

5 June 2009

Dr John Tamblyn  
Chairman  
Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

Dear John,

### **Review into Demand Side Participation in the National Electricity Market**

SP AusNet supports the AEMC's Review of demand side participation (DSP) in the National Electricity Market (NEM) and makes this submission in response to the AEMC's Draft Report. This review provides an opportunity to explore potential barriers to DSP in the regulatory framework to encourage greater consideration and implementation of efficient DSP solutions.

As an overarching comment, SP AusNet would like to reiterate its support for DSP where it provides the most efficient means of addressing energy service needs. While it is essential that the regulatory arrangements support DSP, the focus should be on maintaining neutrality in how we treat and assess investment options and ensuring efficient and effective planning processes.

As you know, SP AusNet is a member of Grid Australia and the Energy Networks Association. Accordingly, in addition to providing this submission, SP AusNet supports the submissions made by those organisations.

SP AusNet would be pleased to discuss the attached submission in further detail with you at your convenience.

Yours Sincerely,

**[Signed] Patrick Murphy**

**MANAGER ECONOMIC REGULATION**

Enquiries: Anh Mai (03) 9695 6627

## **1. Background and Overview**

### **1.1 Background**

The AEMC commenced its review of DSP in the NEM in October 2007. The objective of the AEMC's review is to identify whether there are barriers or disincentives within the Rules which inhibit efficient DSP in the NEM.

SP AusNet has supported the objective of this review and participated in consultation throughout the process.

The AEMC published a Draft Report on 29 April 2009 setting out its findings from the review and consultation process. SP AusNet notes that many ideas raised in the AEMC's Draft Report interact with the AEMC's current work to develop a national framework for distribution planning and expansion, as well as the Ministerial Council on Energy's (MCE) review of the distribution connection framework. SP AusNet recommends that where certain DSP planning and connection issues require resolution, they may be pursued further as part of these processes.

### **1.2 Overview**

SP AusNet's response to the AEMC's Draft Report is structured as follows:

- Section 2 addresses the incentive properties of network regulation and its potential impact on DSP;
- Section 3 comments on distribution network planning, connection and access issues;
- Section 4 discusses service standards and service standard incentive schemes; and
- Section 5 provides SP AusNet's concluding comments.

SP AusNet makes no comment on wholesale market and market reliability issues as these are not priority issues for the business.

## **2. Economic regulatory framework**

### **2.1 Form of price control**

SP AusNet supports the AEMC's finding that the price cap form of regulation does not impede DSP. At a distribution level, tariff basket regulation is intended to provide incentives (and the means) for distributors to structure prices so as to reflect the underlying cost of service. Cost-reflective prices structured in this way provide signals that encourage efficient levels of consumption, having regard to the cost of electricity as well as the cost of substitutes such as demand side participation. Such prices therefore encourage an efficient level of demand side participation.

SP AusNet notes that the roll out of interval metering will go a long way to enhancing timely price signals to users to facilitate demand side response but acknowledges there is a role for demand side response aggregation in the market.

## **2.2 Financial Incentives**

While there are opportunities for DSP in the current regulatory framework, it has always been our view that a DSP-specific incentive would be required to drive significant change and development in this area. It is also considered that seed funding and real financial rewards would be needed to assist in the development of the relatively infant embedded generation and demand side response sectors. SP AusNet considers that financial incentives are the most effective way to drive DSP outcomes, rather than providing cost-recovery mechanisms.

SP AusNet notes that in its Draft Report the AEMC has found that the current economic regulatory framework provides sufficient incentive to encourage efficient DSP. SP AusNet considers that if this view is supported, then there is no need to mandate DSP-specific expenditure or create further DSP-related regulatory obligations as the regulatory settings are presumably correct. Further, any additional costs arising from changes to the regulatory framework to facilitate DSP, including distribution planning requirements, need to be justifiable and fully recoverable.

SP AusNet notes that if it appears that DSP uptake is below what is judged to be an efficient level over time, then it may become clear that a financial incentive is necessary.

## **2.3 Treatment of DSP opex**

The AEMC has found that there is an imbalance in the regulatory framework in relation to the risk of recovering revenue between capex and opex that creates a bias against DSP expenditure. This is because DSP expenditure is often in the form of opex and an efficiency carry over mechanism (ECM) penalises the substitution of capex with opex.

SP AusNet considers that this barrier needs to be removed and supports the exclusion of DSP opex from the ECM to encourage DSP and avoid penalising businesses for implementing a DSP option. This approach has already been adopted by the AER in its demand management incentive schemes (DMIS) for distribution businesses in South Australia, Queensland and Victoria.

## **2.4 Treatment of DSP capex**

SP AusNet notes that embedded generation projects and other DSP solutions can be in the nature of capital and/or operating expenditure. Any framework which removes barriers to DSP needs to treat DSP capex and network augmentation capex equally. However, the AER has indicated that potentially, any demand management capex spent within-period which has not been pre-approved in the price review process will not be rolled into the regulated asset base (RAB).<sup>1</sup> Under such an approach demand management capex is not being treated on an equal footing to network augmentation or replacement capex.

Such a position would deter exploration of DSP solutions. Should the framework not allow this category of DSP capex to be included in the RAB, it is effectively deterring a range of non-network solutions from consideration as it imposes a penalty associated with that capex.

The Office of Gas and Electricity Markets in the UK (Ofgem) is considering this issue and is seeking views on whether it should treat all direct costs (capex and opex) in the same

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<sup>1</sup> AER, *Final Decision, DMIS for Victorian DNSPs*, April 2009, p 16

manner to address any imbalance between these two forms of expenditure to encourage greater demand management:

*Additional spending on capex is shared between customers and shareholders while opex is borne wholly by shareholders. This means that DNOs are more likely to adopt a conventional asset based network investment solution to any network constraints rather than exploring more efficient solutions involving people or other costs classified as opex.*

*[Ofgem] received several responses to the initial consultation document advocating the removal of this barrier to encourage DSM and non-network solutions. This could be done by either applying a common capitalisation policy to all categories of network related costs or by allowing non-network solutions to be added to the regulatory asset value (RAV).<sup>2</sup>*

It should also be noted that any non-network solution implemented to defer network augmentation or replacement would need to be more cost effective than the network solution to even be considered.

SP AusNet considers businesses should continue to be given flexibility as to how they manage their individual expenditure allowances, and that the NER should therefore allow for all actual DSP capex to be included in the RAB, consistent with the ex ante capex approach in the current regulatory framework.

## **2.5 Innovation incentive**

SP AusNet supports the AEMC's finding that there are insufficient incentives for network businesses to undertake research and development and innovation given the "cost of service" approach with periodic resets. SP AusNet would therefore support the inclusion of stronger incentives for network businesses to undertake innovation and research and development (R&D), and to explore further the potential of various non-network solutions.

Fully exploiting the potential of embedded generation and advanced interval metering will require substantial further R&D. Currently NSPs have limited incentives to invest in R&D given they cannot retain the benefits of the significant investment and resources required past the next regulatory review.

DNSPs should be allowed to recover all justifiable R&D costs subject to AER oversight. This could be on an ex ante basis in the context of a regulatory review. Further, DNSPs should be able to make a return on R&D investment and allowed to retain the benefit of this work beyond one regulatory period. The magnitude of any innovation incentive needs to be substantive and much greater in magnitude than the amounts provided for under the AER's DMIS. In this regard, it is noted that the OFGEM has recently recognised the need to encourage R&D expenditure, given the uncertainty and long time horizons associated with the pay-off from such expenditure.

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<sup>2</sup> Ofgem, *Electricity Distribution price Control review Policy Paper*, 5 December 2008, pp 37-38.

### **3. Service standards incentive schemes**

#### **3.1 Service incentive schemes and reliability**

In its Draft Report the AEMC recognises that DSP solutions and network solutions are often not perfect substitutes and can provide different levels of reliability. SP AusNet supports this finding, and considers that it is important to understand that DSP may provide lower levels of reliability than network solutions, or may be less responsive to rapid changes in the supply-demand balance than other supply side options (such as generation and/or transmission).

The AEMC has also found that the rewards and penalties associated with service standard schemes allow DNSPs to appropriately compare the costs and benefits of different solutions. As such, the AEMC has not found that service incentive schemes pose a barrier to DSP.

As a general principle, SP AusNet submits that non-network proponents must be willing to share the risks associated with operating within the current framework where service penalties apply to non-performance. Without a means of sharing the risk of penalty under service standard schemes, a DSP solution must meet the same level of reliability as network augmentations to be considered as an alternative solution. While it is true that network businesses may manage the risks of DSP impacting on their service and reliability performances by costing the risk, this is likely to make DSP more expensive options. In light of this, the AEMC may wish to consider some form of exclusion mechanism of DSP-related service non-performance from service incentive schemes.

### **4. Distribution network planning**

The AEMC's Draft Report has found that:

- there is a lack of planning obligation in the Rules and inconsistency exists across jurisdictions which limit the ability for DSP businesses to participate effectively;
- consultation based on network options creates network options, rather than on a need for a general solution creates a barrier to DSP; and
- there is a lack of transparency in the current planning arrangements which limits the consideration and inclusion of DSP.

SP AusNet notes that the AEMC will pursue these issues as part of its Distribution Planning Review.

In relation to planning arrangements, SP AusNet notes that as part of its work to develop a National Framework for Electricity Distribution Planning, the AEMC has canvassed a number of reforms in a Workshop Paper (Indicative Specifications).<sup>3</sup> These would significantly increase the range of obligations DNSPs would have in relation to DSP in the NEM, such as:

- requiring DNSPs to periodically publish a non-network strategy setting out its preferred processes and approaches to dealing with DSP options;

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<sup>3</sup> AEMC, *Workshop Paper Appendices*, <http://www.aemc.gov.au/Media/docs/003Workshop%20Paper-4b52de7a-1d03-4e34-8c11-a3e4ccb9cb29-0.pdf>

- establishing extensive detailed annual planning reporting requirements to increase and enhance information to the market on network planning and investment; and
- requiring a lengthened and more dynamic regulatory test consultation process for distribution to encourage earlier DSP-proponent involvement.

Further, a major change to the regulatory framework proposed in the AEMC's Workshop Paper includes the proposal to have the regulatory test apply to *all* investments over \$1-2 million, and not just augmentation investments, or replacement projects which contain an augmentation component. This could potentially mean hundreds of projects each year. This is coupled with a proposal to provide 6-9 months for consultation on each project specification report.

These are substantial changes and it is clear that the time and resources required to carry out such obligations will be significant. SP AusNet's opinion is that the considerable resources and regulatory costs associated with the proposed framework will not deliver a net benefit. As such, SP AusNet encourages the AEMC to balance the potential benefit of these reforms against the likely significant regulatory burden and cost to ensure that the reforms are proportionate to addressing the perceived problem. The framework needs to ensure that it delivers benefits which can justify the higher regulatory costs which users will ultimately bear through network charges. SP AusNet also suggests that the AEMC consider its proposals in light of what is necessary to fulfill its MCE terms of reference to enhance and improve the current planning and reporting arrangements.

Finally, SP AusNet questions the view that basing consultation on network options creates a bias for network options. SP AusNet does not consider that network solutions are automatically the default option, although they do provide a reference point for assessing non-network options. Provided that network businesses have an incentive to minimise costs (as is currently the case), the lowest total cost option (including reliability issues) will be adopted.

## **5. Concluding comments**

SP AusNet generally supports the AEMC's findings in its Draft Report, and considers there are no material barriers to DSP in the NEM. However SP AusNet considers a number of issues need to be addressed including:

- ensuring fair treatment of DSP opex and capex;
- providing incentives for innovation;
- managing the risks associated with DSP non-performance; and
- establishing an effective and proportionate distribution planning framework which gives DSP proponents an opportunity to provide alternative solutions whilst minimizing the regulatory burden on DNSPs and costs for users.

SP AusNet reiterates that while regulatory arrangements should not impede DSP, the regulatory settings must provide for the effective assessment of investment options whilst ensuring cost-efficient planning process and reasonable regulatory burden.