

Position paper

on the CEER Consultation „Incentives Schemes for regulat- ing DSOs, including innvoation“

Berlin, May 12, 2017

Interest Representative Register ID: 20457441380-38

Introduction

The German Association of Energy and Water Industries (BDEW) represents over 1,800 members of the electricity, gas and water industry. In the energy sector, BDEW represents companies active in generation, trading, transmission, distribution and retail.

BDEW welcomes the opportunity to comment on the CEER public consultation paper “Incentives Schemes for regulation DSOs, including innovation” dated 24 January 2017. The paper continues and deepens a debate which was tackled earlier in the ACER/CEER strategic paper “A bridge to 2025” (September 2014) and CEER’s paper “The future role of DSOs” (July 2015). The development of both papers was intensely followed and commented by BDEW. As the role of the DSOs is undergoing major changes, due to significant changes in the structure of the energy systems, it is of utmost importance to rethink whether existing methodologies for regulating DSOs are still appropriate or have to be adapted to better incentivise DSOs to meet their – existing and newly emerging – requirements.

In the present paper, BDEW presents the view of its members on the questions at stake and is to your disposability for future debates.

BDEW key messages

- As neutral and well regulated entities Distribution System Operators (DSOs) already today provide their share to facilitate the market and to ensure a non-discriminatory and transparent level playing field for all market parties. Alongside with safeguarding the security of supply and offering a high quality of services, this will continue to be their prior task in the future energy systems.
- As major changes in the energy production structures (above all for electricity) and in the energy usage take place, DSOs witness challenging tasks, requiring new solutions which allow DSOs to continuously fulfil their major responsibilities. Regulation has to take these changes into account and provide for a sound framework which enables DSOs to undertake the necessary investment. Different developments between electricity and gas grids have to be respected. At the same time regulation has to ensure that existing assets can be refinanced.
- There is not one best regulatory approach. Each regulator should analyse thoroughly the needs of the DSOs and the corresponding regulatory instruments to give adequate incentives to DSOs to fulfill their tasks for the customers best. When doing so, regulation has to adopt a “whole system approach”, implying that the best for the whole system – and in the end for the customer – should be the guidance of all regulatory rules.

Chapter 1: Current principles and regulatory approaches

Question No. 1. *Is there any regulatory aim that should prevail over other aims?*

The most important tasks and responsibilities of DSOs are ensuring security of supply, offering a high quality of services and providing for a level-playing field for market parties. Thus, from BDEW's point of view, regulators should focus their work on conditions which allow for these tasks to be fulfilled effectively and efficiently.

Regulation has to respect the aspect of financial viability for the DSO on the one side and the aim of cost-efficiency on the other. Both aspects can be considered as "side conditions" for DSO regulation. In the view of BDEW, innovation is not a regulatory aim as such, but one approach DSOs can choose to fulfil their tasks and responsibilities in a cost efficient way. With the emerging new challenges to DSOs innovative solutions become more important, therefore the regulatory framework should give the option to DSOs to opt for them in practice and thus help fulfilling the prevailing regulatory aims.

Question No. 2. *What regulatory tools are the most effective to achieve regulatory aims?*

As correctly elaborated by CEER, all the regulatory tools described in chapter 1.2 of the consultation paper have their advantages and drawbacks. It is reasonable to check which tools are most suited for application in the light of the changing challenges for DSOs as well as national circumstances.

However, ranking the different regulatory tools is problematic. The best regulatory approach depends not only on the prevailing regulatory aims (which can change over time), but also on the varying situation in different member states as well as on the situation of every single DSO, depending on its existing technical, financial and organisational disposition and its main future tasks and challenges.

Regardless of the regulatory approach it can be pointed out that the regulatory conditions have to be stable and transparent and allow a DSO a fair rate of return. These are the pre-conditions for a DSO to undertake the necessary investments in the grid infrastructure.

Of course, incentives are necessary to make DSOs choose cost-efficient solutions. Regulation has to strike a balance between the aim to keep grid fees affordable for customers today and the necessary to develop intelligent grids which enable the DSO to cope with tomorrow's challenges. The regulatory framework always has to take into account that today's investments will show their benefits not only in the current regulatory period but in many decades ahead.

Question No. 3. Do you have examples of additional important tools in regulation?

The consultation paper gives an exhaustive theoretical overview of the relevant regulatory tools. With regard to tools incentivising innovation and their application in practice, reference is made to the EURELECTRIC Report “Innovation incentives for DSOs” (July 2016) which depicts examples of viable regulatory approaches (see also question no. 11).

Chapter 2: Changing needs

Question No. 4. Considering the national and the European regulatory frameworks, what are the main challenges for DSO regulation?

As the role of the DSO evolves, regulation has to evolve and set the adequate framework for the DSO to fulfil his responsibilities. The European regulatory framework can provide overlying principles which ensure that the DSO acts as a neutral market facilitator. The DSO regulation in detail has to take place at the national level where regulators know the specific national challenges and can apply the policies best adapted to the needs.

Chapter 3: Changing aims and approaches of good practice

Question No. 5. What are the most relevant new issues for DSO regulation?

As mentioned in earlier documents (e. g. CEER’s “Future Role of DSOs”, July 2015), the role of the DSO evolves. One new issue is the rise in decentralised power production and injection of small generators into distribution grids. Another issue is the increasing number of parties using the distribution grid in different ways than before: customers do not follow traditional consumption pattern but use energy flexibly and produce it themselves (they become “prosumers”), and new appliances such as e-mobility use the distribution grid intensely. The combination of these effects present the main change to DSOs, resulting in new challenges for grid operation, management of data and cooperation with the TSO.

For regulation this means that the DSO has to be given the financial and organisational means to adapt to the new challenges, e. g. by taking adequate investment decisions, while respecting the cost-efficiency aim. By doing so, the regulator shall adopt a “holistic view” or, in other terms, a “whole system approach”: it shall evaluate an investment taken by a DSO not only by considering the costs and benefits incurred within the sphere of the respective DSO, but within the whole system. This is important because a single investment taken by a DSO, e. g. into new data management infrastructure, may on the first sight appear inadequate, but regarded from a whole-system perspective it is the best solution because of its benefits which go beyond the single DSO’s sphere. Furthermore, the regulator has to take into account that developments, such as the rise in decentralised power production, evolve distinctly in differ-

ent regions – even within one country. This causes a higher heterogeneity among DSOs, which has to be addressed by the regulatory framework. Take, for example, the difference in renewable energy technologies in northern and southern Germany: In the north relatively large wind parks are connected to the medium- or high-voltage network, while in the south small-scale photovoltaic plants connected to the low-voltage network prevail. These different developments result in different investment and operational needs for DSOs.

Finally, regulators should take into account that in countries where an incentive regulation scheme has been in place for a longer time, potentials to lower costs are diminishing as “monopoly rents” have already decreased to a large extent.

Question No. 6. *What should be the main regulatory goals in the near future?*

As described above, regulatory goals can evolve over time, as the DSO’s tasks do. The regulatory goals which should prevail in the near future depend very much on the needs of the individual DSO. Yet, security of supply and a high quality of service should always remain a prevailing regulatory goal. Similarly, financial viability of DSOs will always remain a necessary condition for regulators.

Question No. 7. *Do you agree that the regulatory process shall be an interactive process between regulators and stakeholders?*

There is no doubt that the regular exchange with DSOs as well as with other stakeholders can help the regulators to better understand the needs of the respective parties. Therefore, an exchange on a regular basis should be part of the regulators’ work.

In the end it is important that regulators adopt a holistic view (“whole system approach”) when deciding on regulatory activities. In any case they should avoid taking decisions which may discriminate against one or several stakeholder groups, neither positively nor negatively.

Question No. 8. *What can be done to allow a more active participation from the stakeholders?*

Consultations like the present one conducted by CEER are one means to allow stakeholders to express their view on the needs for regulation. On the national level, each regulator has to find his own approach for stakeholder involvement, depending, amongst others, on the level to which regulation has already achieved its goals.

In general, it is important that consultations are conducted in an early stage of the regulatory decision process in order to enable stakeholders to express their opinion before any restricting provisions are set. Furthermore, regulatory decisions should be as transparent as possible, which requires all necessary information to be made public.

Question No. 9. Do you agree that technologically neutral indirect approaches are the most efficient way to promote innovation?

As described above (question no. 1), from BDEW's point of view innovation should not be considered as a regulatory goal of its own but as a means for DSOs to cope with new challenges. Thus, the question is whether there is a need for regulators to actively promote innovation. As many of the tasks DSOs face due to the new requirements (cf. Question no. 5) can be best tackled with the help of innovative approaches, the regulatory framework should be shaped such that it allows for DSOs to invest in innovative solutions. This implies that the DSO should not be "punished" if an innovative – and due to its character risky – investment does not bring the intended benefits.

Innovative solutions can vary in type. It should be left up to the DSO to decide on the best suited solutions. Therefore, regulators should restrain from prescribing specific technologies. This does not only apply to innovation but also to "traditional" investment decisions.

Question No. 10. Do you agree that innovation should be seen from the costumers perspective?

In the end, any regulatory approach should have the customer's needs in mind. The "usual" customer wants to have a secure provision of energy, produced as sustainably as possible, for an affordable price. Under this assumption, the customer's interests coincide with the aims of the "whole system approach": what is best for the whole system will in the end be best for the individual customer.

If, as described above (question no. 1), innovation is considered as one means for the DSO to adapt to future needs and if the regulatory framework is shaped such that the DSO's decisions contribute to the best results for the whole system (because it is shaped by a regulator who adopts the "whole system approach"), innovative solutions will evolve when chosen by the DSO and will contribute to the customer's good. By this, the link between innovation and the customer is inherent to the system, there is no need to establish it explicitly.

Question No. 11. Could you provide examples of indirect or direct incentives for innovation which you consider to be effective?

The EURELECTRIC Report "Innovation incentives for DSOs" (July 2016) depicts examples from nine Member States which have implemented new specific regulatory mechanisms to promote innovation and R&D projects. Norway and Finland allow DSOs to invest a specific share of its capital in R&D projects and handle the associated costs as "pass through costs".

In general, it is also important that regulators provide long-term reliability of the regulatory reimbursement of costs as most investments of DSOs have long amortisation periods and are irreversible (i.e. regulatory hold-up should be prevented).

However, with regard to the examples depicted in the Annex of the consultation document BDEW wants to state its doubts on the viability of the German case study. The so called “super-efficiency bonus” is meant to incentivise DSOs to invest in innovative solutions. However, from a DSO perspective this regulation will not incentivise DSOs to do so.

The first obstacle is that the super-efficiency bonus is only addressed to a small group of DSOs, namely the DSOs which are considered “100% efficient” in the DEA method. DSOs whose efficiency is derived from the SFA method as well as all DSOs in the simplified procedure are excluded.

But also among the “100% efficient DSOs” in the DEA method, the “super-efficiency bonus” will not stimulate major investments in innovation due to its complexity and the uncertainty of the effective rate of return. Since the result of the super-efficiency analysis depends on the underlying benchmarking model which is adjusted every 5 years (e.g., parameters, outlier analysis, cost driver analysis), the outcome is not foreseeable for DSOs with regard to the incentive effect for planned innovation activities. The capping to 5% (1.25% / a) further limits the effect and thus the incentive.

If at all, BDEW expects that the efficiency bonus will stimulate few DSOs to initiate investments decisions which increase their relevant super-efficient output parameters further. However, the efficiency bonus will not be able to stimulate innovative solutions with positive medium-term to long-term cost-efficiency effects. Such innovative investments usually lead to rising operational and decreasing capital costs. Regrettably this type of innovative investments is not incentivised by the efficiency bonus.

Question No. 12. What do you think about the CEER position on the whole system approach?

BDEW strongly supports CEER’s position on the whole system approach. As described above (questions no. 5 and 10), all regulatory activities have to consider the societal benefits as their levelling rule. This implies that the decisions of one single DSO may, from a cost-benefit point of view, appear disadvantageous for this DSO or its direct grid users but are beneficial for the system as a whole. Regulators have to take the ambitious task to set the incentives for every grid operator such that the single DSO (or TSO) is not financially “punished” when it produces benefits for the whole system which are not or only few perceptible directly in its own grid.

Question No. 13. *Could you provide examples of the whole system approach that bring added value?*

It is often possible that one company's cost reduction resulting from successfully developing and implementing an innovation does not cover its full development costs. Yet, if other companies imitate the innovator's solution, the overall welfare effect can be positive. Hence, it is important to reward companies for developing new solutions also beyond those areas where they contribute to their individual cost reduction.