DIFFERENCES IN ACTUAL AND FORECAST DEMAND

GARTH CRAWFORD - PRINCIPAL ADVISOR, ECONOMIC REGULATION

AEMC WORKSHOP – 28 FEBRUARY 2013

Outline

> Request for advice → understanding of SCER task
> Opening observations
> What should we want?
> Features of current National Electricity Rules
> Initial views on Commission's questions for discussion
> Questions for Commission's consideration

SCER request for advice

> Investigate the implications of differences between actual and forecast demand with the Rules

> Advise on the merits of the Australian Energy Regulator considering the difference between actual and forecast demand in the previous determination period when undertaking the current determination

> Proposed amendments ‘should these be required’

Opening observations

- Regulatory compacts which lack public legitimacy are risky for all parties
- Policy makers are asking the Commission to “tell us if there a problem”
- Nature of capital expenditure recovery under building blocks approach
- AEMC advice occurring in parallel to complex series of existing and relevant reviews and processes currently underway
  - SCER/COAG market reform agenda
  - Power of Choice
  - Transmission Framework Review
  - Productivity Commission Review of Electricity Network Regulation
  - AER Better Regulation Guideline processes
  - Implementation of and transition to *Economic Regulation of Network Service Providers* rule change
  - Review of national energy consumer advocacy arrangements

What should we want?

- Efficient and timely investment to deliver reliable and secure electricity supply to promote the long-term interests of consumers (NEO)
- Current and future consumers to benefit from real and sustained efficiencies
- Owners and managers of networks to be incentivised to uncover and create efficiencies
- A regulatory framework which promotes sound initial forecasting
- Pricing and revenue framework which is symmetrical and robust when exposed to the errors and inaccuracies inherent in forecasting
- Framework which encourages *relevant* learning from one period to next
- Flexibility to adapt to the diverse demand scenarios facing Australian networks

Features of the existing Rules

- Capacity for the AER to make determination on form of control (price, revenue cap or hybrids, see Cl 6.12.11) in distribution
- Capital expenditure sharing scheme (Cl. 6.5.8A) **(rule change)**
- Potential for asset stranding for capital expenditure retrospectively deemed ‘inefficient’ **(rule change)**
- Choice of use of actual or forecast depreciation (Cl 6.12.18) **(rule change)**
- Capacity to identify contingent projects **(rule change)**
- Regulatory investment tests
- Specific guidance on information underpinning capital expenditure (S6.1.1) including key assumptions, drivers and an explanation of variations from historic trends. (**rule change)**

In other words…the AER effectively determines:

1. Relevant factors to consider in form of regulation decisions
2. The risk sharing between distribution networks and consumers for demand variations
3. Existence and strength of capital expenditure incentives in the sharing scheme
4. The strength of incentives provided by use of either forecast or actual depreciation
5. Whether the network has provided sufficient detail about the methodology and key assumptions underlying capital expenditure forecasts/major investments
6. Whether networks or consumers bear the cost of above forecast capital expenditure

Initial views…questions for discussion

- Difficult to see a lack of available mechanisms in the rules

  → perhaps more lack of practical and well-examined experience in fully utilizing them in combination?

- Focus on analysis of revenue cap or price cap choices may not address underlying issues of falling volumes and peaks, for example.

- Unclear if customers have been as engaged as possible in the ‘risk compact’ and how to reconcile different customer classes preferences

  – however, new Rules deliberately target greater consumer engagement early in the regulatory review process

Initial views…questions for discussion

- If there is a ‘new normal’ in falling/stable network average and peak demand, then tariff structures which do not reflect businesses costs become increasingly problematic
- Unclear if a simple movement to greater revenue cap pricing would address this, or if it could exacerbate the issue → demand/capacity-based pricing?
- Where is the empirical evidence that price caps approaches have not achieved more efficient pricing outcomes?

Initial views…questions for discussion

- Testing the quality of evidence of 'windfall gains' from tariff restructuring
- Broad movement by the AER towards a control mechanism which features less powerful incentives for within period efficiencies appears at odds with recent Rule developments implemented at AER's request
- A better approach might be to provide NSPs with increased flexibility to restructure tariffs to reflect costs using their more granular knowledge of costs and price elasticities

Questions for Commission's consideration

1. What 'problem' is actually being targeted?
2. Are the existing and recently amended features of the incentive based-regulatory model and Rules sufficiently clear to policymakers?
3. How has the AER typically exercised the existing 'envelope' of capital expenditure incentive measures already available to it?
4. Is there evidence of a Rule deficiency linked to an identified problem?