

Ms Claire Rozyn
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235



24 March 2015

Re: ERC0177- Demand Management Incentive Scheme

Dear Ms Rozyn

I write to provide a submission from the Energy Efficiency Council on the National Electricity Amendment (Demand Management Incentive Scheme) Rule 2015 Consultation Paper (hereafter referred to as the "consultation paper").

The Energy Efficiency Council is the peak body for energy efficiency, demand management and cogeneration. The Council includes energy management experts, policy experts and energy users.

The Council supports the immediate introduction of more explicit rules for the Demand Management and Embedded Generation Connection Incentive Scheme (DMEGCIS), similar to the proposals from the COAG Energy Council and Total Environment Centre.

Our submission focuses on the first, most critical question in the Consultation Paper - the need for urgent clarification of the DMEGCIS.

Question 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?

It should be a truism that an optimal balance of supply-side and demand-side investment is essential to deliver on the National Electricity Objective (NEO). The NEO is to "*promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity...*". If we are unable to deliver an efficient balance of investment between the major categories of supply-side and demand-side investment, regulators and market participants are fundamentally failing their primary duty.

Efficient investment in supply-side and demand-side electricity services requires decisions by all parties in the chain of supply and demand, including generators, Network Service Providers (NSPs), consumers and third-party service providers. Whilst some categories of investors, such as generators, are generally expected to make only supply-side investments, NSPs are in a unique position that means that system-wide efficiency will only be delivered if NSPs do both of the following:

- Provide tariffs and/or incentives that encourage an efficient balance of investment supply-side and demand-side services; and
- Directly invest in a balanced portfolio of supply-side and demand-side services.

It is critical to note that cost-reflective time-of-use tariffs for consumers will, by itself, be insufficient to ensure efficient investment in supply-side and demand-side services. Firstly, it is clear that time-of-use tariffs will take many years to roll out. Secondly, even with time-of-use tariffs, users will not face location-specific (nodal) pricing. Finally, even if both time-of-use and nodal pricing were in place, NSPs still make a large number of decisions on behalf of consumers. As a result, the incentives that NSPs face are critical.

Unfortunately, the incentive structures for NSPs still have a supply-side bias that is expected to continue to lead to reductions in the overall cost-effectiveness of their investment strategy. While there have been some improvements in incentive structures in the years following the AEMC's Demand-Side Participation Review III (notably a reduction in Weighted Average Cost of Capital allowances and the shift from price-cap to revenue-cap regulation) NSPs still face substantial incentives that favour investment in supply-side services.

The impact of these distortions can be seen in NSPs' investment patterns. There have been promising signs of cultural change within NSPs, and a number of modest demand-side actions were included in NSPs recent expenditure proposals to the Australian Energy Regulator (AER). However, these proposed demand-side investments were only a fraction of the scale that would represent an efficient balance of supply-side and demand-side investment, clearly indicating that NSPs' culture and incentives still favour supply-side investment.

Therefore, there is still a strong case for a DMEGCIS to address a number of distortions in NSPs incentive structures. The case for reforms to clarify the DMEGCIS has been clearly demonstrated by the AER's recent determinations, which rejected the majority of demand-side investments and DMEGCIS that NSPs had recently proposed. The AER's actions threaten to undo extensive work by the AEMC and other parties to try and shift NSPs towards a more balanced pattern of supply- and demand-side investments.

The Consultation Paper also asks whether changes in market conditions may obviate the need for clarification around the DMEGCIS. It is clear that there have been no recent changes in market conditions that justify delaying clarification around the DMEGCIS.

- First, while total system peak demand in the National Electricity Market (NEM) has declined in recent years, peak demand is still rising in many parts of the network, driving the need for either grid augmentation or demand-management approaches.
- Second, even if demand was falling across all parts of the NEM, assets are aging and will need to be either retired or replaced. Demand-side approaches can be used to either avoid or reduce the need for investment in replacement assets.
- Third, changes in consumer preferences and the emergence of new supply-side and demand-side technologies mean that, even if the system peak continues to fall, there will be a significant change in the pattern of supply and demand in the network, necessitating that NSPs make either supply-side or demand-side investments.
- Fourth, while total system peak in the NEM has recently fallen, most market participants expect that total peak demand will start to rise again, creating a need for either supply- or demand-side investment.
- Finally, and most critically, the rules and regulations of the NEM should not be designed for a single scenario (e.g. stagnant demand), but to allow the most efficient pattern of investment according to changes in demand and supply, across a diverse range of possible futures.

In summary, clarification of the DMEGCIS must be a priority, as:

- While there have been improvements in the incentive structures facing NSPs, NSPs still face incentives that create a supply-side bias.
- There have been no changes in market conditions in recent years that suggest that clarification of the DMEGCIS is not a major priority.
- The AER has demonstrated that they need to be pushed to introduce an effective DMEGCIS.

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 need for DMEGCIS is the result of numerous distortions in the incentives facing NSPs, combined with innovation costs and a supply-side culture within NSPs. As a result, we would anticipate that the scale of payments through DMEGCIS should rise over time (as demand-side activities increase to their optimal level) and then decline (as innovation costs and cultural barriers decrease).

The AER currently has considerable discretion to develop DMEGCIS for NSPs. While the Council would theoretically prefer that the AER have wide-ranging discretion in the development of DMEGCIS, in order to account for the gradual change in energy market rules and NSPs incentive structures, the AER's recent draft determinations clearly indicate that there are cultural and skill problems within the AER that necessitate the development of more explicit requirements around DMEGCIS.

We believe that substantial change is required in the staffing and culture at the AER but, as this will take some time, it is essential to clarify the role and structure of DMEGCIS.

3. Other Issues

The Council notes that the COAG Energy Council and Total Environment Centre have produced extremely similar recommendations for clarifying DMEGCIS. The Council supports the broad direction of these recommendations, but will consult further with its members regarding specific elements of the Rule Change.

Summary

We thank the AEMC for consulting on the important issue of clarification of the DMEGCIS. The Council strongly supports the urgent clarification of DMEGCIS given the AER's recent unacceptable behaviour in relation to DMEGCIS and demand-side management more generally.

We look forward to further engaging with the AEMC staff on this issue. If you have any questions on the points raised in this submission please contact me on 0414 065 556 or ceo@eec.org.

Yours sincerely



Rob Murray-Leach