

Ref: JC:JC:C1875816

9 May 2012

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Warwick

Dear Mr Anderson

**Matters relevant to the framework and approach, ACT and NSW DNSPs
2014-2019 – Discussion Paper April 2012 (Control Mechanisms)**

Essential Energy appreciates the opportunity to respond to the Australian Energy Regulator's (AER's) discussion paper on the control mechanisms for standard control electricity distribution services in the ACT and NSW ('the paper'). Essential Energy's responses to the questions contained in the paper are detailed below.

Question 1

- A. What weighting or ranking should be applied to the assessment criteria listed in Clause 6.2.5(c) of the NER and the additional criteria considered by the AER?
- B. Are there other criteria that the AER should consider in determining the control mechanism to apply to standard control services? How important are these other criteria.

The assessment criteria listed in clause 6.2.5(c) of the National Electricity Rules (NER) and the additions considered by the AER in the paper are discussed below.

Need for efficient tariff structures

Essential Energy believes this criterion should be ranked highly and weighted accordingly by the AER in its assessment of control mechanisms. Efficient tariff structures ensure prices are at cost reflective levels and investment decisions and customer usage is not distorted. Efficient tariff structures are an integral input into achieving the National Electricity Objective (NEO).

Administration costs

Essential Energy agrees that a control mechanism should minimise the complexity and administrative burden on costs for the benefit of consumers. Essential Energy also agrees with the AER's view in the paper that administration costs are likely to be similar under each control mechanism, even though the timing of costs may vary. Administrative costs are more likely to be minimised by applying a consistent control mechanism across regulatory periods and across jurisdictions.

Consistency across jurisdictions and control periods

Essential Energy believes that consistency between jurisdictions and regulatory control periods is desirable and would help reduce administrative costs as noted above. Where possible, it makes sense to align control mechanisms for the same services across jurisdictions, although it is not absolutely necessary. While important, in Essential Energy's opinion, this criterion is not as high a priority as efficient tariff structures or price stability.

Volume risk and revenue recovery

As noted in the paper "*all forms of control mechanism rely on forecast quantities expected to be demanded over the regulatory period*". The control mechanism is irrelevant to volume forecasts, assuming that they have been carried out accurately. For this reason, Essential Energy is of the view that this criterion should not be as highly ranked as efficient tariff structures or price stability.

However, it is logical to expect that volumes will vary to some degree from forecasts over a five year regulatory control period. This is especially true in times of uncertainty, such as those being experienced at the moment and in the foreseeable future, due to issues like customer response to increasing prices, weather and solar schemes.

The issue for the AER to address is which party is best placed to, and therefore should manage the risks associated with volume forecasts being incorrect. If the AER believes DNSPs should wear this risk, then a price cap control mechanism will be the best option. If consumers are seen as the appropriate party to wear volume forecasting risk, then a revenue cap control mechanism will be preferred.

Incentives for Demand Side Management (DSM)

Essential Energy believes that DSM is an important component in reducing the cost impact that increasing peak demand has on a distribution network. However, the control mechanism is unlikely to have a significant impact on DSM in Essential Energy's opinion. DSM is part of the broader regulatory framework and appropriate incentives and their levels should be considered in this wider context.

Essential Energy does not believe this criterion should form part of the AER's consideration of appropriate control mechanisms, but if the AER still wants to include it, a low priority ranking would be valid.

Price flexibility and stability

Essential Energy believes that price flexibility is important in facilitating efficient tariff structures. However, price flexibility will not necessarily be influenced by the control mechanism, as all control mechanisms allow for price flexibility to some degree.

Essential Energy believes that price stability is very important and should be given the same high ranking and weighting as efficient tariff structures. Volatility in prices between regulatory years does not benefit consumers, regulators or DNSPs. Revenue cap control mechanisms may result in, and have resulted in, significant price instability due to the operation of the unders and overs account. This volatility is exacerbated, especially for larger customers, by the operation of a revenue cap and settlement residues for transmission network service providers.

Essential Energy believes the AER also needs to consider expanding this criterion to include price stability not only between years, but also between regulatory control periods.

Question 2

- A. Do you consider a price cap or a revenue cap provides the best incentives to create efficient prices?
- B. To what extent do external factors override the incentives provided by the form of the control mechanism?

As noted in the paper, revenue caps do not provide DNSPs with an incentive to set efficient prices, as revenue is fixed and guaranteed regardless of sales volumes. Essential Energy believes that a price cap provides better incentives to create efficient prices. This view was shared by the Australian Energy Market Commission (AEMC) in a recent report on demand side participation¹.

External factors will influence a price cap, revenue cap or any other form of control mechanism. The paper provides a good example of retailers setting prices in a way that effectively mutes the efficient pricing structures developed by DNSPs. This example can occur under any control mechanism.

Question 3

- A. Do you consider a price cap or a revenue cap is better able to provide DNSPs with an opportunity to recover efficient costs, while limiting revenue recovery above forecast?
- B. Who should bear the risk of errors in forecast volumes, DNSPs or customers?
- C. Is there scope for windfall gains for DNSPs under WAPCs due to (a) sale volumes forecast error and (b) price changes during the regulatory control period?

Essential Energy believes that a price cap is better able to provide DNSPs with an opportunity to recover efficient costs. Under a price cap, revenue increases and decreases in line with economic conditions. For example, revenue can increase with higher connections, CPI and peak demand, and vice versa. This is more cost reflective method of setting prices than is available under a revenue cap which fixes DNSPs revenue and penalises the DNSP in strong economic times or penalises the customer in weaker economic times. The price cap has the ability to reflect underlying economic conditions, and revenue recovery above forecast is reflective of this rather than any gaming by DNSPs.

¹ AEMC, Review of Demand-Side Participation in the National Electricity Market, Final Report, November 2009

Given a DNSP is best placed to forecast volumes it seems appropriate that they also bear the risk of variations from those forecasts. The incentives under a WAPC are symmetrical and the scope for gains or losses is equal. Essential Energy would also like to challenge the AER's view in the paper that actual WAPC data is consistently above forecast. In this current regulatory control period, the exact opposite has occurred and actual sales volumes have been under forecast volumes.

Question 4

- A. What incentives does a DNSP have to conduct demand side management under a WAPC?
- B. Is there any evidence to suggest that a revenue cap results in greater levels of demand side management than a WAPC?

DSM is aimed at reducing peak demand and improving load factors on the network. As prices for most customers are set on throughput with a fixed charge, changes in peak demand are unlikely to have a major impact on incentives for DSM. Essential Energy argues that incentives for DSM are similar, regardless of the control mechanism. As noted above, DSM is part of the broader regulatory framework and appropriate incentives and their levels should be considered in this wider context.

Essential Energy is not aware of any evidence that the control mechanism has any great bearing on the level of DSM in a jurisdiction.

Question 5

- A. Do you consider a price cap or a revenue cap is likely to provide lower administration costs? How significant are the differences in administration costs between these two forms of control?
- B. What are the likely administrative costs of changing from one control mechanism to another?

As discussed above, administration costs are likely to be similar under each control mechanism, even though the timing of costs may vary. Changing from one control mechanism to another is unlikely to have major cost impacts, however costs can be minimised by adopting the same control mechanism across regulatory periods and jurisdictions.

Question 6

- A. Do you consider a WAPC or a revenue cap can better provide price flexibility?
- B. What are the benefits/detriments from a high level of price flexibility?
- C. What is the magnitude of disruption caused by annual price changes from the overs and unders account variations under revenue caps?

Both a revenue cap and WAPC allow for price flexibility to some degree, and so in Essential Energy's view, this is not an important consideration when evaluating control mechanisms.

The magnitude of price movements due to the operation of the unders and overs account under a revenue cap can be, and has been, significant. For example, in the

past, one NSW DNSP had a substantial over recovery under a revenue cap. Prices had to be reduced in the following year by the amount of that over recovery, before then being increased back to higher than the original levels in the very next year. Customers and retailers prefer to have stable and predictable price levels as far as possible, but a revenue cap offers the exact opposite of this. As noted earlier, movements in transmission unders and overs accounts exacerbate this problem, especially for larger customers who have full visibility of transmission prices.

Question 7

A. Is it desirable to have consistent control mechanisms across jurisdictions?

Essential Energy believes that consistency between jurisdictions and regulatory control periods is desirable and would help reduce administrative costs as noted above. Where possible, it makes sense to align control mechanisms for the same services across jurisdictions, although it is not absolutely necessary.

Question 8

- A. Is it appropriate to adopt a revenue cap for standard control services for the NSW and ACT 2014-19 distribution determinations?
- B. What other issues should be considered in determining which control mechanism to adopt?

The AER concludes that based on the outcomes presented in table 4.1 of the paper, its initial preference is for a revenue cap. Essential Energy finds it difficult to understand the AER's logic in coming to this conclusion as table 4.1 does not seem to indicate that a revenue cap has any real advantages over other control mechanisms.

Essential Energy has not yet fully evaluated the appropriate control mechanism that should be applied in the next regulatory control period, and therefore it is too early to adopt a preferred position. This will occur during the upcoming formal framework and approach consultation process.

Essential Energy would be pleased to discuss this matter further. Should you require further information or clarification please feel free to contact Natalie Lindsay on 02 6589 8419 or Jason Cooke on 02 6338 3685.

Yours sincerely



Col Ussher
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