

AER speaking points - AEMC demand workshop 28 February 2013

1. Introduction

- An incentive based regulatory regime needs to use forecasts to establish efficient expenditures and to determine resulting revenues and prices; an incentive regime is also about making sure that risks are borne by those best placed to meet them – I will return to this shortly.
- Although taking into account many factors and variables, it is accepted that these forecasts are just that – forecasts. They will never be perfect.
- As has been observed over the last few years actual peak demand and energy consumption has varied significantly from that forecast by NSPs and regulators for a number of reasons.
- It is also important to note that the AER has no capacity to change approved expenditure levels and/or allowed revenues for the current determinations.
- Existing determinations can only be re-opened for very limited specific reasons; forecasting error is not one of these. This preserves the effectiveness of the incentive-based regime, where network businesses are expected to manage their ongoing risks.
- Overall we think the regime (with the improvements recently made by the AEMC) deals adequately with the issues that have been raised by SCER.

2. *AEMC review*

- Focus of the AEMC review is how the current regulatory framework manages the risks associated with using demand forecasts (forecasts for both peak demand which heavily influences capex and energy consumption which determines network charges) to determine the allowed revenues and prices of NSPs over the regulatory control period.
- AEMC note that the risk of outturn demand being materially different from forecast demand creates two types of risks:

- expenditure risks; and
- volume risks (related to the control mechanism and the ability of the NSP to restructure its tariffs).

3. *Efficient investment and forecast demand (expenditure risks)*

- The AER is required to determine an efficient level of capital expenditure for the five year regulatory period prior to the start of that period;
- The key types of capital expenditure are augmentation, replacement, reliability and non-network;
- The key driver for augmentation capex is peak demand at key points within a network.
- If peak demand is lower than forecast the risk is that the efficient level of expenditure will be lower than approved by the AER and customers will pay higher charges than necessary.
- If peak demand is higher than forecast then the risk is that the efficient level of expenditure will be higher than that approved by the AER and the NSP may undertake the investment but not be fully compensated for it (or alternatively not undertake the investment, possibly resulting in reliability issues, although this will also depend on other factors too given the sometimes sizeable lags between investment and reliability effects).
- The framework currently attempts to balance the risks associated with differences between forecast and actual demand by allowing only actual capex to be rolled into the asset base at the start of the next period – this means customers do not pay in the long-run for investment that is not needed.
- The recent changes to the NER also require the AER to develop a capital expenditure incentive guideline with the aim of developing approaches to provide incentives for efficient investment during the regulatory period (including the basis on which the RAB is to be rolled forward and

the introduction of a capex sharing scheme – which is also aimed at creating constant incentives through the period).

- As noted, the changes to the NER also contemplate the AER, through the development of the incentive guidelines to potentially undertake an ex post review of prudence and efficiency of capital expenditure undertaken in the current period.
- The AER is currently developing its guidelines and an issues paper on the incentive guidelines will be released very soon – in March.
- Through the development of the guidelines we consider that improvements can be made to the existing incentive arrangements such that the risks and potential costs associated with the difference between forecasts and actual demand are further mitigated.
- As noted, an important principle in risk allocation is that risk should be allocated to the party best able to manage that risk. Shifts in demand are inevitable. A key question is whether the tools which exist to manage this risk are adequate.
- The AEMC states in its paper that the NER includes several mechanisms to address investment uncertainty associated with changes in forecast peak demand during the regulatory period (eg. contingent projects, capex reopener mechanism and cost pass through provisions).
- While these mechanisms are designed to address areas of significant uncertainty, they are not intended nor should they address general investment uncertainty associated with what could be described as the typical fluctuations between forecast and actual demand – if businesses are earning a commercial risk-adjusted rate of return, then the regime should not remove all possible risks.
- The mechanisms instead are designed to address extraordinary events, well outside the general business as usual events that businesses, acting prudently and efficiently, needs to be compensated for.

- The contingency mechanism is a good example of this. Significant projects whose need and costs are quite uncertain and are well outside historical trend at the time of the regulatory review can be treated separately and not added to the forecast ex ante allowance, so that customers don't end up paying given the uncertainty over whether they are needed.
- But using such mechanisms to address all investment uncertainty associated with forecasting peak demand for example undermines the incentive framework and the NSPs obligation to efficiently plan and manage its network.

4. Revenue recovery/tariff pricing and forecast demand (volume risks)

- The second key risk identified by AEMC as a result of outturn demand being materially different from forecast demand relates to volume risks (relates to the control mechanism and the ability of the NSP to restructure its tariffs).
- The form of control determines how the NSP's revenues vary as a result of differences between forecast and actual demand over the regulatory period and who bears the risk as a result.
- Under a revenue cap customers bear the risk if actual demand is lower than forecast, whereas under the WAPC network businesses bear the risk.
- AEMC states that under a revenue cap NSPs do not have an incentive to set prices to reflect the underlying cost of supply given that they receive the same fixed amount of revenue regardless of the prices they set.
- However, in relation to a WAPC the AEMC notes that NSPs have an incentive to set their tariff structures to reflect their underlying cost structure.
- The AER has undertaken an analysis of pricing in current and previous regulatory periods and based on this analysis is not clear that the WAPC

control mechanism has generally resulted in or created an incentive for efficient pricing.

- It was found that without the incentive to set, and the ability to implement efficient prices the detriments of the WAPC outweighed the benefits.
- Key detriments were found to include price instability, bias against demand side management and recovery of revenue above efficient cost. Overall it was found that these detriments were being experienced without the benefits of an increase in pricing efficiency.
- This has been the historical picture that we have seen over the past 5-10 years. We also of course recognise that a number of changes are afoot to promote demand side initiatives by networks and other participants as well as a review of pricing principles in the NER, which is intended to promote more efficient forms of pricing in the future.
- These changes which are flowing out of the AEMC's Power of Choice will likely lead to changes in DNSP's willingness to set efficient prices and may reduce the risks that DNSPs face when implementing such prices – at this stage it is too soon to tell.
- So for the next resets for NSW/ACT, the AER has proposed the introduction of a revenue cap as part of the preliminary positions framework and approach paper for the ACT and NSW businesses. A final (stage 1) framework and approach paper for these DNSPs is due to be published in March.
- The decision to apply a revenue cap was based on the criteria in the NER. In addition to those standard criteria the AER also considered the following factors: volume risk and revenue recovery; price flexibility and stability; and incentives for demand side management.
- The AER acknowledges that volume risk is managed better under a WAPC than a revenue cap, however, this is not the only consideration that is relevant. We also observed DNSPs are more likely to recover efficient revenues under a revenue cap rather than a WAPC (under a

WAPC there was a clear tendency for network businesses to consistently over-recover revenues).

- Our conclusion is that although volume risk is better managed under a WAPC the AER considers that a revenue cap is the better control mechanism on the basis that, when considering broader criteria than just volume risk, the revenue cap has less disadvantages.
- I expect that in the future the AER will again test the relative merits of the revenue cap and the price cap taking account of the factors in the rules and as well as any further rule changes as contemplated in the PoC process that would apply at the time.

5. Conclusion

- SCER has asked if NER changes are needed to ensure consumers receive the benefits of sustained reductions in demand, including the AER's ability to consider previously approved capital expenditure and improvements to the rules around network tariff setting;
- We do not consider that any further changes to the NER are required at this time as the recent changes to the NER and the further guideline work that the AER is undertaking should further mitigate 'expenditure risks'.
- Any interventions within the regulatory period to adjust for forecasting error would undermine the current incentive regime (effectively moving to a cost of service model) and would not be in the long term interest of consumers.
- In terms of 'volume risk' we acknowledge that this is better managed under a WAPC but taking into account broader considerations, a revenue cap has less detriments than a WAPC form of control.