9 July 2015

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

Dear Mr Pierce,

RE: AEMC Draft Rule Determination – *National Electricity Amendment (Demand Management Incentive Scheme) Rule 2015* (Reference ERC0177)

The NSW Distribution Network Service Providers, Ausgrid, Endeavour Energy and Essential Energy (the NSW DNSPs) welcome the opportunity to provide feedback on the AEMC's Draft Rule Determination – *National Electricity Amendment (Demand Management Incentive Scheme) Rule 2015* (the draft rule).

The NSW DNSPs support the AEMC's draft rule determination and consider the draft rule to be more preferable to the proposed amendments made by Total Environment Centre (TEC) and the Council of Australian Governments (COAG) Energy Council (the proponents).

Whilst the NSW DNSPs supported the nature of the changes proposed by the proponents in their rule change requests, we expressed concern that some of the proposed amendments were problematic or were more appropriately addressed by the Australian Energy Regulator (AER) in the specific design (or guideline) of the incentive scheme as opposed to the rules.

Consequently, the NSW DNSPs strongly support the AEMC's decision to make a more preferable rule. We consider that the draft rule better achieves the outcomes the proponents were seeking to achieve by their rule change requests, and largely addresses our concerns regarding the appropriateness of the proposed objectives and principles for the demand management incentive scheme (DMIS) and demand management innovation allowance (DMIA).

The NSW DNSPs support the AEMC's decision to make a preferred rule which adopts a less prescriptive approach towards addressing the issues identified with the current operation of the incentive scheme. We consider the objectives and principles contained in the draft rule strike a more appropriate balance between prescription and flexibility than the proponents proposed amendments. In particular, we consider the draft rule provides the Australian Energy Regulator (AER) with sufficient guidance to design a more effective DMIS and DMIA whilst retaining the flexibility for these schemes to be adapted over time to reflect changes in market and/or regulatory arrangements.

The NSW DNSPs also support the policy reasons underpinning the AEMC's draft rule. We consider that the policy direction provided in the draft determination provides additional guidance on the policy intent/outcome sought by the amendment, as well clarification on the intended interpretation and application of the draft rule.

Consequently, overall we consider that the draft rule is well targeted at addressing current deficiencies with the current incentive scheme and is likely to be more effective in promoting an economically efficient level of demand management in the National Electricity Market (NEM) and better contribute to the achievement of the National Electricity Objective (NEO) than the changes proposed by the proponents.

While the NSW DNSPs broadly support the draft rule, we have identified some aspects of the draft rule which would benefit from further clarification and/or amendments to improve the effectiveness of the rule and to address potential unintended consequences from the drafting of the rule. These include:

- The need for the rules to include focused guidance on the assessment of demand management expenditure - there is nothing in the rules which compels the AER to give effect to the AEMC's policy direction to address this issue by amending its forecast expenditure assessment guidelines. The NSW DNSPs consider that stronger measures in the rules are required to address this issue, particularly in light of the AER's view that DNSP's role in delivering demand management should be limited as this is more appropriately provided through the competitive market.
- The need for guidelines to support the application of the DMIS and DMIA – the NSW DNSPs consider that there would be significant benefit from the development of guidelines as this would provide greater transparency and regulatory certainty for market participants, and would temper some of the broad discretion afforded to the AER under the draft rule by making the AER more accountable for how the respective schemes are developed and applied.
- Clarification or correction of drafting issues in respect of the DMIS objective and treatment of the innovative criteria of the DMIA – the NSW DNSPs seek further clarification on these issues as we are concerned that the current drafting of the rule may result in the AER adopting a very narrow interpretation of the provisions resulting in unintended consequences such as projects currently within scope of the existing incentive scheme being excluded under the amended schemes.

These issues are discussed in more detail in our attached submission, as well as general comments in response to the draft rule. Our comments are not aimed at making substantive changes to the drafting of the final rule but rather at suggesting areas which would benefit from further refinement in order to improve the effectiveness of the rule so that it better contributes to the achievement of the NEO.

If you have any queries or wish to arrange a meeting to discuss our submission please contact Mike Martinson, Group Manager Regulation at Networks NSW on (02) 9249 3120 or via email at michael.martinson@endeavourenergy.com.au.

Yours sincerely,

J. Hardwick

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1. General comments

The NSW DNSPs support the AEMC's decision to make a preferred rule and consider that the AEMC's draft rule better achieves the objectives of the proponents rule change requests as 1) it addresses the issues identified with the operation of the current incentive scheme in a less prescriptive manner; and 2) it strikes an appropriate balance between prescription and flexibility, thus addressing specific concerns raised by the NSW DNSPs in section 2.2 of our response to the AEMC's consultation paper.

The NSW DNSPS are broadly supportive of the draft determination, and in particular support the following aspects of the AEMC's determination:

- the express requirement for the AER to develop an incentive scheme that considers net benefits to customers and provides a demand management innovation allowance that supports demand management projects over the long term. With respect to the DMIS this provides incentive to undertake additional projects which may not be cost effective to an individual NSP. Whilst the DMIA modifications provide certainty that projects that span multiple regulatory control periods will be funded for the full life of the project.
- the AEMC's decision to separate the DMIS and DMIA – we conclude with the AEMC that separate rule provisions for the DMIS and DMIA would better guide the AER on the design and application of the scheme and allowance, and would provide greater clarity to distribution businesses and the broader market around how these would operate.
- not codifying a cap on market benefits, as noted by the AEMC is more appropriately addressed in the AER's development of the DMIS rather than the rule provisions governing the design of the DMIS.
- the AEMC's decision to allow for both tariff and non-tariff based demand management projects to be included within the scope of the innovation allowance. As noted in our response to the consultation paper, excluding tariff based options would unnecessarily limit the scope of the incentive and remove a DNSPs ability to trial tariff based demand management. We provided several examples in our consultation paper response of tariff based projects.
- the AEMC's clarification on the role of DNSPs in demand management in light of questions raised in the AER's response to the consultation paper. Whilst third parties may provide a competitive source of demand management based technologies and projects in time, we consider DNSPs should retain the discretion to implement network and non-network solutions to address network constraints and be provided incentives where appropriate to ensure a balanced decision is made.

Whilst the NSW DNSPs consider the draft rule to be appropriately targeted at addressing the issues that have been identified with the operation of the current incentive scheme we consider that the draft rule could be further improved by:

- providing stronger guidance in the rules on the treatment and assessment of demand management expenditure during regulatory determinations in order to complement the incentive scheme and ensure that demand management projects that have tested successfully in trials under the DMIA are able to be incorporated in DNSP's business as usual operations;
- providing greater transparency and regulatory certainty on the application of the DMIA and DMIS through the development of guidelines; and
- clarifying drafting issues, which left unaddressed may result in unintended consequences and inadvertently limit the type of demand management project that fall within the scope of the scheme.

These issues are discussed in more detail throughout the remainder of our submission. We consider the amendments discussed below would provide greater guidance and certainty to stakeholders and would therefore better promote the NEO and AEMC's policy intent, of facilitating economically efficient levels of demand management.

Treatment of demand management related expenditure

The NSW DNSPs are supportive of the AEMC's draft decision to not amend the expenditure objectives and factors. As noted by the AEMC, any changes may be duplicative and unnecessarily complicate the existing regulatory framework. We maintain our position from our consultation paper response that amending the capex and opex objectives to maximise the use of non-network options is inappropriate as it may codify or artificially elevate one possible solution to meeting or managing expected demand when the regulatory framework should provide a balanced incentive to pursue the most efficient and prudent solution. Whilst we were supportive of the rule change proponents' intent, we considered the proposed modifications to the objectives and factors were better suited to the principles and guidance provided to the AER to assist in its development of the DMIS and DMIA respectively.

Whilst we consider the draft amendments are appropriate and well-targeted at addressing issues with the incentive scheme we still have residual concerns regarding the assessment of demand management expenditure during the reset process. As noted above, we consider the existing rules provide an appropriate framework for the consideration and assessment of demand management expenditure. However, in practice our recent experience suggests there is reluctance from the AER to approve demand management projects and uncertainty as to how the expenditure should be assessed. We have found it difficult to obtain funding even for well-proven pilots and projects. As noted in our response to the consultation paper, it appears the AER has a preference to rely on the recent pricing reforms and operation of the RIT-D to incentivise and enable DNSPs to pursue demand management solutions rather than assess demand management projects or fully consider the associated capex/opex trade-offs.

The NSW DNSPs consider that whilst cost reflective pricing and the RIT-D are both valuable tools in promoting demand management they will not sufficiently promote the efficient and prudent use of demand management in isolation. The NSW DNSPs consider expenditure allowances for demand management projects and trials are critical to the development and utilisation of non-network alternatives. The existing rules provided the AER discretion to develop a DMIS and outline its approach to the assessment of forecast expenditure. We do not consider the AER has appropriately utilised either of these regulatory tools to provide DNSPs appropriate incentives to pursue demand management and clarity as to how such projects would be assessed.

As part of the Power of Choice Review similar issues were identified and it was recommended that amendments be made to clarify how projects which straddle multiple regulatory periods be assessed. The AEMC decided against amending the Rules based on feedback from the AER but considered that it might be useful for the AER to consider issuing principles or guidelines regarding the factors that it would take into account when considering the efficiency of demand management project expenditure at the time of a reset.[1] In recognition of similar concern raised in our consultation paper response the AEMC consider that there would be benefit in the AER:

> *…explaining how it will assess the efficiency of demand management project expenditure as part of the regulatory determination process. This could be done in the expenditure forecast assessment guidelines, which set out the AER's proposed approach to assessing forecasts of operating and capital expenditure.*[2]

Ordinarily the NSW DNSPs would consider this a reasonable and logical response to address our concerns. However, given the AER's stated position, its failure to adopt a similar recommendation from the Power of Choice Review and our experience to date we consider firmer action is required to resolve this matter. There is nothing in the rules which would compel the AER to amend its forecast expenditure assessment guideline to reflect the AEMC's policy direction. The NSW DNSPs therefore

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[1] AEMC, *Power of choice review – giving consumers options in the way that they use electricity*, Final Report, 30 November 2012, Chapter 7, p 229.

[2] AEMC, *Draft Rule Determination – National Electricity Amendment (Demand management incentive scheme) Rule 2015*, 28 May 2015, p 24.

suggest the AEMC amend clause 6.2.8 of the Rules to include a specific guideline regarding the factors that the AER would take into account when assessing the prudency and efficiency of demand management expenditure.

A specific guideline would provide DNSPs greater certainty as to the factors a demand management project must satisfy in order to gain approval. Such confidence and transparency in the assessment of demand management expenditure is likely to improve its utilisation as an option to meet or manage expected demand. Therefore, the NSW DNSPs consider that making this amendment is consistent with the NEO and assists in achieving the overarching policy for the rule change request which is to ensure that regulatory arrangements adequately encourage and support DNSPs undertaking demand management.

2. Guideline Development

In its draft determination the AEMC notes there is merit in the AER setting out its approach to the development and application of the scheme and allowance mechanism. It noted that this would include setting out details on the methodologies used to calculate incentive rewards under the DMIS, and its approach to determining the size of the DMIA provided to the distribution businesses. However, in its draft determination the AEMC decided against including a requirement for the AER to develop guidelines for the DMIS and DMIA as it considered that these issues would be addressed as part of the development of the respective scheme and as such a requirement to develop guidelines would result in duplication.

The NSW DNSPs disagree with this position and consider that there is considerable merit in developing guidelines outlining the application of the schemes as this would provide greater transparency and regulatory certainty to market participants. Further, as noted by the AEMC in its draft determination, guidance of this type would complement the principles based approach to the scheme by tempering the discretion afforded to the AER in developing and applying the scheme and allowance and creating accountability.[3]

The NSW DNSPs consider more detailed guidance should be provided and that any guideline(s) should address the following at a minimum:

- setting out the methodology for the application of DMIS, including whether it will operate ex-ante versus ex-post and the methodology for calculating market benefits. Our preference is for a simple ex-ante methodology, similar to the Demand Management Benefit Sharing Scheme submitted in Ausgrid's regulatory proposal;
- setting out the methodology of how the level of DMIA is set (e.g. as a % of network revenue or some other measure)
- setting out the criteria that will be used to assess the eligibility of DMIS and DMIA projects. Including worked examples of what are considered applicable projects under the DMIS and DMIA, particularly clarifying projects that involve expenditure on distribution assets for the DMIS and innovative / broad-based type projects under the DMIA; and
- setting out the criteria the AER will apply in determining whether a DNSP is responding to demand management incentives in determining a DNSPs eligibility for the DMIS.

There is likely to be a slow maturation of any modified version of the DMIS and DMIA without such guidance as DNSPs will lack the confidence and understanding of the respective schemes to obtain expenditure approval from the AER. Therefore, the guidance sought above is consistent with the NEO and assists in the achievement of the policy intent of the rule change request which is providing a balanced incentive to encourage the use of non-network alternatives.

[3] AEMC, *Draft Rule Determination – National Electricity Amendment (Demand management incentive scheme) Rule 2015*, 28 May 2015, pp 37-38.

3. Drafting issues

Whilst the NSW DNSPs are supportive of the AEMC's draft rule, there are areas which require clarification and potentially amendment to give effect to the intent of the draft determination. Specifically, we are concerned about the definition of 'non-network' under the DMIS objective and the interpretation and application of 'innovative' under the DMIA.

DMIS Objective

The NSW DNSPs strongly support the AEMC's change from *may* to *must* in terms of the AER's application of a DMIS. However, we wish to clarify the change in definition of the objective of the scheme. We note that the objective and principles for the DMIS are closely linked to "network options" versus "non-network options." We are concerned that this change has the potential to inhibit a DNSPs incentive to research, develop and use innovative network based solutions to meet network demands at least cost. This issue may arise from a particular interpretation of the definition of a 'non-network option', which is *a means by which an identified need can be fully or partly addressed other than by a network option.* Where a network option is defined as *a means by which an identified need can be fully or partly addressed by expenditure on a transmission asset or a distribution asset which is undertaken by a Network Service Provider.* Consequently, we are concerned that there is scope for the objective of the DMIS to be interpreted as follows:

> *The objective of the demand management incentive scheme is to provide Distribution Network Service Providers with an incentive to undertake efficient expenditure on relevant* options that do not involve expenditure on transmission or distribution assets *relating to demand management (the demand management incentive scheme objective).*

By way of example, load control of residential appliances is a demand management solution that currently involves utility ownership and expenditure on distribution assets in order to deliver the peak demand reductions in the most cost-effective way to customers. These distribution assets include ripple injection plant at zone substations and switches at customer premises to control customer load. There are over 1.3 million domestic customers in NSW that take advantage of these controlled load tariffs predominantly for controlling electric hot water systems. This load under control is estimated to reduce state-wide winter peak demand by over 700MW. Emerging technologies such as electric vehicles and battery storage systems are also well suited to load control and demand response technology solutions in conjunction with tariffs or incentives. However, under a possible interpretation of the draft DMIS rule, any load control solution to address an identified need might only be eligible for a demand management incentive if the assets were not utility owned.

The NSW DNSPs consider the AEMC should provide guidance as to the intended application of the definition as currently drafted to avoid a narrow application that would effectively exclude DNSPs from implementing demand management projects that even partly involved expenditure on distribution assets.

DMIA

The NSW DNSPs also consider any clarification provided in respect of the DMIS objective should be provided for the DMIA. The draft determination states that the DMIA is to provide DNSPs *with funding for research and development in demand management projects that have the potential to reduce long term network costs*.[4] Demand management projects are defined under 6.6.3A(c)(2) of the draft rule as projects which:

> *(i)* *have the potential to deliver ongoing reductions in demand or peak demand; and*
> *(ii)* *be innovative and are not otherwise efficient and prudent non-network options than a DNSP should have provided for in its regulatory proposal;*

[4] AEMC, *Draft Rule Determination – National Electricity Amendment (Demand management incentive scheme) Rule 2015*, 28 May 2015, p 47

Similar to our concerns with the DMIS, a possible interpretation of the 'non-network option' element might exclude research and development in demand management solutions involving a distribution asset.

As per the NSW DNSPs submission to the consultation paper we have some residual concerns around the application and definition of the word 'innovative' or how the uniqueness / novelty of a proposed project is distinguished from a business as usual project. Under the current AER guidelines for the DMIA criteria there is only a requirement that a project "may" be innovative with the main intent appearing to be a research and development fund for the exploration of potentially efficient demand management mechanisms.

With the removal of the word 'may' from the new rule and considering the various views submitted to the consultation paper regarding the 'uniqueness / novelty of a proposed project' vs 'business as usual' projects, the NSW DNSPs would prefer that the AEMC provide a better definition or give guidance in the rules around the application of the word 'innovative'.

Furthermore, the specification of the word "ongoing" in 6.6.3A(c)(2)(i) may also limit DNSPs in researching and developing demand management options under the DMIA that are temporary or short-term in nature. Demand management solutions over a shorter period of a few years can be efficient solutions for the deferral of capital investment projects. The current draft rule may be interpreted as excluding the research and development of demand management approaches that are short-term in nature (eg. not ongoing), such as projects involving short-term customer agreements to shed load or operate embedded generators for incentives over a period of a few years. We suggest that 6.6.3A(c)(2) is redrafted to exclude the word "ongoing" and provide a clearer definition of or guidance around the interpretation of 'innovation':

(i) *have the potential to deliver ~~ongoing~~ reductions in demand or peak demand; and*
(ii) *be innovative solutions that are not business-as-usual approaches for the DNSP; and*
(iii) *are not otherwise efficient and prudent non-network options than a DNSP should have provided for in its regulatory proposal;*

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The NSW DNSPs support the intent of the AEMC's draft rule and that it would, if properly applied by the AER, better achieve the NEO compared to the existing framework. It is therefore important to clarify the drafting issues raised or make amendments as appropriate. Any change to the current operation of the DMIA may reduce the uptake of the allowance unless DNSPs have an understanding of and confidence in, the practical effect of any amendments. We therefore consider strong guidance is required to give effect to the AEMC's intent and guide the AER in its development of the scheme and guidelines.