

Our Ref: 34818, C2008/1673
Your Ref: EPR0002 Stage 2 Review of Demand-Side Participation Draft Report
Contact Officer: Jess Gordon
Contact Phone: 03 9290 1425

9 June 2009

Dr John Tamblyn
Chairman
Australian Energy Market Commission
PO BOX A2449
SYDNEY SOUTH, NSW 1235


Dear Dr Tamblyn

RE: Stage 2 Review of Demand-Side Participation Draft Report

The AER appreciates the opportunity to comment on the AEMC's draft report on its stage 2 review of demand-side participation (DSP) in the National Electricity Market (NEM). While the draft report also covers network planning, connection and wholesale market issues associated with DSP, this submission focuses on the AEMC's draft findings on the regulatory incentive framework.

The AER sees merit in the AEMC considering the impact of the regulatory framework on incentives for DSP. In developing demand management incentive schemes (DMIS) for distribution network service providers (DNSPs), and in its framework and approach decisions for Queensland, South Australia and Victoria, the AER has considered the incentives and barriers impacting on demand management. In doing so, the AER is mindful that policy actions in relation to energy efficiency and greenhouse gas abatement are at different stages across the different jurisdictions.

While the AEMC has confined its review of DSP to peak demand management, the AER also considered broad-based demand management, such as energy efficiency programs, which have potential efficiency benefits associated with lower demand at both peak and off peak times.

AEMC's findings

The AER considers that the draft report provides a sound theoretical analysis of the incentives within the regulatory framework for efficient DSP in response to peak demand, assuming technological and other barriers to cost-reflective pricing can be addressed.

The AEMC's analysis is based on the premise that imperfect network pricing will result in imperfect consumption decisions, and creates the scope for some amount of efficient DSP. The AEMC notes that price signals are likely to be improved through more advanced metering arrangements, however, barriers may still remain in the form of the cost to users in knowing the level of peak demand at specific times, and also in being able to respond to this information. The AER considers that implementing cost-reflective pricing and improving consumers' abilities to respond to the improved price signals represents a superior solution to promoting efficient consumption decisions. The AEMC should give more consideration to the costs and benefits of achieving cost-reflective prices, as compared to the costs and benefits of amending the regulatory framework to better facilitate or provide incentives for DSP.

Also, while it is clear that retail electricity prices diverge from 'true' cost reflectivity, the extent of this diversion is unclear. Quantifying this level of diversion would give context to observed levels of DSP, and the need for and size of associated incentives under the regulatory framework to undertake more or less DSP.

Practical experience with demand management

The AER's experience in considering actual DSP outcomes differs from that suggested by the AEMC's theoretical findings. The AEMC finds that price caps provide incentives for DNSPs to engage in an efficient level of DSP, and suggests that the D-factor scheme, a DMIS applied to NSW DNSPs by the Independent Pricing and Regulatory Tribunal (IPART) in its 2004 determination, creates incentives for DNSPs to carry out DSP beyond its efficient level as it compensates for foregone revenues.

This appears to be inconsistent with the actual outcomes of the NSW D-factor which indicate that the NSW DNSPs are implementing a very low level of DSP and achieving limited network augmentation deferrals. IPART reported in August 2008 that the maximum increase in NSW customers' weighted average prices due to the D-factor was 0.5 percent in 2004–05, however for most regulatory years the maximum increase was 0.1 per cent, and sometimes zero.¹ The AEMC's findings also suggest that businesses subject to revenue caps e.g. transmission businesses, face even stronger incentives to undertake DSP beyond its efficient level, which does not appear to be observed in practice.

While the AER notes the difficulties in determining the efficient amount of DSP, anecdotal evidence from the AER's various DMIS consultation processes indicate that efficient DSP responses to network constraints arising during a regulatory control period are not necessarily being acted on by DNSPs. The AER considers the limited D-factor results indicate that the barriers to efficient DSP, as identified within the AEMC's draft report, may not have been overcome by the D-factor incentive mechanism. That said, the AER notes there are currently

¹ IPART, *NSW Electricity Information Paper No. 3/2008, Demand management in the 2004 distribution review: Progress to date*, August 2008, available on IPART's website www.ipart.nsw.gov.au.

only four regulatory years of data available on the operation of the D-factor, and it may need more time to develop before its effectiveness can be properly assessed.

The AER has decided to continue the D-factor scheme for the NSW DNSPs over the 2009–14 regulatory control period, and will consider its application to the NSW DNSPs for the subsequent 2014–19 regulatory control period when preparing for the next NSW distribution reset. At that time, more data will be available to assist the AER's decision.

Other factors influencing DSP outcomes

In addition to the limited D-factor data, the AER notes uncertainty relating to the effect of various Government policies on DSP and the need for a DMIS. The Australian Government's proposed Carbon Pollution Reduction Scheme (CPRS) and the proposed roll out of 'smart' metering technologies in various jurisdictions have not yet been implemented. These policies, as well as other State and Federal climate change policies could significantly affect the incentives for DSP in the regulatory framework.

The AER's decisions on DMIS for various jurisdictions have noted the uncertainties surrounding DSP and the potential for policy changes to affect the level of DSP in the NEM. The AER's position is to continue to monitor the level of DSP being implemented in the NEM, both under DMIS and proposed as part of network business regulatory proposals, as well as monitoring the costs and benefits of DSP solutions to network constraints. The AER anticipates that results from the NSW DMIS over the 2009–14 regulatory control period will provide more insight into the DNSPs' incentives to carry out DSP, including the need for an ongoing DMIS. Once more data is available, the AER will be better able to consider the need for and design of a national DMIS for DNSPs, as well as barriers created by the regulatory framework.

Efficiency benefit sharing scheme already excludes non-network alternatives

The draft report also considers barriers to DSP relating to operating expenditure (opex) and capex incentive arrangements, in particular the impact of an opex efficiency benefit sharing scheme (EBSS) on network decisions to carry out DSP. The AEMC notes that where an EBSS is applied to opex but not capex this may create a bias against substituting network augmentation capex with opex for DSP contracts due to the lasting penalty associated with the increased opex. The AEMC suggests that DSP costs could be exempted from the EBSS to overcome this bias. The AER notes that the EBSS it published in June 2008 already excludes expenditure on non-network alternatives, in recognition of these potential distortions. As noted in its EBSS decision, the AER considers that including capex in the scheme may give rise to perverse incentives as noted by the AEMC.

Please contact me should you or your staff wish to discuss any issues raised in this submission.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Chris Pattas', written in a cursive style.

Chris Pattas
General Manager
Networks Regulation South