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By email: submissions@aemc.gov.au

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AEMC Review of Demand-side Participation in the NEM – Draft Report

1. Introduction

Jemena appreciates the opportunity to provide comments on the AEMC's Draft Report on its Review of Demand-side Participation (DSP) in the NEM. Jemena welcomes the work the AEMC is doing to identify potential impediments in the regulatory framework to the efficient and effective use of DSP.

Jemena directly owns the Jemena Electricity Networks (JEN) distribution network serving some 300,000 consumers in Melbourne. In addition, Jemena Asset Management (JAM) provides asset management services to other Australian electricity (and gas) distribution networks. The AEMC's conclusions and observations have implications for all electricity distribution networks, and therefore Jemena has taken a whole of market view in responding to the issues raised in the AEMC's Draft Report.

2. Previous submission

Jemena (then Alinta) made a comprehensive submission to the AEMC's review of DSP in its Stage 2 Issues Paper of May 2008¹. Our key points were that:

- Jemena supported removing impediments to DSP so that the National Electricity Rules do not distort distribution business (DB) decisions in favour of either network or non-network options.
- However, if the current Rules were significantly changed in favour of DSP, then the Rules must allow that increased DSP uptake may affect a network's projected reliability, safety, security and quality of supply standards.
- If a DSP option were implemented that placed greater risk on the network, then this risk should be borne by the DSP proponent, and not by the network. Jemena submitted a number of risk accountability mechanisms which could apply to DSP proponents.
- Given that under the current Rules, the benefits of DSP eventually pass to network users, then the DSP costs should equally be passed through to users, and that there were a number of symmetric mechanisms to achieve this.

¹ Alinta AE submission dated 23 June 2008.

3. Major issue in Draft Report – current regulatory incentives for DSP

Given Jemena's earlier views, we were especially interested to note if any current AEMC recommendations or options would significantly shift the regulatory framework in favour of DSP options.

To some extent, the AEMC conclusions are ambiguous. That is, while the Draft Report does not recommend new measures to positively shift the balance in favour of DSP, it does not on the other hand recognise that DBs can be at risk from DSP proposals, and that the risks can be asymmetrical.

Further, (under current Rules) network users will gain from DSP proposals which lower costs but will not have to contribute to failed DSP proposals unless a specific provision for ex-post cost recovery of these failures is in place. Jemena notes that the regulatory framework generally operates ex-ante, so that a DB in forecasting capital and operating expenditure savings from DSP would also have to allow for the costs of non-delivery of DSP services.

The AEMC appears to assume that a fully functioning market in perceiving DSP opportunities already exists and that there is a commonly understood method of evaluating the potential for non-supply of DSP services when required by a DB. The draft report also appears to assume that a DB can potentially hedge its DSP risks under regulation by adequate contracting.

In reality, these conditions cannot be met. The DSP market is embryonic, there is a learning curve for all participants to go through, and it cannot be assumed that DSP proponents will always be willing to share risk.

The direction of the AEMC analysis is perhaps best summarised in the following quote:

A number of stakeholders have advocated that a price cap penalises the use of DSP by network businesses because DSP reduces network demand, which in turn reduces network revenue. This view is erroneous.

The reduction in revenue experienced under a price cap serves an important function in making sure that the network business has full regard to the loss of value experienced by the DSP provider whose load is curtailed under a DSP contract.

Conversely, insulating the network business from this loss of revenue (e.g. through a revenue cap, or through an explicit DSP 'incentive scheme') means that a network business may find it privately profitable to sign a DSP contract that reduces overall efficiency. In practice, this risk is likely to be relatively low. This does not, however, detract from the main finding that a simple price cap provides the most appropriate regulatory incentives for network decisions to buy DSP².

The AEMC finding is that price cap regulation provides a sufficient incentive for a socially desirable level of DSP. However, given the developing nature of DSP services, many network businesses (including Jemena) have generally considered that DSP-specific incentives to encourage the exploration of solutions should be facilitated by the economic regulatory framework.

Whatever the merits of different views, Jemena observes that the draft review has not sufficiently considered the asymmetric nature of incentives under current price cap regulation.

Jemena may be prepared to tentatively accept the view that a specific regulatory incentive is not currently warranted for DBs on the understanding that any DSP-related regulatory obligations are not imposed, or (alternatively) that any mandated DSP expenditure must be

² AEMC Draft Report: *Demand-side Participation in the National Electricity Market*, 29 April 2009, p. ix.

fully recoverable for an efficient DB. However, we note that cost recovery, by itself, is not an incentive mechanism.

Overall, Jemena's view is that the AEMC position that sufficient DSP incentives already exist will need to be confirmed by experience over time. A specific time frame for review of this AEMC position appears warranted.

4. Treatment of capex and opex

The draft report considers that there is a bias arising from the different regulatory treatment of capex and opex which disadvantages DSP options:

In contrast [to capital expenditure], if a network business makes an ongoing commitment to incur operational expenditure, e.g. in the form of a contract for DSP, there is no 'automatic' future revenue allowance. The business must justify the expenditure (for the next five years) as being efficient. There is a risk, therefore, that the regulator is unpersuaded by this justification, and does not recognise the expenditure commitment in full in setting its forecast of efficient operating expenditure. This makes DSP options riskier for the business than network investment options, even if the costs and benefits are identical. This would appear to arbitrarily disadvantage DSP options³.

Jemena acknowledges that where economic incentives are applied to minimise operating costs separately to the controls on capital costs, these may act as a disincentive to pursue non network solutions.

The Draft Report identifies the application of the efficiency carry-over mechanism (ECM) to operating expenditure as penalising efficient substitution between network augmentation and DSP, and explores a number of options for removing this distortion. These include:

- providing exemptions from the ECM for expenditure on DSP; or
- requiring a capital expenditure ECM.

Jemena recognises that ECM schemes could have unintended consequences by acting as a disincentive for network DSP solutions. In NSW, the AER has excluded DSP projects from the operating expenditure incentive scheme, and has also committed to this approach in Victoria, South Australia and Queensland. Jemena supports the AER approach in this matter.

5. Incentives for innovation

The Draft Report observes that:

Innovation in electricity networks is likely to become increasingly important. This is principally because there is likely to be significant new activity in connecting new lower-carbon technologies to the network and also an increased focus on the ways that energy use can be managed. Much of the expenditure that occurs for innovation will be operational expenditure, particularly when undertaking research and developing options⁴.

Jemena fully agrees with these observations. Significantly, the Draft Report finds that the current building blocks framework provides relatively weak incentives for innovation. The report notes that a possible remedy is to provide an explicit allowance to DBs to recover expenditure for approved innovation projects outside the standard expenditure requirement. The Draft Report notes that in other contexts this has been addressed by changing the regulatory framework to make allowances for innovation on a "use it or lose it" basis coupled with compliance reporting requirements.

³ AEMC Draft Report, p 25.

⁴ Op cit p 27.

Jemena agrees with the Draft Report that this might be appropriate framework to apply to the NEM, and we suggest further development of this option.

6. Network access and connection arrangements

In discussing network connection for embedded generators (EGs), the Draft report notes:

The Rules require generators above a threshold [5 MW] to follow a detailed connection process. This is because generators above the threshold have an increased likelihood of having a material impact on system security and reliability.

However, for small generators it may not always be appropriate for such a formal process to occur. The Rules recognise this by allowing generators below the threshold to opt out of the Rules framework and instead follow jurisdictional connection frameworks which tend to be less prescriptive.⁵

The Draft Report refers to the SCO policy response on electricity distribution network planning and connection⁶. That response considered that for small loads and micro-embedded generators, DBs should be required to specify at least one standard connection service subject to AER approval. The Rules would set out the technical requirements for micro-embedded generators.

Jemena contributed to the MCE/SCO consultation on this matter, and was initially concerned with the highly formalised process for establishing connection that was being proposed for all small users, including micro EGs.

Subsequently, the Network Policy Working Group of MCE/SCO has developed (informally) some revised proposals which appear to offer more flexibility to networks in developing connection offers. However, Jemena notes that development of the national connection framework is still far from complete and will be subject to further consultation, particularly through the National Energy Customer Framework process.

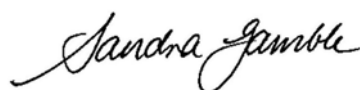
Jemena notes the Draft Report's view that the current framework, including the additions proposed by the SCO, appropriately balances the need for detailed arrangements for certain generators where such arrangements are necessary, while also allowing an appropriate level of flexibility for smaller generators where detailed arrangements would be unnecessary⁷.

Jemena welcomes the Draft Report's finding that the AEMC has not been persuaded that there is a significant barrier as a result of the connection process.

7. Contact details

Jemena looks forward to participation in further stages of the AEMC review. If required, I can be contacted on (02) 9270 4512 or email: sandra.gamble@jemena.com.au.

Yours sincerely



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⁵ Op cit p 47.

⁶ MCE Standing Committee of Officials Policy Response: *Electricity Distribution Network Planning and Connection: A National Framework for Electricity Distribution Networks*, 15 December 2008.

⁷ AEMC Op cit. p 47.