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Dear Mr Khan

DIFFERENCES BETWEEN ACTUAL AND FORECAST DEMAND IN NETWORK REGULATION

Thank you for providing CitiPower and Powercor Australia (**Businesses**) the opportunity to participate in the 28 February 2013 workshop to discuss the request from the Standing Council of Energy and Resources (**SCER**) for advice on the merits of the Australian Energy Regulator (**AER**) considering the difference between actual and forecast demand when undertaking regulatory determinations.

The Businesses are concerned about any proposed changes to the National Electricity Rules (**Rules**) aimed at adjusting revenue allowances for differences between actual and forecast demand. The Businesses consider such a proposal undermines the incentive based nature of the Australian electricity regulatory arrangements and creates unnecessary uncertainty for Distribution Network Service Providers (**DNSPs**).

Set out below are the Businesses' comments on the proposal contained with the SCER request for advice, as well other information that may assist the Australian Energy Market Commission (**AEMC**) in preparing its advice.

Maintain incentive regulation

A key feature of the existing regulatory framework is the reliance on incentives to drive efficient behaviour. The proposal for a "true-up" of demand undermines the incentives underpinning the regulatory regime.

The current regulatory regime provides strong incentives on DNSPs to forecast demand as accurately as possible and where possible, within the regulatory control period to manage actual demand. In circumstances where a DNSP underestimates actual demand, it will potentially have to increase its capital expenditure beyond that allowed under the regulatory control. If this is the case it will be penalised through the absence of any return on that capital over the regulatory control period and secondly, through the capital expenditure efficiency benefit sharing arrangements

currently being consulted on by the AER. Should the Business overestimate demand, the DNSP will be penalised through lower revenues, as under a price cap, its tariffs have been determined based on an unrealised forecast demand.

If a 'true up' of actual demand were introduced, these incentives would change. From a DNSP incentive, it no longer has an incentive to manage actual demand, to the extent it is able to, as there is no longer any reward for doing so. Initiatives aimed at reducing peak demand are likely to be deferred as there is no benefit from doing so. Equally the incentive to set network tariffs efficiently diminishes. It no longer matters on what basis demand based tariffs are set as any under or over recovery would be recouped in the subsequent year.

Further, the arbitrary nature of any revenue adjustment is likely to diminish the incentive to make cost efficiencies. It would be extremely difficult to discern the difference between a genuine cost efficiency and deferral of cost due to lower than expected demand. Equally in circumstances where actual demand has exceeded forecast demand, separating inefficiencies from the need to make additional investments would be difficult. The AER task would hence become highly subjective and arbitrary creating uncertainty for the DNSP that it will ever realise the benefit of any efficiencies it pursues.

Link between demand and costs

Changes in system peak demand or energy consumed at a total network level do not have a major impact on the Businesses costs. Rather, the majority of the Businesses' costs are fixed, or invariant to throughput or system peaks. What is more critical to costs is localised peak demand which, depending on existing utilisation, can impact on project timing and actual expenditure.

Further, it is not always the case that a localised increase in the level of demand will drive network investment. For example, if the increase occurred in an area where there is modest growth and ample capacity in the network, then there would be no need for the change in peak demand to impact capital expenditure.

In any event, the capital expenditure for network reinforcements is not a high proportion of the Businesses' capital expenditure allowance. For example, the Powercor Australia reinforcement capital expenditure amounted to less than 15 per cent of the total gross capex allowance for the 2011-15 regulatory determination period.

Differences between actual and forecast energy

Contrary to the arguments presented at the workshop, the forecast risk around actual and forecast demand is symmetrical. Take for example the system energy forecasts that have applied to the Businesses since 2006. The AER energy forecasts have been above the actual energy consumption for Powercor since 2009, as shown in Figure 1 below. While the AER energy forecasts were below the actual energy consumption for CitiPower in the previous regulatory determination period, they have been above actual consumption in this regulatory determination period (i.e. since 2011). This is shown below in Figure 2.

Figure 1 Powercor actual and forecast energy

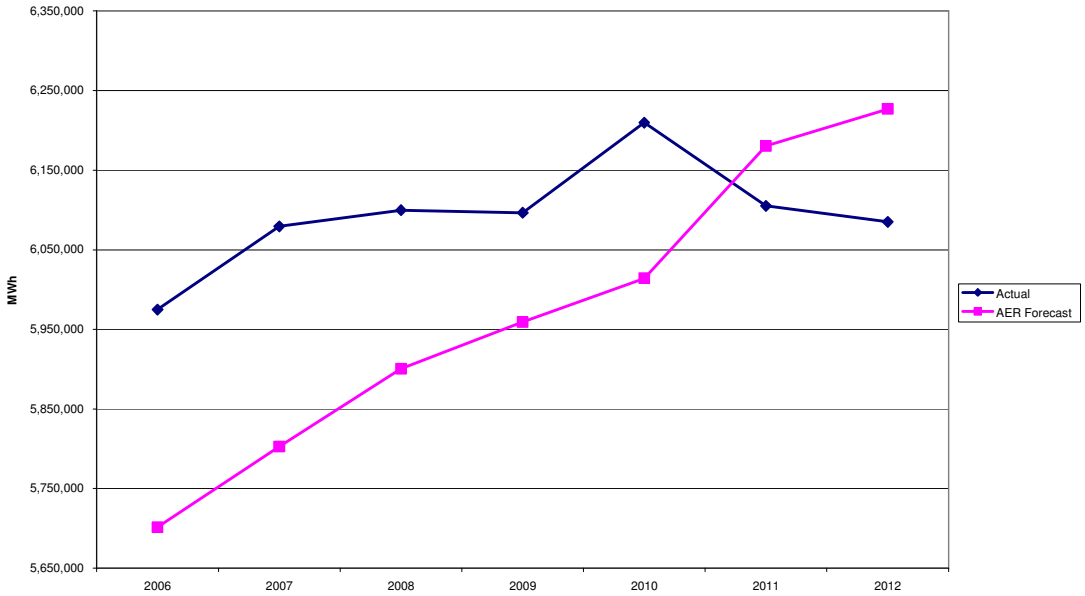

Figure 2 CitiPower actual and forecast energy

Similarly, the risk around forecasting of the network maximum demands is symmetrical. The zone substation demand forecasts of the Businesses detail the non-coincident peaks at each substation. These spatial forecasts are used by the Businesses in estimating the reinforcement portion of capital expenditure requirements in a given year. In the current regulatory determination period, the Businesses spatial forecasts have generally been close to the actual levels.

Forecasting of demand and energy consumption will continue to be a challenging task, given economic uncertainty, growth in photovoltaic systems, self-generation,

customer decisions and weather variations. The risks around these factors are most efficiently managed by the party best able to understand and where possible manage these risks. The Businesses believe that party is the DNSP.

Revenue cap versus price cap

A large proportion of the discussion at the workshop concerned the different incentives when forecasts are not realised under a price cap or revenue cap. The Businesses would be very concerned if the purpose of the advice was to try and "lock-in" revenue caps across all jurisdictions, as that appears to be outside of the terms of reference of the SCER request. It is clear in the Rules that it is the AER which must determine the form of control that is appropriate for each jurisdiction. This consideration is best conducted through the regulatory review process. The Businesses would refer the AEMC to a separate submission from Victorian distributors that explores this issue further.

Impact on other rule changes

Given the most recent changes to Chapter 6 of the Rules have been in place less than 3 months, and for the most part remain untested, it appears highly premature that such a significant change to the incentive-based regulatory regime as proposed by the SCER be considered now. Furthermore, the Businesses are concerned that the proposal to effectively "true-up" any differences between forecast and actual demand at the end of the regulatory control period may conflict with other Rule changes as arising as part of the Power of Choice review.

The Businesses would be pleased to discuss any aspect of this submission with the AEMC. Please contact Elizabeth Carlile on 03 9683 4886 or ecarlile@powercor.com.au.

Regards

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