Department of Primary Industries

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10 March 2009

Mr Chris Pattas
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Our Ref: PD/02/0088

Dear Chris,

Framework and Approach Issues Paper for Victorian Electricity Distribution Businesses

Thank you for providing the opportunity for comment upon the Australian Energy Regulator's (AER's) Preliminary Position Paper on the framework and approach for the next Victorian distribution price review.

The Department of Primary Industries (DPI) is supportive of the preliminary framework and approach that the AER is proposing to use for the next Victorian price review.

The proposed framework bears strong similarities to the regulatory framework that was established by the Essential Services Commission of Victoria (ESC) in the Electricity Distribution Price Review 2006-10. DPI commends the AER for achieving a reasonable balance between the need for a consistent approach across jurisdictions while also accommodating the advanced regulatory framework that has applied in Victoria to date.

The AER is proposing some changes to the regulatory framework applying in Victoria in the next regulatory period. On the whole, DPI is pleased with the proposed changes, particularly the extension of the GSL payments scheme in some instances.

DPI has specific comments against certain components of the proposed framework and approach. These are set out in the attached submission under the following headings for the AER's consideration:

1. Classification of services: unmetered supplies
2. Classification of services: connection and augmentation works
3. Service target performance incentive scheme: removal of the S-factor payment (penalty)
4. Service target performance incentive scheme: capping of S-factor allowances
5. Service target performance incentive scheme: targets for the S-factor scheme
6. Service target performance incentive scheme: GSL payments scheme
7. Reporting on long term reliability
8. Demand side management scheme
9. General provision for network development

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DPI notes that the Victorian economic regulatory arrangements have evolved through many years and there may be reasons why apparent divergences between Victorian practice and those arrangements prevailing nationally may be explained and justified by specific considerations.

The recent heatwave and bushfires experienced in Victoria during January and February reinforce the need for a regulatory framework that balances the long term interests of consumers with the need to provide the privatised electricity distributors with fair and reasonable revenue and appropriate incentives over the regulatory period to facilitate an efficient, secure, safe and reliable supply of electricity.

Thank you for the opportunity to provide input into the framework and approach process. If you would like to discuss any of the issues raised in this submission, please contact Peter Clements (Director, Energy Retail & Distribution) on (03) 9658 4927 or Raif Sarcich (Senior Policy Officer, Energy Retail & Distribution) on (03) 9658 4160.

Yours sincerely

Marianne Lourey
Executive Director
Energy and Earth Resources Policy

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Submission: Framework and Approach Issues Paper for Victorian Electricity Distribution Businesses

1. Classification of services: unmetered supplies

The Victorian Department of Primary Industries (DPI) is supportive of the proposed service classification that the Australian Energy Regulator (AER) intends to make. It preserves the existing classification and recognises and confirms the reasons for why services are classified as they are in Victoria.

The AER is proposing to classify unmetered supplies as a direct control-alternative control service.

The AER correctly notes that the regulatory arrangements relating to the rollout of advanced meters were initially set out in the 2007 Victorian Order-in-Council which were subsequently amended by the November 2008 Order-in-Council. Under these arrangements, the AER believes that unmetered supplies will be regulated by the prevailing Orders-in-Council until 31 December 2010. DPI understands that from 2011, the AER intends regulating unmetered supplies as direct control-alternative control services.

2. Classification of services: connection and augmentation works

The AER seeks comment on whether a change to the current requirement for Distribution Network Service Providers (DNSPs) to tender connection and augmentation works would have an impact on the AER's classification of these services as negotiated distribution services.

The AER correctly notes that classifying these services as negotiated distribution services may not be appropriate if the requirement for DNSP to tender from at least two other people who might otherwise compete for this work is removed as part of the repeal of Victorian economic regulations anticipated to accompany the new pricing determination.

While the market for these services is considered contestable, individual customers may not have sufficient information and knowledge about the industry to understand that providers other than their local DNSP could provide connection and augmentation works. This places the local DNSP in a position of power relative to the customer which may not provide sufficient incentives for the DNSP to price efficiently or negotiate in good faith with the customer.

In the absence of the Essential Service Commission's (ESC) Electricity Industry Guideline 14 or some alternative regulatory instrument that imposes an obligation on DNSPs to allow customers access to alternative providers, the AER would need to give consideration to treating connection and augmentation works as a direct control-alternative control service.

As the AER notes in its issues paper, DPI is examining the need to retain these requirements upon Victorian distribution businesses, and would welcome dialogue with the AER over how best to ensure that network augmentation work is appropriately subject to competition.

3. Service target performance incentive scheme: removal of the S-factor payment (penalty)

DPI supports the AER in preserving most of the key features of the service incentive (or S-factor) scheme established by the ESC in the Electricity Distribution Price Review 2006-10. This scheme, with the amendments made in the last price review, has served Victorian customers well by providing strong incentives for the Victorian DNSPs to find an appropriate trade off between the cost of service improvements and customers' willingness to pay for those improvements.

The AER has not been clear in either its Preliminary Position Paper or its Service Target Performance Incentive Scheme Guideline how long the DNSP will retain any benefit (or penalty) that they derive from the S-factor scheme.

Under the arrangements set in place by the ESC, the Victorian DNSPs retained the benefit (penalty) for a 6 year period. Limiting the payment period to 6 years was achieved by setting the denominator for the calculation of S_t equal to $(1+S'_{t-6})$. Thus, the formula was:

$$S_t = (1+S'_t) / (1+S'_{t-6})$$

While noting that the formula for the denominator will continue to be $(1+S'_{t-t'})$, the AER has not specified what value t' will have.

DPI notes that the AER is now separately proposing amendments to the Service Target Performance Incentive Scheme (STPIS) that were not foreshadowed in the framework and approach issues paper for the Victorian distribution price review. In these proposed amendments DNSPs will only be able to retain any reward or penalty earned under the scheme for one regulatory year, as opposed to the current six.

However, the AER is not proposing to make any commensurate change to the efficiency carryover scheme. The potential outcome of this is that the DNSPs will have the incentive to achieve efficiency gains at the expense of service levels.

The AER is proposing in the framework and approach issues paper that the DNSPs should retain the benefits (penalty) achieved under the Efficiency Benefits Sharing Scheme (EBSS) scheme for a period of five years *after* the year in which the gain is made. This means that the DNSPs will retain the benefit (penalty) for close to six years in total. To effectively offset the incentives created by the EBSS, the DNSPs must also be allowed to retain the benefit (penalty) earned under the S-factor scheme for 6 years.

DPI strongly recommends that the AER specify the length of period that the DNSPs will retain the benefit (penalty) of the S-factor at 6 years as in the past.

4. Service target performance incentive scheme: capping of S-factor allowances

DPI understands that a cap on the S-factor scheme (at +/-3% of total allowed revenue) was introduced to achieve a degree of consistency with the arrangements established for transmission.

Application of the S-factor scheme on transmission can have a significant effect on a Transmission Network Service Provider's revenue where a failure in the transmission network occurs. Failures in a transmission network usually involve significant portions of the whole network, while the impact of such a failure is unpredictable and hard to quantify. Failures may impact very large numbers of customers, or none at all (the financial impacts may similarly be very high or negligible) depending on where in the network the failure occurs and market conditions at the time of the failure.

Generally, the dispersed nature of distribution networks means that the risk of extreme under-performance under the S-factor scheme due to events beyond the distributors' control is limited. Typically, fewer customers are affected by each outage, and outages generally occur over shorter time frames.

There are also a range of exclusions from the S-factor scheme that a DNSP can access if the outage event is of an unusual nature and/or the event could not be controlled or reasonably foreseen by the DNSP. These exclusions were introduced to manage the risk to revenue that the S-factor may have in the event of a large scale outage.

Nevertheless, as the recent Victorian bushfire events have shown, the impact of severe natural disasters upon distribution businesses requires careful management. The AER should consider the exclusion criteria in the context of where major reconstruction works may be required to restore supply, where large numbers of customers may not be in a position to take (restored) supply for an extended period, and where distributors may be incentivised to prolong outages in order to exceed objective exclusion tests.

Furthermore, imposition of a cap on the S-factor scheme potentially reduces the incentives that the DNSPs have to improve performance even though the incentive rates established may suggest that customers are willing to pay for improvements that extend beyond the cap. It effectively places a ceiling on the service improvements that customers can receive even though they may be willing to pay for those improvements.

DPI submits that the cap on the S-factor scheme should be removed in its application to the Victorian distribution businesses, and in the STPIS generally, will be providing input to this effect to the AER's STPIS amendment process.

5. Service target performance incentive scheme: targets for the S-factor scheme

The AER is proposing to set the targets for the S-factor scheme based upon the average of the previous five years of actual performance. This approach differs significantly from the approach established by the ESC in the EDPR 2006-10.

In this review, the ESC set the targets for the five years of the regulatory period the same as the 2005 targets. The ESC took this approach because it received little indication that Victorian customers valued further improvements in average reliability levels. Setting the targets the same as the 2005 targets ensured that DNSPs were not rewarded for improvements already achieved and already paid for by customers.

The approach contrasted with the targets set at the EDPR 2001-05 where the service reliability targets anticipated improvements in average reliability. Extensive consultations undertaken at that time indicated that customers valued improvements in the average reliability they received.

DPI is concerned that the AER's approach to establishing targets for the S-factor may result in more demanding targets over time, even though no evidence has been provided that Victorian customers value and are willing to pay for these improvements.

The S-factor provides incentives to a DNSP to improve reliability where the rewards under the scheme exceed the costs of achieving those improvements. Thus it can be expected that a DNSP will seek to continually improve performance until that limit is reached. With future targets being set using an average of past actual performance, the potential exists for the targets to become more demanding over time.

This provides an opportunity for DNSPs to seek additional expenditure to achieve these anticipated improvements, even though customers have not indicated that they value and are willing to pay for these improvements.

It also raises the possibility of perverse incentives. For example: if a DNSP's performance in the final year of its current regulatory period exceeds the final year performance of the preceding regulatory period, but is below the *average* performance over the current period, then it will be penalised despite improved performance over the previous period (this could occur if the final year of the preceding period was a particularly bad one for the DNSP).

The S-factor framework established by the ESC in the EDPR 2006-10 only provided expenditure for reliability improvements through the financial rewards provided by the S-factor scheme.

The incentive rates were set so that DNSPs faced the same trade-off in costs and benefits as firms in competitive markets. That is, each incremental improvement in average reliability required the DNSP to trade off the cost of this improvement against the willingness of customers to pay for that incremental improvement. By effectively removing targets as the ESC has done, DNSPs are rewarded for improvements in performance and are penalised for deteriorations in performance.

DPI is unaware of what information the AER has relied on to suggest that Victorian customers value any potential improvement in average reliability levels that might arise because of the way the targets are set. DPI requests that the AER make explicit to stakeholders the basis on which it arrived at these conclusions, so that it can be assured that the AER's approach is in the long term interests of Victorian customers.

6. Service target performance incentive scheme: GSL payments scheme

As noted, DPI strongly supports many of the proposed amendments that have been made to the GSL payments scheme, particularly:

- the introduction of GSL payments for duration of interruptions by feeder type,
- the increase in the upper threshold from $250 to $300 for energisation and
- the introduction of a GSL payment for the period of notice given for planned interruptions.

DPI presumes that the AER obtained strong feedback from Victorian customers that they valued the introduction of GSL payments for duration of interruptions by feeder type and for the period of notice given for planned interruptions. DPI notes previous research undertaken for ESCOSA indicated that whilst some customers value four days notice if interruptions are planned, some valued a shorter period whilst other valued a longer period.[1]

DPI also welcomes the AER's proposed retention of the thresholds and payment levels arising from total duration of interruptions.

However, DPI has two concerns with the GSL arrangements proposed by the AER:

- First, the AER is proposing to remove the GSL payment for momentary interruptions. The ESC received a large amount of feedback during the EDPR 2006-10 that quality of service, particularly momentary interruptions, was of concern to Victorian customers. This concern arose because of the increased penetration of technology such as computers in the home and the increased frustration of resetting appliances. The GSL payment was introduced to provide an incentive for distributors to ensure the number of momentary interruptions experienced by customers did not exceed the specified number. Removing this GSL payment will remove this incentive from the distributors.

  As far as DPI is aware, the AER has not set out what information it has relied on to find that minimising the number of momentary interruptions a customer receives is no longer of concern to Victorian customers. DPI requests that the AER provide DPI with a copy of the information it has relied on so that DPI can assure itself that Victorian customers no longer value this GSL payment.

- Second, DPI is concerned over the removal of the thresholds introduced for the GSL payment for the frequency of interruptions. The ESC introduced multi-level GSL payments to more closely reflect study results that showed customers' willingness to pay increases as the number of interruptions increases.

  DPI is unaware of what information the AER has relied on to find that Victorian customers' willingness to pay no longer increases as interruptions increase. DPI requests that the AER provide DPI with a copy of this information so that DPI can assure itself that the proposed arrangements align with the expectations and demands of Victorian customers.

  The incentive rates set in 2005 based on VENCorp's 2002 valuation of customer reliability report should also be re-evaluated in line with VENCorp's most recent report.

7. Reporting on long term reliability

In the EDPR 2006-10, the ESC was concerned that the impact of the investment decisions taken now by the distributors may not be evident in the short term, but may affect the reliability of the network in the longer term. In particular, the ESC noted that the average reliability measures are lagging measures because a change in outcome lags a change in behaviour.

The ESC introduced an annual 'health card' that sought to provide information to the ESC that a distributor may not necessarily be implementing its long term strategy and/or plans necessary for

[1] KPMG (2003) *for* Essential Services Commission of South Australia. *Consumer Preferences for Electricity Service Standards.* Available at http://www.escosa.sa.gov.au/ .

maintaining the reliability of the network over the long term. The measures included in the 'health card' were discussed at length with the Victorian distributors prior to the ESC's final decision.

The benefit of the 'health card' is that it provided the ESC with information that it could use to identify early whether there were fundamental reliability and security issues emerging in the network because of the expenditure decisions taken by the DNSPs.

Information to make this assessment is important because a regulator can only know after the event whether it has got the balance between the incentive for efficiency and the incentive for service maintenance and improvement under the S-factor correct. In the meantime, an imbalance in those incentives that may encourage the DNSPs to seek efficiencies at the expense of reliability and security poses serious consequences for the long term reliability of the network.

The annual 'health card' developed by the ESC aimed to provide the ESC with this 'early warning system' so that measures could be implemented before failure occurred.

It appears that the AER has not retained the ESC's annual 'health card'. DPI requests that the AER set out what information it will rely on to understand and assess how the investment decisions taken now by the distributors is not posing a threat to the long term reliability and security of the network.

8. Demand side management scheme

The AER is proposing to introduce a demand side management scheme into the Victorian arrangements.

DPI is very supportive of demand side management as it can reduce costs, and thus prices, for customers over the long term. As a result, DPI supports the AER in considering this very complex issue.

The AER appears to have based part of its scheme (recovery of foregone revenue) upon the D-factor scheme that has been operating in NSW for the last few years. This area is a new one for the national economic regulation framework and whichever approach is adopted, it is understood that considerable work and refinement will need to go into demand management to realise the benefits. A key part of this work is extensive analysis of the performance of current schemes, particularly the NSW D-factor.

DPI would appreciate the AER making available whatever analysis it or other bodies have done on the NSW D-factor scheme, in order to make informed input on the design of the scheme in future.

In the ESC's 2006-10 review, distributors were provided with funding for demand management activities with associated reporting requirements. The AER should also examine how the distributors have used this funding, what the benefits have been, and whether these benefits support the proposal to allocate more funding for demand management in the next regulatory period.

Similarly, while the scale of the scheme proposed for Victoria in the next regulatory period appears limited, it is important that the AER undertake analysis of the outcomes and net benefits that Victorian customers have received before expanding the scheme in future periods. The reporting requirements of the scheme that are imposed on the DNSPs must be sufficiently comprehensive to ensure that the AER has the information it requires to undertake this assessment.

The reporting requirements currently set out in the guideline appear focussed on the implementation of the schemes rather than also requiring reporting on the outcomes that customers have received and the resulting net benefits that Victorian customers have obtained. The AER should ensure that the reporting requirements it has set out will provide the AER with this information. This will enable an assessment of whether Victorian customers have received net benefits from the outcomes generated by the scheme and thus whether the scheme should be expanded or discontinued.

DPI looks forward to participating in the consultation process that will occur in coming years that will consider how effective the scheme has been over the next regulatory period.

9. General provision for network development

DPI is concerned that over the past regulatory period, some deficiencies and constraints in distribution networks have emerged which may compromise the reliability of supply for customers and the development of more flexible and energy efficient means of supply in Victoria. Recent hot weather events have revealed a large number of supply areas operating uncomfortably close to their maximum capacity in peak conditions, resulting in equipment failures and customers off supply in many instances. Similarly, reported difficulties in finding sufficient network capacity to connect embedded generators to distribution networks has caused concern both for the development of demand side management and also network safety in areas (particularly near-city sites) where embedded generators may wish to locate.

In part, facilities such as the S- and D-factor mechanisms are intended to incentivise distribution businesses to manage these issues appropriately. However, the rapid emergence of a vigorous push for building-based cogeneration facilities and the onset of climate change related extreme weather events may have taken the sector unawares.

DPI would appreciate the AER working with stakeholders to address the needs of the future energy sector in a forward looking fashion as part of this pricing review in looking at the need for particular categories of network investment. DPI looks forward to discussing this issue further with the AER over the coming months.