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Mr Mike Buckley
General Manager
Network Regulation North Branch
Australian Energy Regulator
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Dear Mr Buckley

POTENTIAL DEVELOPMENT OF DMIS FOR ENERGEX, ERGON ENERGY AND ETSA UTILITIES FOR THE 2010-15 REGULATORY CONTROL PERIOD

Thank you for the opportunity to comment on the Australian Energy Regulator's (**AER**) issues paper *Potential Development of Demand Management Incentive Schemes for Energex, Ergon Energy and ETSA Utilities for the 2010-15 Regulatory Control Period* (**Issues Paper**).

Whilst CitiPower and Powercor Australia (**the businesses**) are not immediately impacted by the outcomes arising from the Issues Paper, the decisions made as part of this review are likely to be persuasive in any future considerations with respect to the Victorian price reset. As a consequence, the businesses consider it important to include its views as part of this current consultation.

The businesses have structured the submission around responding to the questions raised in the Issues Paper which are of concern to the businesses.

Do particular control mechanisms, such as tariff basket, revenue yield or revenue cap arrangements create incentives or disincentives for DNSPs to undertake demand management?

In Australia most electricity distributors are subject to a price cap form of price control (revenue yield or tariff basket). The reasoning price caps are preferred can be summarised as follows:

- price caps provide distributors with a strong incentive to develop cost-reflective tariff structures that align prices to their underlying costs;

- the distributor's costs have a greater alignment with output therefore a price cap lowers the risk associated with variations in demand; and

- price caps provide incentives to maximise utilisation of the network, subject to not exceeding capacity constraints.

Cost-reflective tariff structures and maximising network utilisation are entirely consistent with delivering outcomes that are economically efficient and compliant with the *National Electricity Law* objective. Where demand management delivers a more cost effective solution to a network alternative, it will be equally attractive to a distributor under a price cap form of control as any alternative form of control.

Are DNSPs able to offer efficient pricing structures and how does this effect the need for a DMIS?

As noted previously, only under price capping arrangements does the distributor have an incentive to develop cost-reflective tariff structures. Under a revenue cap, a distributor's revenues will be the same irrespective of the tariff structure it adopts; therefore, it does not have an incentive to adopt cost-reflective prices.

The *National Electricity Rules* (**NER**) do provide a number of requirements for distributors to meet when setting tariff structures. Clause 6.18.5(a) of the NER requires tariffs to be set between the stand alone cost of servicing the customer and the avoidable cost of not serving that customer. In addition clause 6.18.5(b)(1) requires consideration of the long run marginal cost for the service.

How does DMIS interact with other incentive schemes, such as efficiency benefit sharing schemes, or service target performance incentive schemes?

The businesses believe the single greatest impediment to greater uptake of demand management alternatives is the service incentive scheme (**SIS**).

The current Victorian SIS is relatively high powered. Consequently the penalties associated with unplanned outages are very significant. Naturally in considering demand management as an alternative to network augmentation the businesses have sought to ensure any potential liability is reflected in its agreement with demand management proponents. What the businesses have however found is that demand management proponents are unwilling to accept liability associated with SIS placing the businesses in the position whereby network augmentation is the only viable alternative.

Interaction between the SIS and demand management was discussed at some length as part of the 2006-10 Victorian Electricity Distribution Price Review process. The Victorian Essential Services Commission reached the position it would, for a trial period at its discretion, grant a short term holiday with respect to SIS liability of up to 3 years for an event that was the result of a failed embedded generator or demand side response. In the businesses view such an approach represents a step in the right direction.

The businesses note the Efficiency Benefit Sharing Scheme (**EBSS**) may also act as an impediment to the take up of demand side initiatives through the substitution of capital expenditure with operating expenditure. This is particularly so under an EBSS that excludes capital as the incentives to substitute operating costs with capital are relatively strong. The

AER's Proposed EBSS Guideline exempts any payments made to demand side initiatives proponents from the EBSS. The businesses support this decision.

What are the likely costs and benefits of implementing and administering the DMIS proposed in this paper or any other potential DMIS?

The businesses believe the current regulatory arrangements do not adequately incentivise the pursuit of demand side management alternatives to network augmentation. The present regulatory arrangements (at least as they apply in Victoria) allow only a limited period (on average 2.5 years) for distributors to retain the benefits of any deferred capital, deter research activities and payments to demand side proponents through efficiency carry over penalties and finally provide no compensation for foregone revenues.

The most efficient and effective way for correcting these arrangements is through an incentive based DMIS. IPART, and now the AER, has attempted to achieve an incentive based arrangement in New South Wales through a D factor. Whilst a step in the right direction, the D factor model is complex in nature, creates a lag between expenditure that is incurred and when it is received and is subject to considerable uncertainty with respect to how the AER will estimate foregone revenues. It also includes onerous reporting requirements and is subject to an ex post evaluation processes which may result in stranding of costs. As a consequence, the D factor is a high cost and extremely discretionary (from a business perspective) solution.

What the businesses would like to see developed is an incentive based arrangement, similar to the Victorian Service Incentive Scheme that rewards distributors based on the benefits likely to result from undertaking demand side initiatives. That is, a DMIS should be self funding so that where the costs of undertaking a demand side management initiative are less than the rewards available under the scheme, the distributor will undertake those works. Under such an approach there would be no need for lodgement of cost/benefit analyses with the AER, negotiation of approvals through the AER or a requirement for ex post assessments of projects. The benefits of such an approach are increased certainty for all stakeholders, reduced administrative burden on both the AER and distributors and a transparent mechanism for encouraging demand side management initiatives.

In addition, the incentive regime should be augmented through a research and development allowance related to demand side management. An unfortunate by product of incentive based regulation is it discourages projects which involve long pay back periods or whose outcome is not guaranteed. Innovation, by its nature, is risky. A ring fenced allowance should be provided for research and development that sits outside the efficiency benefit sharing scheme that is subject to a 'use it or lose it' provision. Additionally the allowance should be subject to an annual reporting allowance describing the activities being undertaken through the allowance. The benefit of the research and development fund is, unlike the innovation fund, it is not subject to detailed cost/benefit analyses requiring AER approval and secondly, by virtue of the funds being made available upfront, will encourage distributors to undertake the development works rather than be deterred through the administration costs associated with accessing the funds.

A greater impediment to the take up of demand side management initiatives however is the Service Incentive Scheme. Demand side management proponents are at this point, unwilling or unable to manage the liability associated with the SIS as it exists in Victoria. Further, the high powered nature of the SIS makes it untenable for distributors to carry the liability for performance that is outside their control. Consequently at this stage of the market development, the businesses believe the most positive step that could be taken by the AER is to create an SIS exclusion ‘holiday’ for outages brought about by the failure of an embedded generator or demand side initiative proponent.

Although not a regulatory framework issue, the businesses would also highlight that distribution networks in general are not configured in a manner conducive to the connection of embedded generation and demand side initiatives. For example, circuit breakers within the distribution network are rarely rated to manage embedded generation resulting in additional risks in terms of health and safety and reliability. It is noted that Ofgem, as part of the fourth United Kingdom Electricity Distribution Price Review, provided funds to distributors to upgrade the network to better manage the connection of demand side initiatives. As part of the next cycle of price resets, the businesses believe the AER should be receptive to similar expenditure targeting network improvements to facilitate demand side initiatives and embedded generation.

Should you have any further questions in relation to this submission, please do not hesitate to contact me on (03) 9683 4465.

Yours sincerely

[signed]

Brent Cleeve
MANAGER PRICE REVIEWS