

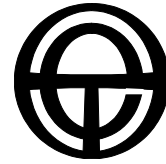
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SUBMISSION

Economic Regulation of Transmission Services

Draft Rule

11 September 2006

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Economic Regulation of Transmission Services Draft Rule

Introduction

Total Environment Centre (TEC) has made previous submissions to the AEMC on the regulation of transmission revenue, including:

- The Scoping Paper on the Review of the Electricity Transmission Revenue Pricing Rules (August 2005);
- The Issues Paper on the Review of the Electricity Transmission Revenue and Pricing Rules: Revenue Requirements (November 2005);
- The Issues Paper on the Review of the Electricity Transmission Revenue and Pricing Rules: Transmission Pricing (December 2005); and
- The draft Rule proposal on transmission revenue issues (June 2006).

We were therefore disappointed at the inadequate coverage in the draft Determination and within the Rule itself of issues that we consider to be of primary concern for the “long term interests of consumers”. We would like to reiterate our position on two issues in particular. The first is *demand management (DM¹) incentives and spending*. DM is worth addressing here, since there is a major focus on incentives as a principle in the draft Rule – but there are none proposed for the incorporation of the investigation and implementation of DM and other non-network solutions (such as embedded generation). These offer opportunities for fostering efficiency, competition and reliability, but generally are only ever treated as minor, peripheral issues within the high-level NEM proposals. They are mentioned as desirable alternatives, but feasible strategies for their inclusion are not presented.

The second is the inadequacy of the draft Rule regarding *information disclosure*, which still allows the transmission network service providers (TNSPs) to obscure details of their financial planning from consumers and other stakeholders. The idea that the AER develop information guidelines is a useful one and we support it in principle, as it might assist with this problem. It is essential that the proposed guidelines are subject to public consultation procedures, since their contents will be of interest to many stakeholders across the NEM.

Total Environment Centre does support the retention in the draft Rule of a revenue cap for transmission network revenue; and the retention of the building block CPI-X methodology (in Section 6A.5).

¹ DM in this submission can be read to include ‘demand response’, ‘demand side management’, ‘demand side response’, ‘energy efficiency’ and ‘non-network solutions’. In general, DM can include both the management of peak loads and energy efficiency as a way of meeting capacity requirements most cost effectively. It includes a diverse array of activities that meet energy needs, including cogeneration, standby generation, fuel switching, interruptible customer contracts, and other load shifting mechanisms.

Recommendations

The most important solutions for establishing a robust demand-side presence in the electricity market and to alleviate risks for network investment include:

- establish a DM funding mechanism
- establish a DM Code of Practice
- promote certainty within the NEM through the clarification of regulatory mechanisms for the recovery of network investment in DM and the treatment of opex expenditure
- ensure networks investigate and implement DM as an alternative to network augmentation where cost effective
- establish incentives throughout the NEM for the implementation of DM and the use of small, local generators
- ensure networks disclose information on impending constraints in a timely manner.

Demand management incentives

Benefits of DM

Demand management (DM) in all its forms must be accepted and promoted throughout the NEM as a viable alternative to entrenched systems because of the benefits that it can deliver to consumers. The NEL Objective is set up to cater for "the long term interests of consumers" and, in particular, on the "efficient use of electricity"; without effective DM neither is being achieved. The draft Determination presents "incentives" as an important part of economic regulation but has neglected to address the potential for incentives for DM.

A report for Energy SA² gives a useful coverage of DM opportunities and potential:

- low cost alternative to generation and transmission investments
- effective short-term tool for overcoming supply side and distribution system inadequacies
- energy efficiency programs
- load shifting
- load curtailment
- embedded generation, including fuel switching
- alleviation of network constraints.

Economic efficiency is central to the NEM. To achieve this there must be equal emphasis on demand and supply as the basis of standard economic regulation. The AEMC's Draft Proposal for this Rule sought to align the, "incentives for TNSPs to invest in, and operate,

² Energy SA, *Demand Side Management – Benefits to Industry & the Community*, 2001, p 5

transmission networks in a way that delivers efficient outcomes for the electricity market, market participants and consumers.” TEC has consistently argued for the explicit acknowledgement of the potential for demand management (DM) to deliver these efficient outcomes, but DM has again been overlooked.

We recommend that DM and other non-network solutions be explicitly mentioned for their potential to contribute towards efficient outcomes.

Recovery of DM spending

There is currently a lack of clarity regarding the recovery of DM spending and several networks have also drawn attention to this. Consultants reporting to TransGrid argued that uncertainty in the treatment of DM by the ACCC may have deterred them from selecting that option: “Any uncertainty as to the regulatory treatment of DSM-related expenditure by TNSPs has the potential to undermine the practical consideration of such alternatives.”³

This situation creates uncertainty for networks investigating DM solutions to network constraints and there needs to be clear conditions under which TNSPs (and, in the future, DNSPs) can recover the costs of implementing DM. This issue has been identified repeatedly as one of the key barriers to investment in non-network solutions. For the determination of acceptable revenue and assessment of regulatory asset bases, details need to be set out regarding how those expenditures will be treated and the rate of return that they could be expected to deliver.

As DM costs are often drawn from operating expenditure, recovery of network investments could be at risk if regulators limit DM recovery to capex investments. It should be ensured that decisions to engage in DM that increase opex do not disadvantage the NSP.

Prudence of DM spending

The Draft Rule provides a mechanism for re-opening the revenue cap on transmission cost recovery for “prudent, unforeseen capital expenditure”. We reiterate our position that it can be difficult within the current regulatory climate to argue the prudence of DM expenditure within the constraints of regulation that requires high levels of reliability and is geared towards supply-side solutions. A shortfall in predicted DM load reductions may leave a TNSP at risk of carrying the full capital cost of an alternative (supply-side) solution as well as the initial DM costs, in order to meet its reliability requirements.

Taking into account TNSP unfamiliarity with DM and to encourage TNSPs to make full use of DM potential, capital expenditure for implementation of supply-side solutions should be eligible for approval if the expected DM resources fall short of the requirements. The eligibility of these DM-related capital expenditures under this mechanism should be made explicit.

³ NERA, *Augmentation of Supply to the Western Area: Preliminary Cost Effectiveness Analysis*, May 2003, p 36

DM proposals before augmentation

An efficient, cost-effective electricity supply system should make adequate allowance for options other than those that rely on network solutions. Demand management in its various forms can indeed be more cost effective, and hence more efficient, thus meeting the NEL objective. There is also the capacity for enhancing competition through the establishment of a DM providers market, which is currently in a fledgling state.

A major barrier to effective DM and other non-network solutions is the planning processes that TNSPs are required to undertake under the Rules. Currently, TNSPs are not required to solicit proposals for alternative non-network solutions before deciding to augment their networks. They are required to report on non-network alternatives to potential constraints and creation of new assets⁴, but there is no onus on the TNSP to do other than consider these alternatives (see also “Information disclosure” below). This can prove to be an impediment to cost-effective non-network solutions since, without clarification of the recovery of DM costs, networks may perceive the risks to be too high.

In addition, there are no guidelines on how they should determine what these alternatives may be, nor about how to assess them (let alone implement them). There should be clear protocols outlining how non-network alternatives should be valued for the purposes of comparison to network augmentation. There should also be clear protocols for information disclosure, specification of constraints, requests for proposals, and evaluation of proposals.

Most importantly, the Rules should refer to a DM Code of Practice for distribution and transmission networks, with the NSW model to be adopted as a minimum (including the protocol for disclosure of information); networks should be obligated to *implement* non-network solutions where more cost effective than augmentation. This would be a key step in facilitating a DM services market.

Furthermore, recognising that transaction costs of participating in a request for proposal process would be very high for many small DM opportunities, the AEMC should also promote standing offers for small DM services.

DM incentives

Incentives have been promoted by the AEMC as a way of encouraging action by networks and, as well as the incentives mentioned above in terms of allowing proper consideration of DM costs, direct incentives as well as direct regulation could be offered to promote DM and other non-network alternatives. One way would be to stipulate a specific minimum spending level for DM by networks. Given the large technical and economic potential for DM, between 10% and 25% of the projected network capital expenditure could be specifically earmarked for cost-effective DM projects and apportioned to the regulated asset base. This funding should be allowed only on “use it or lose it” terms, and could step up from an initial small percentage, increasing as networks become more adept at facilitating DM, then gradually reducing as the potential for DM is utilised.

⁴ National Electricity Rules, Chapter 5, section 5.6.2A

Another technique which has been applied to some effect in NSW with distribution networks is the use of the D-factor. This is essentially an incentive arrangement for DNSPs to promote the consideration of DM in network planning, with the requirement that, "the DNSPs must demonstrate to the Tribunal that its demand management implementation costs are less or equal to the avoided distribution costs before it can pass through any costs to customers."⁵ A similar principle could be applied at a transmission level. The TNSP could be allowed to earn extra revenue of a value up to the specified costs of DM implementation, when this was not originally planned for within the current regulatory period. The potential for a short-term increase in price by passing through costs to customers would be offset by the long-term benefits to all stakeholders of increased realisation of DM potential and the encouragement of greater network familiarity with DM.

Since TNSPs are not yet fully experienced in DM measures, the AEMC could pursue the feasibility of a transitional mechanism. The aims would be to remove risk, such as by allowing TNSPs to become familiar with DM techniques for meeting time and load targets, and develop strategies for maintaining service and reliability requirements wherever DM does not meet the required targets. This could include milestones for TNSPs to develop DM implementation plans as well as exit strategies to allow alternative measures to be undertaken. Such a mechanism could include procedures for the TNSP to interact with the AER in finding solutions for such situations on a case-by-case basis. There is no reason why such a mechanism could not be inserted in the Rules, since it contains other interim arrangements.

Information disclosure

NSW currently requires distribution networks to investigate and report on cost-effective non-network solutions to network constraints. The guidance for compliance with this licence condition is provided by the NSW DM Code of Practice.

These reporting requirements should be adopted nationally for all NSPs to improve the consideration of non-network solutions and, in turn, reduce unnecessary costs for consumers. The annual public disclosure of information on emerging network constraints is essential to the development of non-network responses to these constraints. The current standards for annual reporting on emerging network constraints are insufficient to properly allow for non-network alternatives to be developed.

There is also an anomaly in the current situation concerning disclosure by TNSPs of financial performance. Under existing regulations (up to 1 July 2005), "The TNSPs regulated by the ACCC are required to provide certified annual statements containing details of their financial performance."⁶ However, Energy Australia, "... did not provide consent to disclose information, [so] its details were not included in this report. The ACCC

⁵ Independent Pricing and Regulatory Tribunal of New South Wales, *Guidelines on the Application of the D-factor in the Tribunal's 2004 NSW Electricity Distribution Pricing Determination*, April 2005, p 1

⁶ Australian Competition & Consumer Commission, *Transmission Network Service Providers Electricity Regulatory Report for 2003/04*, April 2005, p 1

notes that this is the second year that Energy Australia has not provided consent."⁷ This means the public have not been fully informed of the financial performance of a TNSP and so stakeholders are being shut out of the decisions made by a TNSP. Considering the regulated monopoly status of the TNSPs, there should be a requirement for full disclosure by all TNSPs, and this should be in sufficient detail to allow for transparency of their financial position for all stakeholders. The situation has not improved with subsequent revisions of the regulations, and TNSPs can still withhold information from the public.

TEC supports in principle the direction in the draft Rule to the AER to develop information guidelines. However, the description of the contents of these guidelines within the draft Rule seems extremely limited, particularly given the more extensive delineation given within Chapter 5 of the Rules. It is not clear how these two requirements (in Chapters 5 and 6) will be applied to TNSPs, once again diminishing clarity for both the networks and the end users. There is also no direction given for reporting on TUOS rebates, which seems a significant oversight. We note that rebates are dealt with in the transmission pricing review, but there should be rigorous reporting on the details.

⁷ Australian Competition & Consumer Commission, *Transmission Network Service Providers Electricity Regulatory Report for 2003/04*, April 2005, p 1