

19 October 2012

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

Via website: www.aemc.gov.au

Dear John

**Power of Choice Review, Submission in response to AEMC Stage 3 Draft Report
(AEMC Reference EPR0022)**

Grid Australia welcomes the opportunity to provide a submission to the Australian Energy Market Commission's (the AEMC) Stage 3 Draft Report for the Power of Choice Review.

Grid Australia recognises the importance of customers making informed choices about their use of energy and technology and considers that an appropriately framed demand side participation regime has the potential to positively influence both energy and network cost outcomes.

The objectives and proposed strategies set out in the AEMC's draft report appear to be sound and are generally supported by Grid Australia.

Transmission services can and do contribute to more effective demand side participation, albeit in a more limited capacity compared with retailers and electricity distributors (as correctly reflected in the AEMC's proposed strategies).

Transmission investment needs can also be deferred or even reduced if there is effective demand side participation more generally. This can be economically efficient, particularly where investment is being driven by relatively short periods of peak demand. Furthermore, even though transmission charges are typically less than 10% of a residential electricity bill they can be a more significant component of the charges paid by larger electricity users.

For these reasons it is worth reiterating the aspects of this review most relevant to the contribution that can be made by transmission network service providers. These include:

- How transmission network service providers harness demand side participation
- The importance of regulatory incentive design for transmission
- The role of transmission pricing

These are each briefly discussed in turn.

Harnessing demand side response and the role of the Regulatory Investment Test – Transmission and Annual Planning Reports

At the outset it is worth noting that the benefits of demand side participation (DSP) at end consumer level, i.e. which may be encouraged by the distribution networks, also flow through to the provision of benefits at the transmission level. This is because transmission network capacity investment is in response to distribution network 'demand', which will take into account the contribution of DSP. Grid Australia supports proposals for improved forecasting of DSP proposed by the AEMC.

Transmission network service providers (TNSPs) also assess DSP options for direct application in supporting transmission services.

TNSPs are required to plan and develop their networks in order to meet, among other things, the reliability standards applying under the Rules and under jurisdictional arrangements.

In order to address an emerging network limitation, the transmission network service provider is obliged to follow the Regulatory Investment Test – Transmission (RIT-T) to identify credible rectification options and select the most cost effective solution. For smaller augmentation projects similar information is provided in annual planning reports.

The process for the conduct of the RIT-T assessment is prescriptive, being defined in the Rules, is subject to a guideline developed by the Australian Energy Regulator (AER), requires a rigorous assessment of options and their costs, and extensive public consultation.

Broadly the RIT-T process involves:

1. The TNSP identifying the investment requirement and options for rectification, including non-network options such as demand side participation or generation support.
2. The TNSP publishing a Project Consultation Specification Report to provide the opportunity for interested parties to propose solutions to the identified need.
3. Submissions from interested parties being sought for no less than 12 weeks.
4. The TNSP assessing submissions and determining a list of credible options.
5. The TNSP undertaking a project assessment and determining the most cost effective solution (the preferred option).
6. The TNSP preparing and publishing a Project Assessment Draft Report.
7. Submissions from interested parties being sought for 6 weeks.
8. The TNSP assessing submissions and issuing a Project Assessment Conclusions Report.
9. A further period for parties to raise disputes and for the AER to make a decision on any disputes.

Under this framework there are significant opportunities for demand side participation options to be put forward and considered. TNSPs are required to consider 'credible options', which include both network and non-network solutions, regardless of whether a proponent has offered a non-network solution.

At the transmission level it is most useful to work with aggregated demand side response capability. Published information on network deficiencies over the planning period is made available to prospective service providers via the Annual Planning Report, and where most suitable DSP solutions may ultimately be adopted. Schemes have been established with generators located in a load area and with demand side aggregators. Demand side aggregators contract with numerous smaller customers to provide demand side response when required. This is then offered to transmission network service providers in response to formal 'requests for proposals'.

These requests are usually issued where the transmission network service provider has reason to believe there is sufficient demand side potential, or where a generator or demand side aggregator identifies potential in response to information provided to the market as part of the RIT-T assessment process.

The key feature of a request for proposal is that it clearly specifies the required demand side response, including the circumstances under which it would be required, the relevant load areas where demand side response would be most beneficial, and the levels of demand side response being sought. A request for proposal also includes the commercial terms and conditions to be met by the provider of demand side response. In essence it is a 'call for tenders' from the market to meet a defined demand side response requirement on a competitive basis. This process complements the RIT-T process by providing a genuine commercial opportunity to potential providers of demand side response.

The importance of regulatory incentive design

The mechanism described so far explains the processes for eliciting demand side response as an option for meeting transmission service needs. However, it does not fully explain what motivates transmission network service providers to utilise these mechanisms.

The major advantage of having profit motivated businesses providing transmission services is that regulatory incentives can be used to encourage efficient behaviour and decision making.

To date, a key commercial incentive for transmission network service providers has been provided by the inherent commercial benefits of deferring capital expenditure within a regulatory control period. Because revenue is capped on an ex-ante basis for the five year regulatory control period, deferral of any capital expenditure reduces financing costs but not revenues. As a result profits can be enhanced if demand side response can be procured at a price that is less than the savings in financing costs.

An issue to be addressed is that there is less incentive for a transmission network service provider to identify demand side options on an ex-ante basis at the time of a revenue cap application. For example, under current arrangements, the costs of such options are recovered on a 'pass through' basis and do not provide a strong commercial incentive for network service providers to seek out and propose these options.

However, the capital incentive schemes that are a significant component of these incentive arrangements have recently been the subject of a Rule change proposal from the Australian Energy Regulator (AER). The draft Rule change decision by the AEMC on this matter has proposed giving the AER the ability to design and develop new schemes for encouraging efficient capital expenditure. Accordingly, by default, the AER will also be able to amend the incentives for transmission network service providers to seek out and use demand side participation as an alternative to capital investment.

For this reason the AEMC ought to ensure that, in its guidance to the AER in the design of these schemes, the AER expressly addresses the need to encourage efficient demand side participation. The AER should also be required to consider the interaction with other regulatory incentives, including the operating expenditure incentive schemes, noting that network support payments are usually treated as operating expenditure under accounting standards. These proposals for transmission appear to be consistent with similar proposals already being proposed in relation to electricity distribution in Section 7.3.1 of the Draft Report.

Grid Australia considers that focussing on improved incentive design is preferable to additional prescription in the Rules requiring the use of demand side participation by transmission network businesses. In general this is also preferable to additional Rules imposing further administrative requirements on transmission network service providers.

The role of transmission pricing

There are at least two important considerations when considering the impact of transmission pricing on demand side participation as follows:

- The structure of transmission prices
- The way in which this structure is reflected through to customers by intermediaries such as retailers and distributors

The structure of transmission prices

Transmission prices currently contain price signals related to the different costs of providing transmission services to different locations. They also have, to a limited extent, a time of use cost signal. These can be varied from region to region to reflect local conditions via the Transmission Pricing Methodologies approved by the AER as part of the five-year revenue setting process for each transmission network service provider. It is this component of transmission prices that has the most impact on encouraging the reduction in load at times of peak demand.

The Rules impose limits on the extent to which the AER can approve various price structure options, even where alternative price structures would be more cost reflective. For example, in NSW, there are periods in summer where peak demand can occur over a wide range of times during the working weekday. However, the AER has interpreted the Rules to require the adoption of maximum demand pricing rather than peak period energy pricing.

Therefore there appears to be potential to relax some of these restrictions in the Rules to enable the AER to adopt more efficient time of use pricing specific to the relevant load areas.

Process for passing through cost reflective transmission prices

This is primarily a matter for the regulation of the prices set by electricity distributors who incorporate transmission charges with their own network charges to produce composite network use of system charges. Greater transparency of this step may be warranted to ensure the efficient allocation of transmission charges between various classes of customers e.g. between small and large electricity users.

The extent to which time of use transmission charges can be passed through to end users also depends on the nature of metering available to the various classes of end users. In this regard strategies to encourage the efficient adoption of smart meters across a wider range of end use customers are supported.

In summary, transmission network service providers can, and do, participate in securing efficient demand side participation. Grid Australia considers that there are some aspects of incentive design and network pricing that could usefully be considered further as part of this review.

I would be pleased to discuss these matters further if that would be of assistance.

Yours sincerely



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