

20 December 2007



Mr Mike Buckley
General Manager - Network Regulation North
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

BY EMAIL: AERInquiry@aer.gov.au

Dear Mike

**2009-2014 NSW AND ACT ELECTRICITY DISTRIBUTION DETERMINATIONS
PROPOSED GUIDELINES**

We refer to the Australian Energy Regulator's (AER's) recent release of a recent Issues Paper for NSW and ACT distribution businesses, covering the issuing of guidelines for:

- the application of a demand management scheme;
- control mechanisms for alternative control services; and
- assessing materiality for pass-through events

in the context of upcoming reviews for those businesses. We enclose an attachment that comments on the first and third of these issues.

We trust that this submission is helpful in providing you with further guidance in framing the appropriate transitional demand management and pass-through arrangements to apply to NSW and ACT businesses. We hope that it has also provided you with a useful perspective on the way that these arrangements may also best apply to other distribution businesses.

If you have any further questions in relation to the enclosed submission, please do not hesitate to contact me on (03) 9898 3900 or at roman.domanski@euaa.com.au.

Yours sincerely

A handwritten signature in black ink, appearing to read "Roman Domanski".

Roman Domanski
Executive Director

Encl

Energy Users Association of Australia
ABN 83 814 086 707

Suite 1, Level 2, 19-23 Prospect Street, Box Hill, Victoria, 3128
Phone: (03) 9898 3900 Fax: (03) 9898 749 Email: euaa@euaa.com.au
www.euaa.com.au

Attachment

In relation to the operation of a demand management scheme for NSW and the ACT and the materiality level that should operate in respect of the pass-through arrangements applicable to those businesses from 2009 – 14, we make the following comments.

1. Guidelines on the introduction of a Demand Management Scheme

The EUAA's stated position

In the joint Energy Users' Association of Australia (EUAA) and Energy Action Group (EAG) submission into the Independent Pricing and Regulatory Tribunal (IPART) revenue determination for NSW distribution businesses¹, we commented that the IPART's 'd-factor' proposals for demand management (DM) contained some positive elements, but did have limitations.

At that time, the EUAA and EAG understood that IPART proposed to introduce the scheme to provide the distribution network service providers (DNSPs) with incentives to introduce DM initiatives by guaranteeing the pass-through of all costs for DM projects approved by IPART. The 'd-factor arrangements' were also designed to provide recovery of all foregone revenue via a complex 'd-factor' in the Weighted Average Price Cap (WAPC) formulae. However, IPART's Draft Decision on DM made no mention of what the impact of this arrangement might be on consumers, either those providing DM or on consumers more generally.

The EUAA supports the continuation of arrangements that incentivize DNSPs to look to implement demand response measures where this is cost-effective and results in net avoided network costs for end users. As noted by the AER in the Issues Paper, tariff-based incentives are limited in effectiveness as retailers may not pass price signals on to customers and residential consumers' demand is relatively price inelastic. Additionally, we note the comments in the Issues Paper that the form-of-regulation and network characteristics have a significant impact on whether additional incentives to introduce demand-side response measures (such as the d-factor) are required.

Additionally, like the AER, we note that the Australian Energy Market Commission (AEMC) is conducting a review under section 45 of the Nation Electricity Law to investigate the role of demand side participation in achieving the National Electricity Market (NEM) Objective and to ensure the full and efficient participation of the demand side in the NEM.

It may be appropriate, to, where possible, build some flexibility into the operation of the forthcoming revenue determinations for ActewAGL and the NSW distributors so that recommendations from that review can be considered and implemented within the upcoming regulatory period, if this is feasible. We hope that the review will provide further incentives for the distribution businesses to introduce demand management response measures.

¹ Energy Users' Association of Australia and Energy Action Group, *New South Wales 2004 Electricity Distribution Review: Submission on IPART Draft Decision*, March 2003, p. vii, & pp 29 -30

Additionally, there may be some 'quick wins' for demand side management associated with this review that benefit both the networks and users interested in participation in demand side response. The EUAA considers that there should be an opportunity to introduce those 'quick wins' prior to the regulatory period commencing in 2014.

Finally, the AER itself must ensure that the data actually collected by the DNSPs under existing arrangements is factored into future revenue determination processes, and forecasts for capital projects are suitably adjusted to reflect increased DM uptake. Otherwise, significant learnings and incentives associated with the introduction of the scheme may well be lost, and end users may end up paying twice (through distribution revenue allowances, and through d-factor payments) for the operation of an ineffective scheme.

2. Guideline on Materiality for pass-through events

We note that the discussion around 'costs' incurred in responding to an event that qualifies as a 'pass-through' event does not clarify whether those costs are 'efficient' or otherwise. The EUAA considers that any discussion of costs must be a discussion of 'efficient costs': costs that have otherwise efficiently been incurred in meeting the costs associated with pass-through events, and for which an allowance has not otherwise been sought or given as part of a relevant revenue or price cap determination.

We now address each of the issues relevant to the consideration of 'materiality' for pass-through events in turn.

2.1 Should materiality be assessed based on the costs of an event during the regulatory control period, or the revenue impact of an event in the regulatory control period?

We consider that 'materiality' should be assessed in the context of 'costs incurred' rather than 'revenue foregone' for a number of reasons:

- The focus on costs when assessing the impacts of pass-through events is consistent with the focus on costs when assessing the impacts of pass-through events in relation to transmission services under Chapter 6A of the National Electricity Law (NEL). An inconsistent treatment of the impact on costs of revenue across transmission and distribution business may provide businesses that have interests in both types of business with both an incentive and an opportunity to 'game' the process of assessing the cost impact(s) of pass-through events, if the assessment of the impacts of 'pass-through' events is not consistent between these businesses.
- The rationale for providing regulated businesses with access to a 'pass-through' mechanism is consistent with allowing regulated firms to recover cost increases occasioned by specific, unforeseeable events. Effectively, access to a pass-through mechanism compensates those firms for additional costs that are borne as a result of the unexpected event. Additional costs incurred may or may not have any relationship with revenue, and if there is such a relationship, quantifying that relationship is likely to be difficult and subjective.

- The Issues Paper documents a relatively consistent consideration and assessment of ‘costs’ rather than ‘revenue’ by other regulators (even in the context of the consideration of additional capex requirements brought about through pass-through events). Absent a compelling reason to change focus from a consideration of costs impacts rather than revenue impacts brought about by pass-through events, the EUAA does not consider that a change in focus is warranted at this time

Additionally, and as the AER notes, NSW Distribution businesses have suggested that there has been some uncertainty about the application of the ‘materiality’ threshold to increases in capex. As the AER has also indicated, the revenue or cost impact of an increase in capex is more difficult to calculate than the impact of an increase in costs on opex, as it involves assumptions about asset lives and rates of return.

The EUAA considers that, consistent with the adoption of an ‘ex ante’ framework for capex, there should NOT be available a mechanism to reclaim increases in capex (as opposed to opex costs) through a pass-through mechanism. This is because:

- Such a position is consistent with the NER arrangements for transmission businesses. While the transmission rules do not specifically bar recovery of increased capex costs, due to the nature of the Transmission Rules, pass-through events that have significant capex impacts have not been approved for capex costs to-date. One of the primary purposes in bringing the regulation of transmission businesses under the regulation of the Australian Energy Regulator (AER) was to simplify and standardize the rules applying to distribution and transmission businesses. These objectives are not furthered if capex costs are allowed for distribution businesses, but not for transmission businesses.
- There are clauses in the NER that allow for the re-opening of a revenue determination to include an allowance for additional capex, in specified circumstances. There are also ‘contingent project’ arrangements for transmission businesses, under which a claim for additional capex can be assessed. These mechanisms (and associated cost hurdles) should apply to distribution businesses (again, in the interests of promoting consistent regulation). The application of NER Clause 6A.7.1-type rules for distribution businesses might make irrelevant the consideration of a ‘pass-through’ regime for capex for distribution businesses.
- Having differing rules for the re-opening of opex and capex across transmission and distribution businesses creates incentives to ‘game’ those differences. Inconsistent treatment across transmission and distribution business may provide businesses that have interests in both with an opportunity to ‘game’ the process of assessing the cost impact(s) of pass-through events, and the categorization of the cost impacts of those events.

2.2 Should the costs or revenue impact of an event be measured on an average annual basis, or measured as the total costs or revenue impact of the event for the remainder of the regulatory control period?

We agree with the AER that it is desirable for the measure of revenue selected to be consistent with the measure of the costs or revenue impact of the event. If *total* revenue is selected it ought to be compared to *total* costs or revenue impacts of the event, and if *average* revenue is selected it ought to be compared to *average* costs or revenue impacts of the event.

We consider that the AER should, where possible, adopt a mechanism that does not provide distribution businesses with the incentive to delay costs, or move costs between one regulatory year and the next. This is a particularly relevant consideration if the event occasioning a pass-through application falls in the second half of a regulatory period, and there is the opportunity to delay the incursion of that cost so as to bring costs for the next regulatory period over the threshold. For this reason it would appear sensible to adopt a total revenue / total cost measure that minimizes, where possible, the ability for the pass-through mechanism to be gamed in this way.

2.3 To which of the following measures of revenue should the costs or revenues of the event during the regulatory control period be compared?

For the reasons stated in the preceding paragraph, the EUAA considers that it is appropriate to use a total cost / total revenue approach to the calculation of the 'hurdle' that must be passed in order for a pass-through claim to be assessed. As previously mentioned, this approach avoids creating an incentive for distribution businesses to manipulate the timing for the incursion of costs occasioned by the pass-through event.