS) currently in use, the approach is that the networks (the seller) are:

- Given funding from the buyer to investigate actions which might reduce the cost of providing the service (and hopefully the price) - through part A of DMEGCIS,
- Paid by the buyer to implement a lower cost approach to delivering the service - through opex and capex allowances,
- Reimbursed by the buyer for any foregone revenue losses that implementation of the cost reduction program might cause - through part B of DMEGCIS.

When outlined in this manner, it is clear that the process of the DMEGCIS and its DMIS is entirely at the risk of consumers and provides considerable benefit to the networks without the networks facing any risk. This is contrary to what occurs in the competitive environment. The argument provided to support such a one-sided arrangement is that the networks will not do anything to reduce their costs unless they are effectively indemnified of any losses incurred. The basis of the rule changes proposed is that the networks need to be paid a bonus to do what a firm in competition would do from its own resources just to retain market share.

The MEU also notes that networks are currently exposed to competitive pressures as consumers seek alternatives to paying excessive electricity prices, yet the networks are currently being insulated from these pressures by the use of revenue caps on revenue allowances granted by the regulator.

While the MEU supports the application of incentive regulation, it is concerned that the existing incentives provided by the DMIS and DMEGCIS are not achieving the desired outcomes (and therrfore not providing outcomes in the long term interests of consumers), and whether the structure of the entire incentive needs to be changed.

The MEU notes that the Consultation Paper cites a concern that the funding provided by consumers for networks to investigate DM activities has historically been modest and the conclusion drawn is that the incentive programs are not delivering significant benefits. The MEU is convinced that this is not entirely the case. The MEU has also observed that there is little coordination between networks as to the DM programs undertaken and there is a redcued focus on what outcomes are expected and their wider application.

Overall, the amount of funding provided by consumers across the NEM on DM programs has been significant yet the benefits seen by consumers have been extremely modest. Decisions are made by individual networks as to what DM programs they will investigate regardless of what programs other networks might have carried out or what other networks are planning to do. Identification of those DM programs where the most benefit to consumers will occur is not a driver of how the funding will be used and there is no overarching requirement that there be coordination between the networks of the various DM programs they propose to undertake. Just as importantly, there is no central point where the results of all the DM investigations funded by consumers are published, made widely available and demonstrate the value of the outcomes compared to the investment made by consumers.

To address the concerns, the rule changes propose there be implemented an explicit objective and principles underpinning the DM incentive program and that there be a payment to the network (seller) of a share the net benefit achieved by the implementation of a DM project. The current elements of the incentive scheme would still apply, viz:

- Funding for networks (seller) to assess/test DM opportunities
- Payment of compensation for loss incurred by the network (seller) by implementation of the DM project

Pragmatically, although the MEU has a concern that the concepts of paying networks to investigate DM opportunities and indemnifying them against loss when a DM project is implemented is contrary to what occurs in a competitive environment, the MEU accepts that unless there is an incentive provided to networks, then DM projects are unlikely to be implemented, especially if the networks were not to realise an increase in profits.

Is there a need for change?

That there is a gap in the delivery of DM is not in question. The fact that DM has not occurred to the extent expected or desired highlights a need for change. MEU members report that networks do not actively encourage DM even when the MEU members make proposals for its implementation. It is clear the networks have the power to implement or to deny DM opportunities but are generally electing not to do so. That this occurs means that the decisions on DM are controlled by the networks despite the fact that the rules recognise the need for DM. Based on the outcomes, it would appear that either the rules are not forcing networks to implement the lowest cost options or the incentive is not great enough to get networks to make the change, or both.

The MEU considers that the recent changes to the network regulation rules and the greater use of benchmarking by the AER in assessing efficient levels of allowances for opex and capex, networks might be incentivised to use DM more as a method to get to the efficient frontier of costs, but there is no certainty this will occur.

The MEU considers that the AEMC needs to examine whether the rule changes on network regulation will result in greater use of DM as a tool to get to the efficient frontier or whether the current structure allows networks to avoid use of DM to be efficient. The MEU doubts this.

Strengthening the incentives for implementing DM should encourage greater use of this tool.

The rules on incentives

The MEU considers that a DM incentive program is appropriate to be included in the rules, because without it, it is probable that DM will continue not being used to reduce the cost of network services. The MEU considers that, as there is a wide variety of DM projects that could be implemented and different approaches that can be used (each with their own unique features) then to be too prescriptive in the rules is unlikely to result in the best outcome for consumers.

The AER already has a raft of incentive programs for networks - on opex (EBSS), capex (CESS) and performance (STPIS). If there is to be an incentive for DM, such an incentive regime needs to be consistent with the other incentive schemes. The MEU therefore considers that the rules for a DM incentive scheme should be as high level as the rules are for the other incentive schemes. To make the DM incentive scheme more or less prescriptive than the others could lead to a bias in the outcomes.

The principles behind the incentives

As noted above, the rules for the DM incentive need to be consistent with the rules for the other incentives applying to networks so that the sharing of benefits provides no greater benefit from any of the other incentive schemes. This will require the AER to ensure there is consistency of outcomes between all of the incentive schemes it implements. Therefore the MEU considers that the rules should not determine the amount to be shared (eg 30/70 or 50/50) but allow the AER to set the sharing level to ensure there is consistency and no bias.

For example, under the current rules, if an operational cost is identified as a lower cost option to network augmentation, the opex increases and the capex used decreases. The capex incentive therefore delivers a benefit to the networks but this benefit is offset by a reduction in the opex incentive benefit so the network is incentivised to implement a change where there is a net benefit to it. Implementing a DM incentive needs to ensure the balance between the schemes is not disrupted.

There is a cost to the network to implement DM so a principle must be that any reward that is shared must be inclusive of the costs involved with implementing the DM project. For example, if a DM project is a tariff based one, then the costs of implementing the project will be the increased opex incurred by the network to cover the incentive payment offered to a consumer to load shed or load shift, as well as the costs the network incurs for managing the project. The net benefit (ie after the costs have been deducted from the benefit) is what would be shared with the network and consumers through the incentive scheme.

In a competitive market, the rewards from implementing a cost reduction program are not long lived (as noted above); such a benefit might last from between 3-5 years but unlikely to be longer. So a principle of a DM incentive is that the requirement to share the benefit of DM should be limited, in a similar way to that used for the opex incentive where the benefit is shared only for 5 years.

However, the MEU notes that there is an intention to retain the existing elements of the innovation allowance and the compensation to the networks for losses. The rules should verify that the sharing of any net benefit must include the funds that consumers contribute for the investigation into the DM program and for the "make good" of the losses the networks is allowed as a result of the implementation of the schemes (ie any benefit that might accrue to the networks under the incentive scheme must recognise that consumers have invested in identifying DM projects to be implemented and that networks are not exposed to any risk as they are indemnified from incurring losses).

Recent changes to the rules

The MEU notes that the rules have been changed to make the connection of embedded generation a more transparent process and to reduce the transactional difficulties in obtaining a connection but they have not addressed the benefits that embedded generation provides to networks nor do they address the sharing of the rewards of the benefits provided by the embedded generation.

Therefore, there is still a need to provide an ability to recognise the benefits provided to the networks by embedded generation. The new incentive rule should specify that embedded generation is to receive some of the benefits achieved by their operation and the basis on which these are to be shared with the network and consumers.

The Innovation Allowance (DMIA)

Currently, the DMIA is effectively operated as a series of independent projects identified and undertaken by each network. The MEU is aware that there are views expressed that the allowance is merely a tool for networks to test "pet" projects, some of which have little real relevance to the majority of consumers, and may be unlikely to ever be implemented on a wider scale.

The MEU considers that greater coordination of the projects funded by the DMIA is required in order to eliminate duplication. Most importantly, the MEU is concerned that DMIA projects are identified by the networks with little input from consumers or recognition of what other networks have done or are planning, and that there is no open sharing of the results of the projects undertaken.

As the funds are provided by consumers, there is a need to ensure that the maximum benefit to consumers is achieved from their utilisation. This can be best achieved by the rules requiring:

- Greater clarity on what is expected from each project and the benefits that will accrue to consumers
- Greater input by consumers into what projects are to be undertaken
- Greater coordination of projects to eliminate duplication
- Public release of the results of each project with analysis as to whether the outcomes support the investment made and whether the project will be implemented in the network operations

Effectively, the entire process must be coordinated across the NEM (including projects by transmission and distribution networks and overseas entities) to avoid duplication and be more transparent, with clear definition as to what is proposed, what might be achieved, what outcomes resulted and a timeframe developed for if and when the project is to be implemented more widely.

The value of a DM incentive scheme

As noted above, the MEU supports the introduction of a DM incentive as there is evidence that without such a scheme the networks will not be active in implementing the DM which would benefit consumers. The MEU advises that its support is dependent on the incentive scheme including a number of controls that limit the ability of the networks to "double dip" by effectively being rewarded twice for the same activity and that there is recognition that consumers are funding investigation of options for DM and indemnifying networks against losses.

There is a question that, as the current round of network regulation is being carried out by applying revenue caps rather than prices caps, addressing the issue of network losses from implementing DM is not needed. The MEU considers that regardless of current approach to regulation, the rules need to be reflective of what might occur in the future to avoid the need for a further rule change to address changes. With this in mind, the MEU considers that the incentive scheme should be introduced on an all-embracing basis rather than by a piecemeal approach.

The AER should be provided with the discretion as to how an incentive scheme will be implemented and even if it is not be used at a particular time for a particular network. For example, the MEU notes that the AER in its draft decision for the NSW electricity distribution network review has elected to suspend the opex incentive (EBSS) for what appear to be quite sound reasons. The MEU considers that the rules should recognise the need for the AER to have this discretion to apply (or not) the DM incentive scheme as well.

Tariff based DM

Tariff based DM is just another tool in the toolbox for implementing DM. Encouraging load shifting to limit the need for augmentation has just as much value to consumers as implementing network support or demand reduction. To exclude a tariff based DM project from the incentive scheme will limit many DM options that might provide a benefit to consumers generally.

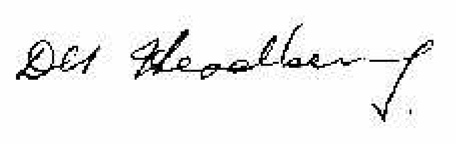
The question arises that a tariff based DM project might already be captured within the new approach to network pricing. The MEU does not consider that this occurs. The new network pricing approach applies a reallocation of costs such that, under the proposed long run marginal cost (LRMC) approach, more heavily used elements in a network will be priced higher than similar elements with lower utilisation. This provides a benefit to all consumers using a specific element of the network. However, this issue is complicated by consumers of the same class having the same tariff regardless as to where they are located in the network and by the allocation of the residual revenue after the determination of the LRMC for each network element. This means that the value of the new pricing approach might well be watered down by these complexities.

The MEU is concerned that, in practice, the benefit provided by a small number of (even one) consumers providing DM will generate a saving to all consumers rather than to those that incur the cost to provide the DM; allowing tariff based DM to be included in the incentive scheme provides an incentive for the networks to investigate such options and provides an avenue for the consumers providing the DM to recover the costs they incur in providing it. It needs to be recognised that under the new pricing rules and regulatory approach, there is no incentive on the networks to implement DM through tariff based approaches as they will still receive the same revenue regardless.

The MEU considers that as long as the benefit that is shared is net after all the costs to achieve the benefit are deducted from the gross value of the benefit, there is no reason not to include tariff based DM in the incentive scheme.

The MEU would be interested in further discussing its views with the AEMC and is open to providing more explanation if needed

Yours faithfully



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