19 August 2010

Mr Chris Pattas
General Manager
Network Regulation South
Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

By email: AERinquiry@aer.gov.au

Dear Mr Pattas,

Victorian Electricity Distribution Draft Determination and Revised Proposals

Origin Energy Electricity Limited (Origin) is pleased to provide a response to the Australian Energy Regulator (AER)'s Draft Determination and the Victorian Distribution Network Service Providers' (DNSPs) responses to this Draft Determination.

1. Forecasts of maximum demand and volumes

Origin welcomes the critical approach the AER has adopted in reviewing the Victorian DNSPs' forecasts of maximum demand and consumption, as these are primary drivers of price under the regulated framework.

Accuracy of forecasts of maximum demand in the current period

Origin notes the AER's finding that "despite recent hot summers, the Victorian DNSPs significantly over forecast maximum demand in their 2006 regulatory proposals to the ESCV" and that, while the economic downturn may have affected this somewhat, "on average, the Victorian DNSPs over-forecasted maximum demand by 24 per cent."[1]

The economic downturn in Australia was moderate. Growth in the first year of the present regulatory period was well above average and didn't fall below its long term average until the latter half of 2008. Origin notes that neither SP Ausnet (SPA) nor Jemena (JEN) address the discrepancy between their prior maximum demand forecasts and outcomes in their revised proposals - even though the AER calculates that their maximum demand forecasts were 17 and 18 percent above the actual outcome, respectively. Origin seeks explanation of these discrepancies from SPA and JEN.

United Energy (UE) addresses the discrepancy between forecasts and outcome in the current period largely by arguing that the Essential Services Commission (ESC) allowed for inflated maximum demand forecasts on the basis that it was being "conservative". UE

[1] AER Draft Determination pp.80-1

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raises this as a potential regulatory precedent.[2] The AER finds that UE's maximum demand forecast was 27 percent above the outcome in the current period.[3] Origin questions any regulatory precedent that might be established to allow for such inflated forecasts of maximum demand with a view to being "conservative" on distribution revenue.

Relationship between increases in demand and falls in consumption

Origin raised a concern in its initial submission about possible discrepancies between forecasts of maximum demand and consumption. Origin noted that the two factors should be correlated in most instances. There can be an incentive under the pricing framework for DNSPs to overstate forecasts of growth in maximum demand and to understate forecasts of growth in consumption. The AER has determined this was a factor in the DNSPs' initial proposals, noting that:

While the AER acknowledges that growth in energy consumption has slowed in recent years, figure 5.2 and 5.10 demonstrate that the Victorian DNSPs now predict a massive change in customer behaviour from 2009 (the first year of estimate/forecast data) such that total energy consumption would actually decline, in spite of continued growth in maximum demand and customer numbers. The AER expects that this is due to the Victorian DNSPs overstating the impact of certain policy changes.

In light of the DNPSs' revised proposals, Origin maintains its concern in relation to this matter. Some correlation should be presumed between the drivers of increased peak demand, customer numbers and increased consumption. Where such a correlation is not in evidence the DNSPs should explain the basis for this explicitly in each case. For example, where DNSPs propose increases in peak demand resulting from increased penetration of air-conditioners, this should also drive increases in consumption. UE notes in its revised proposal that:

The revised forecasts also confirm that peak summer demand will continue to grow at a substantially higher rate than energy consumption, primarily from continued increases in air conditioner penetration in the Residential sector.[4]

In fact, under UE's revised forecasts, consumption will *fall*.[5] This seems counterintuitive. If the large numbers of new air-conditioning units are the key driver of peak demand in the residential sector then this should also work to increase consumption, even if the new units are only used during the hottest four weeks of the year. These increases in consumption, as well as other drivers of consumption outlined in Origin's initial submission, might be expected to offset the impact of government policies designed to reduce consumption. Origin urges the AER to apply fresh scrutiny to all DNSPs' revised forecasts of growth in demand and consumption.

Impact of time of use tariffs

Origin welcomes the AER's analysis of the projected impact of time of use (TOU) tariffs on energy demand and consumption. Origin raised a concern in its initial submission that the impact on demand might be assumed to be minimal but the impact on consumption fully factored in – even where the DNSPs had found evidence of the magnitude of both

[2] United Energy Revised Proposal, p.236
[3] AER Revised Proposal, p.81
[4] United Energy Revised Proposal, p.237
[5] United Energy Revised Proposal, Table 13-5, p.261

effects to be reasonably scarce. Origin encourages the AER to apply similar scrutiny to the revised proposals, as a number of elements suggest that inconsistencies remain in this respect, as outlined below:

- JEN, PWCR and CTPR all rely on an assertion by Frontier Economics (Frontier) that the bulk of savings in relation to AMI tariffs will arise from customers voluntarily electing to take up TOU tariffs.[6] In the absence of further evidence to support this assertion, Origin questions this. The subset of customers likely to initiate a voluntary switch to TOU tariffs may be too small to deliver savings that are significant across a Victorian distribution network.

- In relation to savings from increased penetration of In Home Displays (IHDs), Frontier cites the NERA Cost Benefit Analysis. Frontier finds that savings from IHDs in NERA's "high demand response" scenario were probably too low.[7] While Frontier acknowledges that IHDs are not mandatory in the Victorian roll-out, it asserts that considerable impacts on overall consumption are likely, simply because the meters will have the capacity for IHDs to be connected. In the absence of more evidence, Origin would question the magnitude of this impact. In any event, customers who seek out IHDs to actively monitor their consumption will be very conscious of cost and environmental impact, making them likely to limit both their maximum demand and consumption.

- CTPW and PWCR also cite emerging technologies with effects on energy consumption similar to smart meters.[8] These technologies may be limited to a relatively small number of customers, and not necessarily those with the most energy to conserve. But if the uptake is significant over the period, then for reasons outlined in the point above, comparable impacts on peak demand and consumption are likely.

Origin acknowledges that there are a range of complex issues in relation to plotting the impact of TOU on consumption in the next regulatory period, especially in light of the TOU tariff change moratorium imposed by the Victorian government. However, we remain unconvinced that growth in consumption and peak demand will be so rapidly decoupled through the impact of TOU of tariffs and a handful of other government policies – some of which (standby power standards, for example) are yet to be formulated in a concrete manner. There is a fundamental incoherence between rapidly growing peak demand and shrinking consumption.

Consumption forecasts are a major driver of final price, particularly in the initial proposals of JEN, SPA and UE. This is why in Origin's view these forecasts must be based on rigorously tested assumptions. In this vein, Origin welcomes the summary data the AER has provided in tables 18.11 and 18.14, which shows the net impact of each factor, including consumption, on the cumulative price change for each DNSP.[9] This is helpful data and Origin would encourage the AER to provide similar tables comparing the DBs revised proposals with the final decision, as well as in determinations in other jurisdictions, for distribution in both electricity and gas.

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6 Frontier Economics, *Review of policy adjustments,* p.vii
7 Frontier Economics, *Review of policy adjustments*, July 2010, p.23
8 Citipower Revised Proposal, p.107; Powercor Revised Proposal, p.100
9 AER Draft Determination, p.749,755

TOU tariffs and the application of the Weighted Average Price Cap

Origin notes the AER's comments in relation to the impact of TOU in building the Post-Revenue Tax Model (PTRM). The AER finds:

While it may be the case that tariff reassignments occur and will affect the expected revenues of the DNSP, the AER considers it inappropriate to pre-empt such outcomes and any such revenue impacts [that] *are appropriately considered by the DNSP at the time of preparing pricing proposals.* […] *This also avoids complex arguments about likely tariff structures which are unnecessary during the building block determination process.*

In this way, each DNSP will be required to populate the Weighted Average Price Cap (WAPC) formula with substitute values, to replicate the impact of consumption under TOU tariffs in past years, according to the method outlined by the AER in its Draft Determination.[10] A number of factors, including assumed load factors, will determine the reasonableness of these estimates.

The assumptions each DNSP makes in relation to TOU and the WAPC will have an impact not only on revenue, but also on price outcomes relative to X factors, particularly if a large number of customers are to move across to TOU tariffs in one year. The annual pricing approval process is not transparent, so retailers will be unable to assess the relevant assumptions.

Origin asks whether the AER might consider gathering information from DNSPs on basic working assumptions in the area of substitute values in the WAPC and TOU tariffs, in the lead up to the pricing approval process. If the AER could share some of this information with retailers this would be of great value. This information gathering could potentially sit under the Regulatory Information framework the AER has proposed for on-going monitoring of the impact of AMI technologies.[11] Evidently, this would not preclude DNSPs also sharing this information with retailers, as a matter of course.

2. Assigning customers to a new network tariff

Origin notes the AER's finding that the AER's distribution determination does not impose any obligation on electricity retailers to notify customers of any network tariff assignment or reassignment made by a DNSP. Origin welcomes this clarification. In relation to DNSPs re-assigning customers, the AER writes:

Regarding the packaging of services as part of a tariff (such as load control, premium services), United Energy has informed the AER that such services are to be implemented on a trial basis in the forthcoming regulatory control period. For example, trials for direct load control services will be funded from the Demand Management Incentive Scheme (DMIS). […] *The AER also understands that United Energy currently does not have procedures for assigning/reassigning customers who decide to receive such services, but will develop procedures if such services are provided as part of a tariff. When developing such procedures a DNSP must have regard to the procedures set out in appendix G of this draft decision, as well as clause 6.18.3 of the NER.*[12]

[10] AER Draft Determination, Appendix E
[11] AER Draft Determination, p.995
[12] AER, Draft Determination, p.68

The procedures outlined in appendix G of the AER's draft decision address a situation where a customer's circumstances dictate that their network tariff must change, not a situation where the Distributor is seeking to offer premium services or any sort of commercial arrangement to a customer, or to seek a return in excess of the regulated return. This latter scenario would require the customer's informed consent, the full set of customer protection arrangements, as well arrangements to modify the final bundled tariff. Evidently, these matters are not covered in Appendix G. Origin would like to highlight that there is much uncertainty in relation to how DNSPs might offer load control products to customers and more policy may need to be developed in this area before the Regulator can approve any procedures a DNSP might propose.

3. Pass through events

Origin notes the AER's finding that, under the NER, the definitions of 'regulatory change event' and a 'service standard event' will permit DNSPs to pass through legitimate, genuine uncontrollable costs that arise through changes in regulation and/or the imposition of new regulations. However, the DNSPs have proposed a wide variety of additional events which they deem should be defined as specific 'nominated pass through events' of a regulatory nature, including:

- The transfer of non-pricing distribution regulatory arrangements to a national regulator;
- A change in safety regulations by Energy Safe Victoria;
- Recommendations arising from the Royal Commission into Victorian Bushfires;
- AEMO fees or charges and,
- An emissions trading scheme.

Origin sees that specific 'nominated pass through event' definitions such as those listed above are unnecessary, because the Regulatory Event and Service Standard event are adequate.[13] In relation to UE's proposal for a 'nominated pass through event' specific to bushfire mitigation recommendations arising from the Royal Commission into the Victorian Bushfires, UE submits:

It is not clear what form the recommendations of the Royal Commission will take and what steps Victorian DNSPs will be required to take as a result of those recommendations. It is therefore far from definite that the recommendations arising from the Royal Commission will fall within the category of regulatory change event or service standard event. Those recommendations are, however, likely to have a material cost impact on Victorian DNSPs.[14]

Origin does not agree with this view. A 'service standard event' carries with it the condition that the event in question should substantially affect the manner in which the DNSP is required to provide a direct control service. This is a reasonable threshold for a new government requirement to pass before it should be considered in the context of cost pass through, but broad enough to capture new financial, operational or capital obligations imposed on DNSPs as a result of the Royal Commission.

In their revised proposals, CTPR, PWCR, JEN and UE have argued that if the AER is to reject the long list of additional 'nominated pass through events' of a regulatory nature, then the AER should guarantee that any one of these events will automatically create an

[13] AER Draft Determination, p.710
[14] United Energy Revised Proposal, p.329

opportunity for a pass through. Such a guarantee would be equivalent to approving the definitions themselves, which Origin thinks is unnecessary, for the reasons outlined above.

Origin also supports the AER setting specific percentage limits in the materiality threshold for nominated pass through events. These limits mean that a nominated pass through event can only be approved if it has a material impact on the DNSP, with materiality defined as a given percentage of revenue. CTPR and PWCR have proposed that the threshold should be "that the event has a material financial impact on [the DNSP], with material being interpreted according to its ordinary meaning."[15] This would create room for interpretation and cannot provide equivalent certainty.

Origin would be concerned if a broad variety of nominated pass through events were approved, and these were subsequently interpreted to capture a much wider range of events and associated costs than intended; particularly if the related materiality thresholds were insufficiently robust. As such, Origin supports the AER's draft determination in this area.

4. Monitoring of outcomes

Origin notes that the regulatory framework provides DNSPs with an *ex ante* allowance and that DNSPs are not required to spend all the allowed capital operating and maintenance expenditures. However, Origin concurs with the AER's finding that there is considerable benefit in on-going monitoring of the level of actual expenditure, and the outcomes achieved by the Victorian DNSPs against the approved allowances in the AER's distribution determinations. This framework will better inform the AER in its assessments at the next Victorian distribution determinations, and improve the accountability of Victorian DNSPs.

In Origin's view it would be of great value to develop a more nuanced understanding of which DNSPs have found more innovative and efficient techniques to reduce expenditure, and which have deferred expenditure to the detriment of long term network performance. This understanding should help reduce the scope for dramatic differences of opinion over capital expenditure requirements like those that have arisen in the current determination process. Differences of opinion like these create significant risk and uncertainty not only for DNSPs but also for retailers, who must develop detailed understandings of network revenue requirements months in advance of the final determination outcomes.

Should you require further information on this submission please contact me on 03 8665 7155 in the first instance.

Yours sincerely

SIGNED

Steven Macmillan
Regulatory Pricing and Policy Manager

[15] Citipower Revised Proposal, p.406