

18 April 2012

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By online submission

Dear John

**RE: Consolidated Rule Request – National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011**

AEMO welcomes the opportunity to provide feedback on the AEMC's Directions Paper on the consolidated rule request on the economic regulation of network service providers.

The revenues of network service providers in the current framework are regulated through the ex-ante building block approach. As such, revenue regulation has typically been designed around setting economic and commercial incentives on how assets are delivered rather than the services provided.

The current arrangements also provide for a state-by-state approach to revenue setting which allows for inefficiencies and inconsistencies to arise within the framework. Therefore AEMO strongly believes that the revenue setting arrangement in the NEM is an important factor in ensuring the revenue setting and planning frameworks complement each other.

The AER noted in their proposal that the current process for forecasting electricity network businesses' capital and operating expenditure restricts their ability to ensure the investment of the regulated electricity networks is efficient. The AER have suggested that this also affects their ability to ensure networks earn appropriate returns.

AEMO's submission to the AEMC's Issues Paper proposed that its national demand forecasting process be explicitly included in the revenue setting arrangements. This would ensure that future state-wide demand and energy forecasts are produced in an independent and transparent manner.

AEMO noted that the AEMC did not directly address AEMO's submission in its Directions Paper. The AEMC stated in their Directions Paper "Demand forecasting to inform the revenue determination process is in scope; the broader accuracy of demand forecasts for planning processes is not"<sup>1</sup>.

AEMO believes that these matters cannot be separated because the accuracy of the demand forecasts is imperative, particularly in the AER's allowance of forecast network expenditure for the regulatory period. Under the current revenue setting arrangements, there is a clear incentive for the TNSP to over-forecast demand requirements. In this context, the

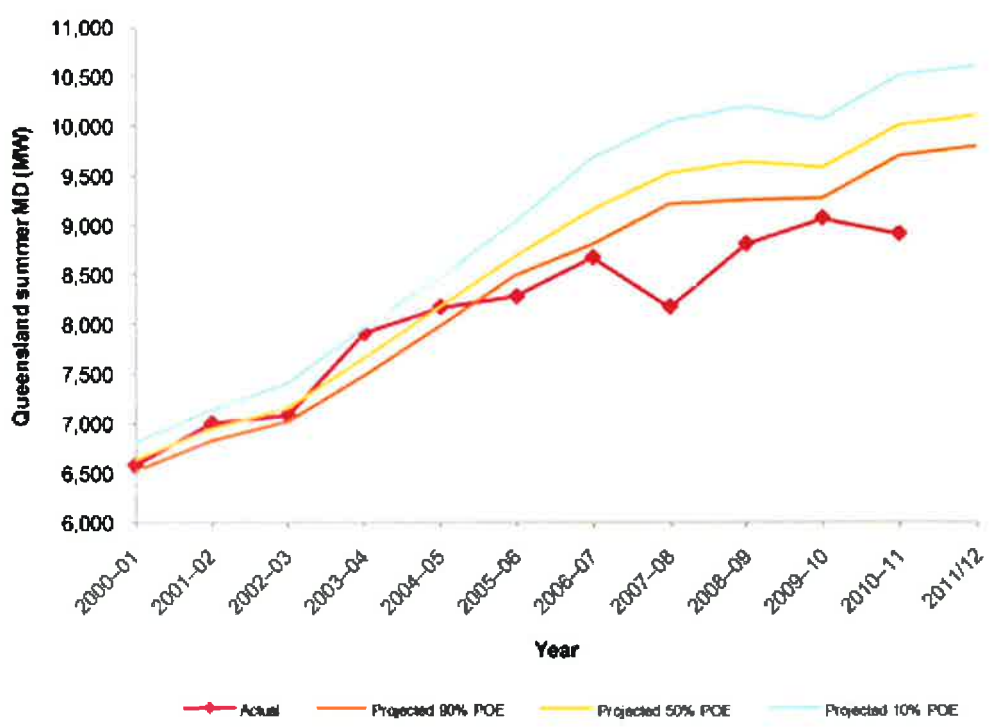
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<sup>1</sup> AEMC Directions Paper, Page 167

benefits of independent demand forecasting become obvious and are best considered by way of example of where there is no independent oversight of demand forecasts.

Figure 1 below presents Queensland's summer 1 year-ahead 10%, 50% and 90% probability of exceedence (POE) maximum demand forecasts over the past 10 years with actual summer maximum demand. It suggests that there has been consistent over-forecasting over the previous regulatory period.

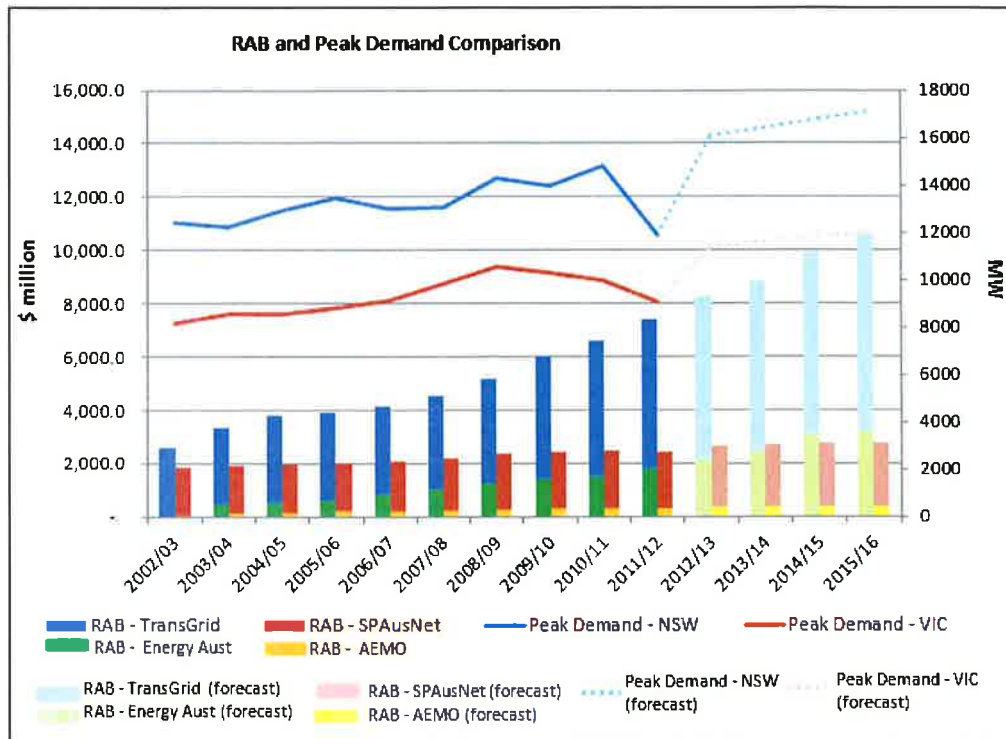
**Figure 1 - Queensland Demand Forecasts vs actual – 2000-01 to 2011-12**



SOURCE: AEMO 2011 ES00

The effect of over-forecasting drives up NSP's capital expenditure which subsequently exacerbates their regulated asset base (RAB). This can be seen in Figure 2 below. The figure compares the growth in peak demand with RAB over the last 10 years between New South Wales and Victoria. It shows that New South Wales RAB has been growing consistently higher than the Victorian RAB despite similar peak demand in both states.

**Figure 2 – Annual Energy across the NEM**



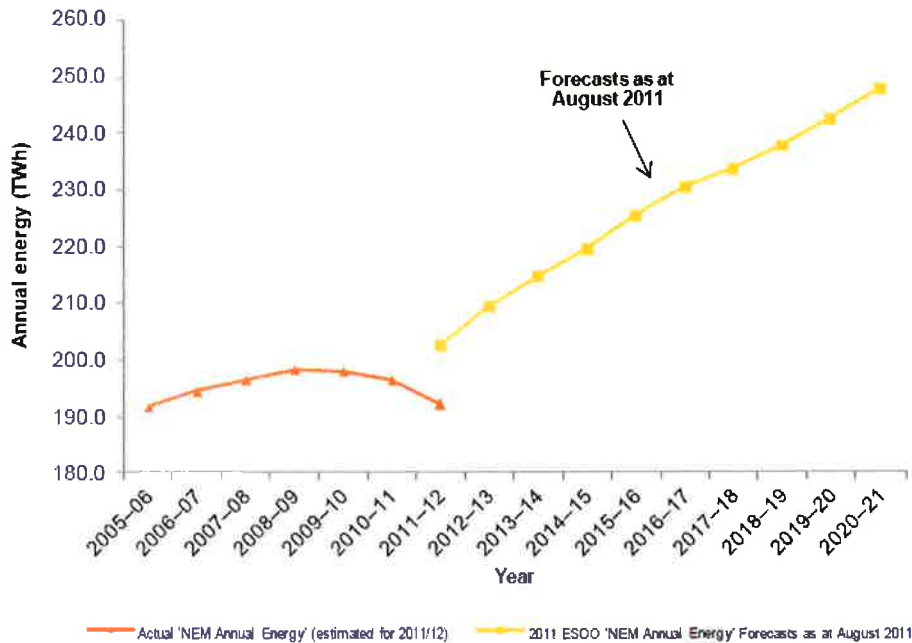
SOURCE: AEMO

To ensure future determinations fully examine and justify high expenditure, which is eventually passed through to consumers, more scrutiny is required on the accuracy of demand forecasts during the revenue determination process. This is particularly important over the forthcoming period as annual energy and the growth rate of maximum demand are forecast to decrease due to changing consumer behaviour in response to rising electricity prices and government renewable policy incentives. To date these changes have not been included in jurisdictional planning bodies' forecasts.

The 2011 ESOO had forecast growth in annual energy for all five regions in the NEM but given what has been observed in the last seven months the estimated annual figure has been revised down from 202.6 TWh to 192 TWh for 2011-12. This is a five per cent reduction in forecast annual energy across the NEM.

Figure 3 below shows a shift from a three per cent increase in electricity annual energy across the National Electricity Market (NEM) to a two per cent reduction in the last seven months, when compared to industry forecasts in the 2011 ESOO published in August.

**Figure 3 – Annual Energy across the NEM**



SOURCE: AEMO 2011 ESDO UPDATE

As an independent party, AEMO will ensure the state-wide demand and energy forecasts are produced in a transparent manner, removing uncertainty on the underlying factors used in those forecasts.

The first stage of AEMO's National Energy Forecasting Project is to produce a report in June 2012. This will contain a first set of national forecasts which will include the impact of developments driven by climate change policy, rising electricity prices, and the changing costs of different energy technologies. Following this, AEMO plans to continue to work in consultation with industry through the energy forecasting reference group to monitor changes which impact demand and to provide updated information as necessary.

AEMO proposes that the AEMC reconsider the benefits of this initiative for their draft rule determinations.

If you have any questions please do not hesitate to contact Louis Tirpcou on (03) 9609 8415.

Yours sincerely



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**Corporate Development**