Electricity Distribution Price Review (EDPR) –

SP AusNet Response to Framework and Approach Position Paper

Submitted: 6 March 2009

SP AusNet
A member of Singapore Power Group

About SP AusNet

SP AusNet is a major energy network business that owns and operates key regulated electricity transmission and electricity and gas distribution assets located in Victoria, Australia. These assets include:

- A 6,574 kilometre electricity transmission network indirectly servicing all electricity consumers across Victoria;
- An electricity distribution network delivering electricity to approximately 575,000 customer connection points in an area of more than 80,000 square kilometres of eastern Victoria; and
- A gas distribution network delivering gas to approximately 504,000 customer supply points in an area of more than 60,000 square kilometres in central and western Victoria.

SP AusNet's vision is "to make important things in life happen today and tomorrow". The SP AusNet company values are:

- Safety: to work together safely. Protect and respect our community and our people.
- Passion: to bring energy and excitement to what we do. Be innovative by continually applying creative solutions to problems.
- Teamwork: to support, respect and trust each other. Continually learn and share ideas and knowledge.
- Integrity: to act with honesty and to practise the highest ethical standards.
- Excellence: to take pride and ownership in what we do. Deliver results and continually strive for the highest quality.

For more information visit: www.sp-ausnet.com.au

Contact

This document is the responsibility of the Regulatory and Business Strategy Division, SP AusNet. Please contact the officer below with any inquiries.

Patrick Murphy
Manager Economic Regulation
SP AusNet
Level 31, 2 Southbank Boulevard
Melbourne Victoria 3006
Ph: (03) 9695 6623

Table of Contents

1 Introduction

SP AusNet is broadly supportive of most positions outlined in the Australian Energy Regulator's (AER's) Framework and Approach position paper. This response outlines areas where SP AusNet believes modifications need to be made or new issues considered.

The response generally follows the structure of the Framework and Approach position paper and is set out as follows:

- Section 2 addresses the classification of services;
- Section 3 addresses the form of control;
- Section 4 addresses the implementation of a service Target Performance Incentive Scheme (STPIS) with particular attention to transition issues;
- Section 5 addresses the implementation of an efficiency benefit sharing scheme (EBSS); and
- Section 6 addresses the implementation of a demand management incentive scheme (DMIS).

With regards to the modified (STPIS) released by the AER in February 2009, it should be noted that SP AusNet intends to address substantive issues of a general nature in its response to the separate consultation process on that scheme. Therefore, in its response to the Framework and Approach position paper, SP AusNet intends only to address issues that are specific to Victoria and the transition from the Victorian to the National Scheme.

The discussion in Section 6 also constitutes SP AusNet's response to the AER's *Proposed Demand Management Incentive Scheme* for the Victorian electricity distribution network service providers (DNSPs).

2 Classification of Distribution Services

SP AusNet generally agrees with the AER's classification of Distribution Services. However, there are some matters of concern with the document that are addressed in this section of SP AusNet's response to the Framework and Approach position paper.

2.1 Requirements of the NEL and NER

SP AusNet agrees with the AER's analysis of the National Electricity Law (NEL) and National Electricity Rules (NER) requirements.

2.2 Overview of current service classification arrangements in Victoria

The classification of a number of services in Victoria has changed over time from the original classifications made in the 1995 *Victorian Electricity Supply Industry Tariff Order*. The reasoning behind the original classification and subsequent changes provides some context for the present regulatory arrangements and may prevent some inappropriate classification in the current review, and this is briefly described below. Items that have been changed over time include Public Transport connections, standard metering, and public (street) lighting.

Public Transport Connection Points

The 1995 *Victorian Electricity Supply Industry Tariff Order* classified the transportation of electricity to Extra High Voltage (EHV) Customers as an excluded service. EHV customers were defined as customers taking supply at a nominal voltage of 66kV or more and the nominated public transport 22kV sub transmission connection points. Therefore, all sub transmission customers were excluded from the price controls.

The reason for excluding these customers from the price controls was because each DNSP had only a small number of these customers and there was significant diversity in their energy consumptions. Excluding them from the price controls ensured that their usage did not distort the prices and revenues associated with other customers in a distribution category.

An unintended consequence of this decision was that, this grouped these public transport 22kV sub transmission connection points with other sub transmission customers but left every other public transport connection point as part of the prescribed service. Once the Essential Services Commission (ESC) introduced the tariff basket form of price control in 2005 this separate treatment became inappropriate.

Therefore, the revised 2005 *Victorian Electricity Supply Industry Tariff Order* changed the status of these supply points back to a prescribed service. This ensured all supply points for public transport could be treated on the same basis. As such, these points no longer require any specific or specialist acknowledgment or treatment in the AER's review.

The AER's final Framework and Approach Paper should make clear that the changes in the regulatory status of the public transport supply points referenced in the 2005 *Victorian Electricity Supply Industry Tariff Order* simply restores consistent regulatory treatment for all public transport

supply points. It should also be made clear that any specific or specialist acknowledgement of these supply points should not be required in the price review process going forward.

Prescribed Metering Services

It should be noted that, in Victoria, all prescribed metering services for unmetered supplies (Type 7) refers only to those customers that have an unmetered supply for energy that is contestable in the National Electricity Market (NEM). At present, that is restricted to public lighting services for public lighting customers as defined in the *Victorian Public Lighting Code*. Any other customers receiving public lighting services and all other unmetered supply types remain uncovered by either Electricity Distribution Price Review (EDPR) provisions or Advanced Metering Infrastructure (AMI) Order in Council provisions.

Excluded distribution services

In its discussion of excluded distribution services, the AER needs to make clear that prices have not been set as part of an EDPR previously. These services are regulated under Guideline 14 and must meet the "fair and reasonable" test defined in the Guideline.

Price submissions can be initiated by the DNSPs or the regulator but are of an ad hoc nature and may relate to individual services, a group of similar services or the entire services listing.

It also needs to made clear that the services classified as "Standard Services and Miscellaneous Services" (which have standard fees) are the only ones for which pricing is published.

2.3 Future regulation of metering services

SP AusNet supports the AER's conclusions with regards to the metering services to be regulated under Chapter 6 of the NER.

2.4 Classification of distribution services

2.4.1 Network Services

SP AusNet supports the classification of 'standard' network services as direct control services and, in turn, standard control services.

2.4.2 Connection Services

Connection and augmentation works

As indicated by the AER, the DNSPs are required to call for tenders from at least two other parties who compete for connection and augmentation work. The Victorian DNSPs have worked with this or similar obligations since 1994 and the market for these services is now well developed. Third party providers regularly compete for and win these works and SP AusNet believes that with or without this obligation the contestable market would continue.

Therefore, SP AusNet believes that Guideline 14 has served its purpose as it has established a market for the provision of connection and augmentation services and protected the new entrants as they have established themselves. The market is now mature and Guideline 14 or a similar instrument is no longer required.

SP AusNet also notes that, even in the absence of the requirement to tender services, DNSPs are no longer resourced to carry out all of these works on their networks (SP AusNet's notes that approximately 75% of augmentation work in its area is carried out by contractors and that 24 contractors are wholly or partly accredited (4 with preliminary accreditation) to perform this work on behalf of customers). Therefore, to re-establish a monopoly on these services a DNSP would need to re-establish the resources to do so. This is likely to be difficult and costly in the face of well established competitors that have the benefits of their own operational and economic efficiencies.

Therefore, SP AusNet supports the classification of connection and augmentation works as negotiated services.

Connection – energisation

SP AusNet supports the classification of 'standard' energisation of a connection point as a direct control service and, in turn, alternative control service.

2.4.3 Metering services

Manually Read Type 5 or Type 6 Meters (> 160MWh)

The AER has classified this metering service as a direct control service and, in turn, an alternative control service. This decision is based on the following reasoning on page 39 of the Framework and Approach position paper:

> *... the AER considers there is a regulatory barrier to any party other than the Victorian DNSPs providing these services. Furthermore, the economies of scale and scope available to Victorian DNSPs, in particular in relation to its network services, are also likely to prevent metering services being competitively provided by an alternative service provider. The AER also considers that there are no real substitutes for these services, as all customers need to receive metering services for billing purposes.*

SP AusNet does not believe that the facts support the case set out above for the following reasons:

- first tier customers that meet this criteria have a greater choice than any other customer, as they may also elect to take a type 4 meter, as is required for similar sized customers that are supplied by second tier retailers; and
- first tier retailers may also make the decision to place these customers on type 4 meters,

Therefore, while DNSPs may have some market power in the provision of these services, customers have strong countervailing market power.

In addition, it is SP AusNet's experience that customers electing to retain their existing type 5 or type 6 meters are doing so to retain their access to legacy tariffs. While financially beneficial to these customers, given these customers energy usage profile, these legacy tariffs are very inefficient and result in higher charges to other customers. Therefore, either an early sunset date should be placed on the provision of this service or metering charges should be deregulated to allow a DNSP or retailer to provide incentives for the customer to switch to a more efficient tariff.

On these grounds, SP AusNet believes that the provision of metering services to customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters

or type 6 manually read accumulation meters is contestable and, therefore, an unclassified service.

Unmetered connection points

SP AusNet believes it should be noted that all metering services for unmetered connection points in Victoria are with respect to public lighting connection points only.

SP AusNet agrees that metering service for unmetered supplies should be classified as direct control services, and then as alternative control services.

2.4.4 Public Lighting Services

Operation, repair, replacement and maintenance

SP AusNet agrees that the operation, repair, replacement and maintenance of existing public lighting assets should be classified as direct control services, and then as alternative control services. However, the AER should make clear in its finalised Framework and Approach Paper that this refers only to the standard service as defined in the *Victorian Public Lighting Code*. If a written agreement exists to vary rights and obligations under the code then the services should be classified as negotiated services.

Clause 1.4.1 of the *Victorian Public Lighting Code* allows parties to agree to "vary their respective rights and obligations" and such a variation may be either to above or below the standards set out in the code. SP AusNet believes that this is an important differentiation with respect to the classification of these services as it broadens the opportunities for the parties to negotiate. Furthermore, clause 1.4.2 of the code imposes an obligation on the parties to negotiate in good faith. Section 7 of the code provides for a dispute resolution process that, at the customer's election, may include the Energy and Water Ombudsman (Victoria) Ltd or any other external dispute resolution body.

Alteration and relocation

The AER has classified this public lighting service as a direct control service and, in turn, an alternative control service.

SP AusNet does not agree with the AER's view that a customer cannot choose who alters or relocates existing public lighting assets. Clause 4.4 of the *Victorian Public Lighting Code* explicitly requires a DNSP to co-operate with other parties that the customer may engage to carry out these works. Therefore, there is no regulatory barrier to the provision of these services by other parties. With regards to the construction aspect of such projects, SP AusNet does not have the direct resources to undertake this work and, therefore, does not have market power in this regard (SP AusNet's notes that approximately 50% of this public lighting work in its area is carried out by contractors and that 24 contractors are accredited (4 with preliminary accreditation) to perform this work on behalf of customers).

Clearly where these assets are gifted to the DNSP upon completion, the operation and maintenance should continue to be regulated as per the current regulatory arrangements.

SP AusNet believes the construction services are contestable services and, as such, should be unclassified services.

New public lighting assets

SP AusNet agrees with the AER's position that the new public lighting assets are provided on a competitive basis but considers this means they should be designated as unclassified services rather than negotiated distribution services.

SP AusNet does not have the direct resources to undertake construction of these projects and therefore, does not have market power in this regard.

Again, where these assets are gifted to the DNSPs upon completion, the continued operation and maintenance should be regulated as per the current regulatory arrangements.

2.4.5 Fee Based Services

SP AusNet generally agrees with the AER's current classifications of these services with two exceptions. These are:

- an elective underground service where existing overhead service exists; and
- a charge for damage to overhead service cables caused by high vehicles.

SP AusNet does not publish a fee for these services as the cost of the provision of an underground service or the cost of repairing an overhead service within SP AusNet's distribution area varies with specific customer circumstances to such an extent that a single charge rate would not be reasonable. Therefore, SP AusNet currently treats this service as a quoted service and publishes rates for the recovery of labour and materials for these services. SP AusNet proposes that this item continue to be treated as a quoted service rather than a Fee Based service.

In addition, with regards to additional charges due to a wasted attendance, SP AusNet does not distinguish between wasted or non wasted attendance. Rather its practice is to charge the same fee for each visit regardless of whether the electrician/customer is prepared for a previously arranged visit. If the electrician/customer is unprepared, then SP AusNet will make a charge for that visit and require arrangements be made for a further visit.

If the attendance at a site is as a result of an emergency or fault call, it is not SP AusNet's practice to charge where the fault or emergency is found to be related to SP AusNet's assets. Therefore, the customer is only charged where a fault crew has been called out in error. The most common situation where a charge may be applied is where the fault is on the customer's own installation or they have failed to check that their main switch is turned on.

With the inclusion of the suggested changes outlined above, SP AusNet supports the classification of Fee Based services as direct control services and, in turn, alternative control services.

2.4.6 Quoted services

As noted in the previous section, SP AusNet believes Quoted services should include two items currently listed by the AER under Fee Based services. These are:

- an elective underground service where existing overhead service exists; and
- a charge for damage to overhead service cables caused by high load vehicles.

SP AusNet otherwise supports the classification of Quoted services as direct control services and, in turn, alternative control services.

2.4.7 Other previously excluded services

There are other excluded distribution services that are listed under the 2005 *Victorian Electricity Supply Industry Tariff Order* that relate to individual customers and situations that do not appear to have been classified by the AER in their current Framework and Approach position paper. The prices for these services are determined individually and may differ from customer to customer. These services are:

- inter network provider distribution;
- network services for connection where customers operate parallel generation and require a standby supply;
- provision of reserve (duplicate) supply;
- charges for higher quality and reliability;
- charges to operators of embedded generation units;
- charges for non-compliance with the distribution code;
- charges for the provision or receipt of reactive power.

Each of these services must be negotiated individually on the basis of availability at a connection point and the availability of alternative service options. These services are only provided where customers seek them and may not be provided if customers do not require them.

SP AusNet believes that the nature of these services should result in them being classified as negotiated distribution services.

2.5 Other Matters

2.5.1 Public lighting terminology

Public lighting services are an area where there are many contentious issues aside from those relevant to this review. Terminology is one such area where inconsistency, jargon and multiplicity of terms has led to confusion and misunderstanding. One common term that is frequently misused is Operation repair, replacement and maintenance, the correct term is Operation, maintenance and replacement (OM&R). The repair of lights is a function of maintenance and its separate identification leads to confusion and misguided expectations regarding the services that will be provided. SP AusNet believes that the AER should ensure that from the outset the correct use of these terms so as not to add to any confusion in this area.

2.5.2 Minor corrections

The second last dot point on page 21 should read as:

> *the presence and extent of any substitute for, and the elasticity of demand in a market for, **electricity** or gas (as the case may be), and*

The second dot point under 2.3.1.2 on page 23 should read:

> *the distribution business ~~**who**~~ provides its standard metering service to that distribution customer, or*
> *the distribution customer ~~**who**~~ has an unmetered supply.*

2.6 Conclusion

Table 1: SP AusNet's Position on Classification of Services

Service Grouping	Negotiated Distribution Services	Direct Control Services Standard Control Services	Direct Control Services Alternative Control Services	SP AusNet View
Network services		All "standard" network services		Agree
Connection services	Connection and augmentation works for new customer connections		Connection – energisation	Agree
Metering services			Metering services provided to existing first tier customers with annual consumption greater than 160 MWh that have either type 5 manually read interval meters or type 6 manually read accumulation meters	Disagree Should be Unclassified
			Metering services for unmetered supplies	Agree
Public lighting services	Above or below standard services		Operation, repair, replacement and maintenance of DNSP's public lighting assets	Agree, with modification for above and below standard services
			Alteration and relocation of existing DNSP's public lighting assets	Disagree Construction should be Unclassified
	New public lighting			Disagree Construction should be Unclassified
Fee based services			All fee based services	Agree, after reclassification of certain services to quoted services
Quoted services			All quoted services	Agree, after reclassification of certain services to quoted services

3 Form of control

Generally, SP AusNet supports the AER's position on the form of control mechanisms. Nonetheless, SP AusNet would like to highlight one aspect of the proposed form of control for alternative control services. These are addressed in section 3.1 below.

3.1 Alternative control services

The AER outlines the current Victorian arrangements for the pricing of these services in its Framework and Approach position paper:

> *The control mechanism for these services is a price cap, given effect by the approval of an up-front price for these services in the EDPR, with no automatic escalation applied to these prices over the regulatory control period. Where a distributor wishes to amend its schedule of charges, it must submit an application in accordance with the relevant guideline. (page 58)*

Thus, the current approach to price adjustments is via ad-hoc submissions by DNSPs or ad-hoc requests made by the Regulator for DNSPs to make price submissions. Individual DNSPs making a request requires the Regulator to request submissions from all other DNSPs to facilitate benchmarking. SP AusNet experience is that this process has been unsatisfactory as the resultant reviews have been lengthy and costly, and have not resulted in any price adjustment.

Of particular concern, the lack of automatic indexation of these prices imposes an unnecessary regulatory burden on both the DNSPs and the regulator as in practice five ad-hoc submissions would be required every regulatory period to achieve such indexation. This is unnecessary since the underlying cost drivers (which are predominantly labour based) can be established once at the start of the period, as part of the current review and the appropriate indexation put in place.

It must be noted here, that the forecast of excluded service revenue is netted off the building block revenue requirement calculated by the regulator during the review process. Therefore, assuming these forecasts are accurate, the DNSPs is largely indifferent to any growing cross subsidy from the customers of the price capped distribution use of system (DUOS) services to the excluded service customers which results from the lack of indexation under the current ESC methodology. The regulatory burden imposed to change these prices under the current regime simply strengthens an already poor incentive for excluded prices to reflect actual costs.

Therefore, SP AusNet strongly supports the AER's preliminary position and believes the final Framework and Approach Paper should continue to make clear that it will establish an initial set of services and prices and a proposed methodology to automatically adjust those prices throughout the upcoming regulatory period. This approach would provide certainty for customers and DNSPs alike. It would also mean that significant amounts of time and effort in constantly reviewing the cost inputs on an ad-hoc basis would be avoided.

This approach is simple, provides certainty for all stakeholders, and reduces the need for regulatory intrusion.

4 Application of a STPIS

The AER released its modified STPIS in February 2009. SP AusNet intends to address substantive comments on that modified scheme that are of a general nature in its response to that consultation process. In this response SP AusNet addresses issues raised in the Framework and Approach Position Paper specific to Victoria and the transition from the Victorian to the National Scheme in the following sections.

4.1 Victorian Issues

The Framework and Approach position paper has not addressed the material issues that arise from the proposed transition from the current Victorian Scheme to the National Scheme. These issues are particularly important in Victoria as the existing Jurisdiction scheme has been operating for 10 years. This imposes considerable incentives on a DNSPs performance and SP AusNet has responded on the expectation that these incentives would persist. SP AusNet would view any lessening of these incentives as a retrograde step.

4.1.1 Revenue at risk

The AER's current draft *Electricity Distribution Networks Service Providers STPIS* has replaced the original default 3% cumulative cap with an absolute 5% cap on revenue at risk under the scheme. This is a material change from the current uncapped Victorian S Factor Scheme.

Capping results in a distortion of the incentives in the scheme. In particular, a business is disincentivised to dramatically improve performance even if the technical analysis shows such improvement can be achieved if the financial benefits are restricted through application of a cap. Conversely, a DNSP could theoretically allow performance to decline dramatically knowing any penalty was capped.

In justifying a cap, the AER noted in its original Final Decision on *Electricity Distribution Networks Service Providers STPIS* that:

> *an uncapped scheme may introduce an unreasonable level of risk for DNSPs that have not previously operated under a service performance incentive scheme. (page 16)*

This rationale does not apply in Victoria and SP AusNet is strongly of the opinion that the default position for Victoria should be that the scheme be uncapped.

The AER also defended its proposed cap by noting that its proposed 3% cumulative cap was unlikely to bind, even in Jurisdictions currently with an uncapped scheme:

> *to date, the greatest change in annual revenue under a jurisdictional s-factor scheme has been 2.6 per cent. (page 16)*

This analysis was based on historic information that excluded consideration of results in the current Victorian Scheme. For example, SP AusNet's S Factor result for 2008 was a 7.3``% increase in revenue (to be paid from 2010). Therefore, with consideration of more recent data the AER's observation above no longer holds.

Furthermore, the AER has not undertaken similar analysis for the proposed move to an absolute cap of 5%. SP AusNet considers this move increases the likelihood of the cap binding in the Victorian Jurisdiction. Assuming the application of the AER scheme in Victoria for the period from 2001 to 2010, the proposed 5% cap would have bound for SP AusNet in 2 of those years and, if performance remains stable, would bind for a further 6 years to 2016. SP AusNet also notes that revenue variation hit both the upper and lower bound in this period. This illustrates the material impact of the cap in Victoria and the significant distortion to incentives introduced by such a cap.

It is recognised that the disadvantages of applying a cap on the incentives of the scheme are well understood and that the key rationale for capping is risk mitigation. SP AusNet believes the AER's scheme already provides a DNSP with adequate mechanisms to control risk without a cap through the following four measures:

- the exclusion regime which protects the DNSPs from large unforeseen events that impact on its network; (beyond the limited exemption regime in the current Victorian scheme that does not achieve this outcome).
- the S Bank allows the revenue effect of one off events to be removed from the financial outcomes;
- the five year price/service proposals allows a DNSP to propose a modified exclusion regime, different reliability measures and changes to targets. This provides a further opportunity for a DNSP to justify individually tailored measures to control risk if their circumstances justify it; and finally
- the AER can suspend the scheme entirely in consultation with the affected DNSP.

After consideration of these factors, SP AusNet believes that the default position for Victoria should be that the scheme be uncapped. That is, the burden of proof should be placed with the DNSPs to justify a cap be imposed.

4.1.2 Performance Targets

SP AusNet does not believe that the S Factor results for the 2009/10 financial year will be finalised in time for input into the current review process. Therefore, the final Framework and Approach Paper should make clear that the targets for the S Factor scheme will be set using the average performance from 2004/05 to 2008/09, subject to modifications proposed by the DNSPs in their proposals.

4.1.3 Incentive Rates

As proposed in the AER's current draft DNSPs STPIS, SP AusNet supports the use of the latest VENCorp Study (undertaken by CRA in 2007) which sets the value of customer reliability (VCR) at $47,850/MWh for urban and rural customers.

4.1.4 Exclusions

SP AusNet is generally supportive of the proposed exclusion regime to be applied in Victoria by the AER. However, the recent unprecedented fire risk conditions and resultant bushfires that have devastated Victoria have raised very serious questions over whether all rare high impact events will be adequately captured in the new regime. As the owner of the networks that bore the brunt of this event, SP AusNet's is carrying out considerable analysis on the consequences of this and future events and will be in a position to provide more considered input on the exclusions once this analysis has been complete.

4.2 Transition Issues

SP AusNet has identified two key transition issues for consideration. These are:

- The treatment of the six month period from 1 January 2011 to 30 June 2011; and
- The financial interaction of the two schemes in the price cap formula for the new period.

Further issues are likely to be identified as analysis of the new scheme proposed by the AER proceeds. Therefore, SP AusNet encourages the AER to engage in further consultation with the DNSPs on the STPIS before the Framework and Approach Paper is finalised in May 2009.

4.2.1 The six month period 1 January to 30 June 2011

The Framework and Approach Position Paper states:

> *Clause 2.4 of the AER's STPIS provides that where a DNSP's regulatory control period commences on 1 January or 1 July, annual performance must be measured from 1 July until 30 June inclusive. The regulatory control period for the Victorian DNSPs begins on 1 January 2011, and so they will be required to measure performance under the STPIS from 1 July 2011. (page 78)*

Under the AER's proposal, performance for the period 1 January to 30 June 2011 is excluded both from the existing ESC scheme which ends on 31 December 2010 and the of the AER's national scheme which it proposes commence on 1 July 2011.

SP AusNet does not believe it necessary or desirable to exclude this six month period in the new AER scheme. The Regulator should seek to avoid removing an incentive for a period of time as this again distorts the long term incentive properties of the scheme. This is of particular concern when performance in the time period in question will be used to set targets in the future. That is, performance in the six months from 1 January to 30 June will be included when generating the targets for the regulatory period starting in 2016.

SP AusNet considers targets can be generated for the time period relatively easily from existing data and that payments can be incorporated into the new proposed scheme.

Targets can be generated for the six month period using the average from the equivalent six month period from the same five years used to set the full year targets for the scheme. That is, the average performance from the first six months of 2004/05 to 2008/09, subject to modifications proposed by the DNSPs in their proposals could be utilised.

Using an equivalent six month time period accounts for any asymmetry in the distribution of a DNSP's S Factor performance throughout a year (that is, performance in any given month is not expected to be 1/12 of the annual performance).

Under the AER proposal payments begin in the 2013 calendar year for the performance achieved in 2011/12. Revenue adjustments for the six month period should be paid in 2012.

4.2.2 Financial interaction of the two concurrent schemes

While performance measurement under the two schemes will not overlap, the payment streams or revenue effects of that performance will overlap throughout and beyond the upcoming regulatory period due to the nature of the ESC scheme.

The final Framework and Approach Paper must recognise that the price cap formula will need to incorporate the effects of two S Factor scheme payments simultaneously. The ESC S Factor scheme adjusts revenue for the performance in a calendar year two years after the actual

performance (which is also measured over a calendar year). Once in place, the revenue adjustment applies for six years.

For example, for the last year of performance measured under the old scheme, calendar year 2010, revenue adjustments will be required from 2012 until 2017. The AER price cap formula will have to incorporate an S term determined from the ESC scheme for every year of the upcoming regulatory period.

SP AusNet believes the final formulas should be set in the final Framework and Approach Paper released in May 2009, and that this formula should reflect the basic principle that the schemes should be mutually exclusive and, therefore, that the interaction of the two schemes should be additive rather than cumulative. That is, the revenue effects of one scheme should not influence the underlying operation of the other scheme.

5 Application of an Efficiency Benefits Sharing Scheme

SP AusNet supports the application of the EBSS to the DNSPs in the forthcoming regulatory period.

SP AusNet also considers that it is appropriate that the DNSPs may propose categories which it considers to be uncontrollable for exclusion of the scheme.

SP AusNet would also highlight that the EBSS removes actual opex increases or decreases associated with a recognised pass through event. Therefore, the interaction of the scheme with a pass through event outlined in a DNSP's proposal should also be recognised explicitly in the finalised Framework and Approach Paper.

6 Application of a Demand Management Incentive Scheme

SP AusNet vision is to become a leader in delivering smarter and more flexible networks, and examining opportunities for demand management is a key part of this objective. Given this, SP AusNet supports any incentives to encourage DNSPs to explore innovative non-network solutions and improve and maximise network performance and efficiency.

SP AusNet considers that the AER's proposed demand management incentive scheme (DMIS) is a step in the right direction in encouraging demand management. However, SP AusNet considers that the AER's DMIS should go further in encouraging DNSPs to proactively consider and take actions to promote demand management. SP AusNet suggests several options in the following sections which it considers will provide better incentives for DNSPs to deliver better demand management outcomes.

Therefore, SP AusNet encourages the AER to provide more progressive and higher-powered incentives in a Victorian DMIS as a means of testing the capacity for innovative non-network solutions. The outcomes of this will assist in informing the AER on likely impacts of different DMIS options in the lead up to developing a National scheme.

As a business that operates in a jurisdiction which has often been progressive in regulatory reform and innovation, SP AusNet considers that the development of a substantive DMIS would be welcome. Such a move would also be timely given the imminent roll out of smart meters across Victoria.

6.1 Background and Context

Clause 6.6.3 of the NER contemplates demand management as a non-network alternative which can manage the expected demand for standard control services. In this context, the term "demand management" encompasses different forms of demand side participation (DSP) which covers a number of concepts:

- distributed generation (DG) or embedded generation (EG) where small-scale power generation technologies (typically in the range of 3 kW to 10,000 kW) are used to provide an alternative to or an enhancement of the traditional electric power system;
- demand management (DM) where a retailer/network business and user contract to allow users to be compulsorily switched off during peak periods. This load curtailment at the individual customer level allows network businesses to reduce stress on the network and smooth peaks; and
- demand side response (DSR) where users (often through an aggregator) contract with the network business to voluntarily switch off during peak periods to reduce stress on the network and smooth peaks.

SP AusNet's experience to date lies largely in distributed and embedded generation. While SP AusNet does not currently have any DM or DSR contracts, we offer a discounted 'interruptible' tariff to medium sized customers that are willing to accept some, or all, of their load being interrupted for short periods. SP AusNet has also made adjustments to time-switched water heating load in South Gippsland to load shift and defer network augmentation.

SP AusNet considers that an attractive financial incentive would drive investigation of further opportunities to look at innovative customer solutions involving all DSP forms, but DG and EG in particular. For example, as a DNSP, SP AusNet is in a good position to develop DG projects (such as combined heat and power units (CHP)) or EG projects (photovoltaic cells) to maximise efficient operation of the network and defer traditional network solutions such as adding transformer capacity or duplicating the network. Apart from cost and network operation efficiency, DG and EG could also provide other benefits such as reducing carbon emissions and increasing the level of renewable energy available to meet the Australian Government's Mandatory Renewable Energy Target (MRET).

6.2 AER's Proposed DMIS

The AER has proposed to implement a very limited DMIS for Victoria which mirrors the scheme in place for South Australia and Queensland. The AER's final demand management incentive scheme for South Australia and Queensland released earlier this year provides a demand management innovation allowance (DMIA) as an ex ante allowance in the form of additional revenue for each year of the regulatory period. This allowance, capped at approximately 1 per cent of Annual Allowable Revenue (AAR) over the whole regulatory period, provides for cost recovery of broad-based demand management expenditure. In addition, the proposed DMIS allows for the recovery of any foregone revenue that results from project expenditure related to non-tariff services approved under the DMIA.

6.2.1 Fulfilling the intention of the NER

Clause 6.6.3 of the NER states that the AER may develop an incentive scheme to provide incentives for DNSPs to:

- implement non-network alternatives; or
- to manage the expected demand for standard control services in some other way.

SP AusNet submits that the proposed DMIS is unlikely to encourage greater demand management. To achieve this, stronger incentives are required to overcome the significant barriers which currently exist in the sector in relation to how demand management is considered and valued. In its current form, the proposed scheme merely provides a cost pass through.

In its explanatory statement, the AER states that the DMIA is not intended to be the primary driver for demand management expenditure by DNSPs. It considers that the primary source of funding for demand management should be in the forecast opex and capex allowances approved in the price review. As such, the AER's proposed DMIS for Victoria is a very limited package which is much less generous than the D-factor scheme available to NSW DNSPs in their current 2009-14 regulatory period.[1]

However, DNSPs are unlikely to propose extensive demand management programs as part of the opex and capex programs in their price review submissions given there is little demonstrated interest or participation in demand management in the sector. As such, it is important that DNSPs have a strong incentive to change a 'business as usual' approach and stretch the ways in which they provide network or non-network solutions.

An incentive is designed to change behaviour by offering a reward or penalty. In this case, the AER needs to provide a reward to encourage DNSPs to develop and implement demand

[1] The D-factor provides a revenue driver for all implemented demand management which defers capex on an ex post basis.

management – a cost pass through mechanism is unlikely to achieve that. As regulated businesses, DNSPs are unlikely to accept the risks associated with innovation, research and development. Further, the current regulatory framework provides little incentive for DNSPs to move away from a business as usual approach to planning and operating their networks. Therefore, a DMIS needs to provide a real financial incentive for DNSPs to overcome the barriers to demand management and encourage a step change in attitudes and actions related to demand management.

The AER states that its proposed DMIS has been developed to comply with the relevant requirements prescribed under clause 6.6.3 of the NER. However, in developing this scheme, SP AusNet believes the AER needs to further consider a number of factors highlighted in clause 6.3.3, particularly:

- *the need to ensure that benefits to consumers likely to result from the scheme* are sufficient to warrant any reward or penalty under the scheme for DNSPs. The proposed DMIS is unlikely to deliver any benefits to consumers and as such, cannot be justified in relation to its administrative costs
- *the extent the DNSP is able to offer efficient pricing structures*. The proposed DMIS allows a DNSP to recover revenue forgone in a regulatory control period resulting from a reduction in the quantity of energy sold directly attributable to a project approved under the DMIA. Revenue recovery under this scheme is limited to the foregone revenue directly attributable to the implementation of non-tariff demand management expenditure. The AER has stated that this is because tariff-based demand management involves critical peak pricing which allows businesses to adjust tariffs to accommodate the demand management. SP AusNet would like to clarify this issue. Within our basket tariff structure, individual tariffs cannot be adjusted in such a way which would allow us to fully recover foregone revenue form decreased demand. As such, the scheme does not adequately consider the ability of a DNSP to control its tariffs.
- *the possible interaction between a DMIS and other incentive schemes*. The AER has yet to provide a solution to manage the risk of a demand management solution potentially providing a lower level of network performance than a traditional network option and the impact this would have on a DNSP's performance against service performance incentives (in our case, the S-factor). SP AusNet recommends a means of handling this be considered as part of this consultation process.
- *the willingness of the customer or end user to pay for increases in costs resulting from the implementation of the scheme*. SP AusNet considers that the AER has not fully considered this factor and that any scheme which encourages greater demand management could gain support from customers. If the AER considers that it must provide an extremely modest scheme because of potential costs to users, then it would be useful for it to set out the expected costs of a more generous scheme and some approximate thresholds at which users would refuse to bear the additional cost. SP AusNet notes that the generous D-factor scheme in NSW deferred approximately $24 million in capex with less than a 5 cent impact on customers' annual bills. This suggests that there is scope for a significant DMIS which could be supported by users.

6.2.2 Treatment of demand management capex

SP AusNet notes that expenditure under the DMIA can be in the nature of capital or operating expenditure. However, the AER has indicated that any demand management capex spent within-period which has not been approved in the price review process, will be treated as opex

and not rolled into the regulatory asset base (RAB). Such a position would deter exploration of non-network solutions. Under such an approach demand management capex is not being treated on an equal footing to network augmentation or replacement capex.

Allowing DNSPs to roll demand management capex into the RAB and retain the capex savings from network replacement/augmentation deferral would be a necessary benefit to encourage DNSPs to undertake demand management. This is particularly the case given that the regulatory framework operates to reward DNSPs more from spending capex than opex. This balance of incentives already works to deter demand management (which is traditionally in the form of opex).

The AER's proposed DMIS would effectively magnify this problem by seeking to treat all demand management project costs as opex. SP AusNet notes that DG and EG projects may require some level of capex. If the AER makes a policy decision not to roll this capex into the RAB, it is effectively deterring a range of non-network solutions from consideration as it imposes a penalty associated with that capex.

SP AusNet notes that the Office of Gas and Electricity Markets in the UK (Ofgem) is considering this issue and is seeking views on whether it should treat all direct costs (capex and opex) in the same manner to address any imbalance between these two forms of expenditure to encourage greater demand management:

> *Additional spending on capex is shared between customers and shareholders while opex is borne wholly by shareholders. This means that DNOs are more likely to adopt a conventional asset based network investment solution to any network constraints rather than exploring more efficient solutions involving people or other costs classified as opex.*
> *[Ofgem] received several responses to the initial consultation document advocating the removal of this barrier to encourage DSM and non-network solutions. This could be done by either applying a common capitalisation policy to all categories of network related costs or by allowing non-network solutions to be added to the regulatory asset value (RAV).* [2]

Given this, SP AusNet urges the AER to reconsider its views on excluding demand management capex which has not had ex-ante approval from the RAB.

It should also be noted that any non-network solution implemented to defer network augmentation or replacement would need to be more cost effective than the network solution to even be considered.

6.3 SP AusNet's Proposed Incentive Options

SP AusNet is interested in working closely with the AER on doing more investigation and analysis to develop a practical DMIS that can deliver improved demand management outcomes. The AER should consider the following suite of options for inclusion into the Victorian DMIS to provide real incentives to innovate and implement demand management:

- a revenue driver such as the D-factor scheme;
- an uncapped ability to recover costs associated with research and development or implementing demand management or other non-network solutions where it can be

[2] Ofgem, ***Electricity Distribution price Control review Policy Paper***, 5 December 2008, pp 37-38.

shown there is a valid business case and the expenditure is reasonable and efficient. Assessment could be on a case by case ex ante basis (within period);

- uncapped cost recovery as well as recovery of foregone revenue for implementation of any demand management project which defers capex. Assessment could be annually on an ex post basis;
- explicitly providing for all demand management capex to be rolled into the RAB regardless of approval timing to avoid penalising DNSPs for implementing cost-effective demand management;
- an incentive rate for connecting distributed or embedded generation to the distribution network and the ability to retain that benefit over the regulatory period; and/or
- the option to participate in a performance incentive scheme, subject to the availability of appropriate benchmark information and a suitable incentive rate.

These incentives would operate on top of the incentives that are provided by the ex-ante expenditure framework which already provides the benefit of:

- any return on revenue related to capex deferred by demand management; and
- the value of capex savings in implementing demand management.

These options are explained in more detail below.

6.3.1 Revenue driver like a D-factor scheme

As part of their current regulatory arrangements, NSW DNSPs have a D-factor into the weighted average price cap (WAPC) control formula that allows them to recover:

- approved non-tariff-based demand management implementation costs, up to a maximum value equivalent to the expected avoided distribution costs (as defined in the determination);
- approved tariff-based demand management implementation costs; and
- approved revenue foregone as a result of non-tariff-based demand management activities.

To justify their expenditure under the scheme, businesses must demonstrate the project is a lower-cost option which defers network augmentation. Cost recovery under the D-factor is on an ex post basis and is uncapped. A business can achieve a positive or negative D-factor in any year which is factored into its annual revenue requirement. For example, a positive D-factor allows for an average price increase in network tariffs.

The D-factor scheme has achieved some success in NSW. Between 2004–05 and 2005–06, NSW DNSPs spent approximately $8.26 million on 26 demand management projects under the D-factor scheme. Over this period NSW DNSPs avoided $24.23 million of planned capex and opex through the approved demand management projects. According to IPART, the impact of the D-factor on customer prices has not been significant.[3]

This performance indicates that an incentive can be effective. It should also be noted that there is scope for Victorian DNSPs to respond similarly, given that an incentive scheme has yet to operate in Victoria.

[3] IPART, ***NSW Electricity Information Paper No2/2007 – Demand management in the 2004 distribution review: progress to date***, August 2008, p 5.

6.3.2 Uncapped cost recovery for research and development

As regulated businesses, DNSPs do not have incentives to adopt innovative and commercial solutions as they do not have competitive pressures on them and there is the potential for DNSPs to lose money on innovations which fail. Given this, it is important that the regulatory framework encourage R&D and innovation to ensure that customers are provided with efficient, effective and flexible networks.

Capping a broad-based innovation to the level in the proposed DMIS (in SP AusNet's case, $3 million over five years) will not encourage a significant level of innovation as developing and testing technologically advanced equipment is expensive. Exploration of high cost innovative projects or trialling innovative commercial arrangements could result in large costs. However, if this leads to better and more flexible networks in the long run, then the whole energy market would benefit, not just the DNSPs and users. In light of this, capping broad based innovation spending at a low level will not encourage real progress in this area.

SP AusNet proposes that broad based innovation funding start at the level established in the proposed DMIS but not be capped. DNSPs should be allowed to recover all justifiable R&D costs as long as the AER approves it. This could be on an ex ante basis within the period, or an ex post basis after the regulatory period concludes.

6.3.3 Cost recovery for projects which defer capex

The AER could provide a scheme which allows DNSPs to recover demand management implementation costs for any project which defers capex. It would be assessed on an ex post basis annually, in line with the regulatory reporting timings, and be uncapped.

Foregone revenue related to the projects should also be available for claiming, and should relate to all projects and not just non-tariff based projects. Limiting this to non-tariff based projects would render it effectively inaccessible as hardly any services fall into this category.

6.3.4 Including demand management capex in the RAB

Allowing DNSPs to roll demand management capex into the RAB and retain the capex savings from network replacement/augmentation deferral would be a necessary benefit for DNSPs which undertake demand management. This is particularly the case given that the regulatory framework operates to reward DNSPs more for spending capex than opex. This balance of incentives already works to deter demand management (which generally involves opex).

6.3.5 Embedded generation allowance

The AER could provide a $/kW incentive rate (or revenue driver) to encourage the connection of distributed generation to the network. Ofgem has applied a £1.50/kW/yr incentive rate to all DNSPs except for one which faces higher costs in connecting distributed generation to its network.

SP AusNet considers this would encourage DNSPs to explore innovative solutions which may involve installing distributed generation in key locations. It could also allow for DNSPs to develop embedded generation solutions to take to customers and install at key locations in the network. DNSPs may also be interested in owning and operating embedded generation to maximise the efficient use of our networks, and paying users a fee to allow us to access their locational advantage.

6.3.6 Shared savings scheme

DNSPs would benefit from a higher powered incentive scheme which clearly provides rewards for pursuing demand management and providing benefits to society as a whole through reduced carbon emissions. A higher-powered incentive scheme similar to the S-factor could recognise the value to society of reduced energy consumption by providing an additional revenue stream for network businesses to pursue. It would effectively share the benefits of cost-effective or socially beneficial energy reduction. A shared benefits incentive scheme may be an option as a longer term goal and would involve:

- an appropriate measurable target to set (net benefits achieved, energy or capacity saved);
- a fair quantum of reward;
- the marginal incentive rate; and
- caps or floors to mitigate the risks of the incentive.

SP AusNet would recommend the AER examine a risk-free scheme initially, with a view to moving to a more robust arrangement once quality data is available. The effectiveness of a shared savings scheme can be compromised by an inadequate specification of net benefits and also by any caps placed on demand management programs.

SP AusNet recognises that such a scheme may be difficult to implement at this stage as data is not readily available for energy efficiency. However, it could be considered as a longer term option.

SP AusNet is committed to doing more in demand management. We consider that an effective and more ambitious DMIS is a key component of setting up a regulatory framework which encourages DNSPs to seek greater demand management opportunities.

6.4 How proposed DMIS compares to SP AusNet's scheme options

Table 2: Comparison of distribution incentive packages

	Proposed DMIS	SP AusNet option
A revenue driver such as a D-factor	×	✓
Capped cost recovery for broad based demand management R&D on a true ex ante basis	✓*	×
Uncapped cost recovery for broad based demand management with ex ante (within period) approval	×	✓
Uncapped cost recovery for capex-deferring demand management assessed annually on an ex post basis	×	✓
Inclusion of demand management capex in the RAB regardless of project approval timing	×	✓
Recovery of foregone revenue only for non-tariff based demand management	✓	×
Recovery of foregone revenue for all demand management	×	✓
Embedded generation incentive rate	×	✓
Shared benefits / Performance incentive	×	✓

* Provided ex ante but on a use-it-or-lose-it basis. Must be non-tariff related. Only for projects which can be proven to be reasonable and efficient.

6.5 Conclusion

The proposed DMIS needs to go further in providing real demand management incentives and SP AusNet suggests that more progressive and higher-powered incentives are necessary to encourage improved demand management outcomes. This could be used to test the capacity for DNSPs to respond to incentives and deliver innovative non-network solutions. SP AusNet considers this would be a useful and beneficial initiative as Victoria's DNSPs have not yet been provided with incentives for demand management and potentially have good opportunities to respond. The outcomes of this will assist in informing the AER on likely impacts of different DMIS options in the lead up to developing a National scheme.

As a business that operates in a jurisdiction which has often been progressive in regulatory reform and innovation, SP AusNet considers that a substantive DMIS would be a welcome. Such a move would also be timely given the imminent roll out of smart meters across Victoria.

SP AusNet recommends the AER consider the outlined suite of demand management incentive options to enhance and strengthen a potential DMIS for Victoria. These measures are aimed at overcoming barriers to demand management.

SP AusNet looks forward to engaging proactively with the AER in designing a more innovative scheme for Victoria. SP AusNet considers that an effective and more ambitious DMIS can encourage DNSPs to seek greater demand management opportunities and deliver improved network efficiency across the State.