



13 March 2013

By email: Zaeen.Khan@aemc.gov.au

Zaeen Khan
Australian Energy Market Commission
Level 5, 201 Elizabeth Street
Sydney, NSW, 2000

Dear Mr Khan

SCER request for advice on differences between actual and forecast demand in network regulation

The five Victorian Distributors—CitiPower, Jemena Electricity Networks, Powercor Australia, SP AusNet and United Energy Distribution (**the Distributors**) appreciate the opportunity to provide comments on the Standing Council on Energy and Resources (**SCER**) request for advice on differences between actual and forecast demand in network regulation.

The Distributors consider that it would be inappropriate to make any further changes to the National Electricity Rules (**NER**) until the most recent, significant, changes have been implemented and allowed to operate for some time. Most stakeholders at the Australian Energy Commission's 28 February 2013 workshop, including the AER and representatives of several consumer-interest organisations, were similarly minded.

In particular, the Distributors are concerned at the prospect of regulatory regime changes that might constrain the discretion of the Australian Energy Regulator (**AER**) in determining the appropriate control mechanism to be applied. An in-built preference toward revenue capping for electricity distribution would risk the benefits of flexible pricing—the introduction of which is a goal of SCER—not being fully realised.

The NER currently provides discretion to the AER to choose between a number of control mechanisms for a Distribution Network Service Provider (**DNSP**) including a weighted average price cap (**WAPC**) or a revenue cap. In relation to the NSW and ACT DNSP 2014-2019 determinations, the AER's preliminary position is that a revenue cap is superior to WAPC in terms of recovering efficient costs, but inferior in terms of price stability and efficient pricing incentives. The AER has concluded on balance that a revenue cap would be more appropriate for these DNSPs. The AER also considered that 'the theoretical incentives for efficient pricing provided by the WAPC have resulted in little practical benefit in DNSPs' pricing.'¹

¹ AER, Framework and approach paper – Ausgrid, Endeavor Energy and Essential Energy, June 2012, p. 46.

The Distributors consider that the conditions to realise the benefits of WAPC are well advanced in Victoria. In particular, the Distributors note:

- The SCER response to the Australian Energy Market Commission's (AEMC's) Power of Choice recommendations in which it has directed officials to raise rule change proposals in relation to:²
 - amending the NER distribution pricing principles to provide better guidance for setting cost reflective distribution network charges
 - phasing in of efficient and flexible retail pricing options for residential and small business consumers through the introduction of cost reflective electricity distribution network pricing structures.
- The Victorian Government mandate to:
 - conclude the roll-out of advanced metering technology by the end of 2013
 - ensure flexible network and retail pricing is made available to all residential and small customers from 1 July 2013.

The Distributors consider that these developments mean the conditions to enable the theoretical benefits of a WAPC to be realised both exist, and are well advanced, in Victoria. The AER's assessment of a WAPC outlined in the framework and approach paper for the NSW and ACT DNSP 2014-2019 determinations, and the manner in which the Victorian context differs, are considered further below.

The need for efficient tariff structures

The AER acknowledges that a WAPC provides an incentive to set efficient prices but considers that material increases in pricing efficiency have not been apparent in Victoria. The AER further considers that a WAPC creates an incentive to set inefficient prices by rebalancing tariffs to attain additional revenue.

Under a WAPC, forecast error can lead to under or over-recovery of costs, however this is not evidence of inefficient price structures. Efficient price structuring can only be assessed by reference to the costs at a tariff component level. This is currently acknowledged in the NER where the pricing principles require that the charge for a given tariff component must take into account the long run marginal cost of the element of the network service to which that charging component relates.³

The incentive properties of the control mechanism are therefore key to producing efficient pricing outcomes. The AEMC analysis for the 28 February public forum contrasts the poor incentives for cost-reflective pricing under a revenue cap with the stronger incentives that exist under WAPC which offers the opportunity for DNSPs to minimise profit risk. Flexible pricing will be introduced for customers in Victoria from 1 July 2013. If at the same time, the Distributors were subject to a revenue cap control, then there would be no incentive for them to maintain or enhance cost reflective and efficient pricing. The full benefits of flexible pricing can only be realised under a WAPC control.

Incentives for demand-side management

The AER considers that a WAPC may reduce the incentive for DNSPs to undertake demand-side management initiatives, as DNSP profits would be directly linked to electricity volumes distributed. It also considers that a revenue cap provides a short

² SCER response to the Power of Choice Review, Reform area 6, March 2013.

³ NER, clause 6.18.5.

run incentive for demand-side management, as profit would be maximised by a DNSP reducing its costs.

However, as indicated by reform area 6 of the SCER response to the AEMC Power of Choice review, efficient and cost reflective prices provide the best environment for effective demand-side management. Such prices provide the means for consumers to make informed and efficient consumption decisions. This also best aligns with the National Electricity Objective which, amongst other things, seeks to promote the *efficient operation and use* of electricity services. The AER acknowledges that a WAPC is superior to a revenue cap in terms of the incentives it provides for cost reflective prices.⁴

A revenue cap that provides a short run incentive for a DNSP to reduce its costs in order to maximise profits has the potential to lead to sub-optimal solutions being implemented. The long term interests of consumers are best served by incentives for efficient solutions by *both* the network and its users. This is not necessarily equivalent to networks sponsoring demand-side management (at a cost to all users), when it is arguably less costly to networks and all users for this demand-side management to be voluntary and motivated by customers having the price signals and ability to respond themselves.

The Distributors therefore consider that a WAPC provides better incentives to pursue demand-side management than a revenue cap. Recommendation 18 in the AEMC's final report on the Power of Choice review recommends reform to the demand management and embedded generation connection scheme to provide a return for demand-side management projects which deliver a net cost saving to consumers.⁵ Such innovations would work in harmony with a WAPC and together would provide significantly superior incentives to DNSPs to pursue demand-side management initiatives than through a revenue cap.

Efficient and cost reflective pricing is a pre-requisite for achieving the demand-side response that is the principal justification for introducing advanced metering technology and flexible pricing for customers in Victoria. The Distributors consider that only a WAPC can provide the appropriate incentives for efficient and cost reflective pricing. The Distributors believe that the benefits of a customer-led demand-side response, in combination with reform of the demand management and embedded generation connection scheme, are likely to outweigh any perceived reduction in the incentive for DNSPs to initiate demand-side management that might be associated with a WAPC.

Volume risk and revenue recovery

The AER considers that a WAPC provides a low likelihood of a DNSP recovering efficient costs due to the incentives that exist to understate the volume of sales forecasts. The AER also considers that there are incentives to increase the prices of services for which sales are increasing most rapidly.

The Distributors consider that the potential for appropriately derived forecasts to be above or below the level of actual outturn demand is symmetrical. Under a WAPC, the DNSP would bear the associated risk of inaccuracies and be able to manage this within its tariff basket. The AER concern of potential demand forecast bias is addressed under the NER via provisions for the AER to approve what it considers to

⁴ AER, Framework and approach paper – Ausgrid, Endeavour Energy and Essential Energy, June 2012, p. 47.

⁵ AEMC, Power of Choice Review, Final Report, 30 November 2012, p. iii.

be an appropriate demand forecast.⁶ In its discussion paper for the 28 February forum, the AEMC has cited AER examples of sales forecasts that have underestimated actual sales volumes and resulted in windfall gains to DNSPs.⁷ However, it is the AER's final approved forecast that is ultimately used for a regulatory period. As SP AusNet notes in its submission to the AER's framework and approach paper for NSW DNSPs, there are also numerous examples where the AER (and the ESC before it) overestimated a DNSP's energy consumption.⁸

With regard to the second AER concern, the building blocks design allows for DNSPs to recover average costs. There will therefore always be a need for a degree of Ramsey pricing to ensure revenue recovery by adjusting prices for those customers whose demand is unresponsive to higher prices, and whose usage decisions are less likely to be distorted by the required cost recovery. At a practical level, the approach can involve pricing to those elements of the identified demand growth which contribute the most to the need for new investment and in relation to which there is a high marginal cost. The NER requires a DNSP to adjust its tariffs so as to ensure recovery of expected revenue in a manner that least distorts efficient consumption patterns. The Ramsey formula implies that price-cost mark-ups are higher in markets where demand is less elastic, and where the consumption response will therefore be proportionately less.

Should you have any further questions in relation to the above please do not hesitate to contact me on (03) 8544 9053 or robert.mcmillan@jemena.com.au.

Yours sincerely



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On behalf of the 5 Victorian Distributors

⁶ NER, clause 6.12.1(10).

⁷ AEMC, SCER request for advice on differences between actual and forecast demand in network regulation – workshop discussion questions, p. 7.

⁸ SP AusNet, RE: NSW framework and approach paper – control mechanisms, Submission to AER preliminary positions paper and framework and approach, 22 August, 2012, p. 2.