Matters relevant to distribution determinations for NSW and ACT DNSPs for 2009-2014

ActewAGL response to AER Preliminary Positions Paper

Post tax revenue model
Roll forward model
Efficiency benefit sharing scheme
Service target performance incentive scheme
Control mechanisms for direct control services

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1. Introduction

ActewAGL welcomes the opportunity to comment on the Australian Energy Regulator's (AER's) *Preliminary Positions Paper*. ActewAGL also appreciates the AER's willingness to engage in ongoing consultation with stakeholders, in parallel with and beyond the formal process for responding to the *Preliminary Positions Paper*. Given the significance of the matters covered in the paper and the limited time available to resolve the many outstanding issues, ongoing consultation is clearly important.

The transitional Rules require many significant changes to the regulatory arrangements for the ACT – for example, a new approach to revenue modelling and the introduction of side-constraints on tariffs. The transitional Rules also give the AER discretion to introduce further significant changes, including new incentive mechanisms. Each of these matters raises complex issues that require extensive analysis and consultation. Unfortunately, the need to finalise positions within the next few months means that the consultation process is severely truncated.

ActewAGL is generally supportive of the AER's preliminary positions on the matters covered in the paper – the post tax revenue model (PTRM), the roll forward model (RFM), efficiency benefit sharing scheme (EBSS), services target performance incentive scheme (STPIS) and the control mechanism for standard control services. However, we seek the AER's clarification on several aspects of the preliminary positions. In addition, we make some suggestions for pragmatic approaches to resolving some of the issues in the limited time available. ActewAGL also notes that there are still some important areas requiring further detailed consideration – for example, the information requirements associated with the EBSS.

1.1 Overview of ActewAGL responses

Post tax revenue model (PTRM)

- ActewAGL supports the AER's preliminary position that the PTRM developed in Chapter 6A should form the basis of the PTRM to be applied to the ACT and NSW DNSPs.
- ActewAGL proposes an alternative approach as to how the closing roll forward value should be divided into specific asset classes for the opening 2009-10 Regulatory Asset Base (RAB), should ActewAGL decide to split its asset base into categories. The *Preliminary Position Paper* suggests two possible methods for dividing the RAB. ActewAGL suggests an alternative, more pragmatic, approach based on the disaggregation from the roll forward of the tax asset base.
- The AER's proposed model involves a 'hybrid approach' to recognising capital expenditure. ActewAGL notes that this hybrid approach would involve a significant administrative burden and would instead prefer to equate capital expenditure, disposals and capital contributions for the 'as-incurred' and 'as-commissioned' approaches.

Otherwise, ActewAGL requests that the AER consider a threshold for assets to be considered under the hybrid approach.

- ActewAGL also seeks confirmation of the AER's proposed approach to depreciation. We note that the transitional Rules allow DNSPs to use depreciation schedules nominated by them for each asset or category of assets, but the *Preliminary Positions Paper* seems to imply that the AER interprets this Rule as stipulating the application of straight-line depreciation.

- The AER also needs to ensure that capital contributions are treated as assessable income for the purposes of determining the tax building block in the PTRM.

Roll forward model (RFM)

- ActewAGL agrees that it is appropriate, and consistent with the transitional Rules, to apply the same roll forward model as that applied by the Independent Competition and Regulatory Commission (ICRC) to ActewAGL at the 2004 determination.

- The *Preliminary Positions Paper* accurately sets out the mechanics of the ICRC roll forward model.

Efficiency benefit sharing scheme (EBSS)

- ActewAGL supports the proposed introduction of an EBSS, based on the EBSS developed for transmission, with financial incentives to apply from 2014. ActewAGL supports the key features of the proposed scheme.

- ActewAGL believes that a key aspect of the model requiring further development is the information requirements. The AER says in the *Preliminary Positions Paper* that it will develop the framework for collection of information in the future. ActewAGL believes that if an EBSS is to apply then the information requirements should be agreed and set out by 1 March 2008, otherwise the AER should use its discretion and not introduce a scheme.

Service target performance incentive scheme (STPIS)

- ActewAGL supports the AER's proposal to not introduce a STPIS with a financial impact at the 2009 distribution determinations for the ACT and NSW.

- We agree that it is appropriate to limit the scope of a STPIS for 2009-14 to information monitoring and collection, consistent with the AER's obligations under the transitional Rules.

- ActewAGL agrees that after the national scheme is developed, a paper trial may help to prepare for the implementation of the scheme for the 2014-19 regulatory period. We note the AER's intention to consider specific measures, targets and attributes for each distributor[1]. ActewAGL believes that to be useful, the paper trial should be based on a schemes tailored to the ACT, rather than the generic national scheme.

Control mechanism for standard control services

- ActewAGL takes the opportunity to clarify the details of the current form of regulation applying to standard control services in the ACT including miscellaneous fees and charges.
- ActewAGL notes that side constraints are not currently imposed by the ICRC and we do not favour their use. However, we accept the AER's proposed approach to applying the side constraints, as required under the transitional Rules.

2. Post tax revenue model

The post-tax revenue model calculates the DNSP's annual revenue requirement for each year of the regulatory period. The annual revenue requirement is to be determined using a building blocks approach, as stipulated in the transitional Rules. The transitional Rules require the AER to publish the post-tax revenue model before 1 February 2008 or the date that is one month after the commencement date.

2.1 Current ACT arrangements and NER requirements

The transitional Rules require some significant changes to the current ACT approach to revenue modelling. Key differences between the approach adopted in the ICRC's current determination and that required by the transitional Rules include:

- The ICRC adopted a pre-tax approach to the calculation of tax exposure, whereby the allowance for tax is embedded in the return on equity requirement. Therefore there is no separate requirement for the calculation of a separate tax building block. The transitional Rules prescribe the use of a post-tax approach to revenue modelling. This will require ActewAGL to determine the value of its tax asset base in order to calculate the tax depreciation allowance in each year of the regulatory period
- The ICRC applied a real WACC to a nominal Regulatory Asset Base (RAB) in order to provide the required return on capital. The transitional Rules stipulate the calculation of a nominal vanilla WACC, which is then applied to real asset values.
- The ICRC's current determination was influenced by discussion and debate between the ICRC and ActewAGL over most of the weighted average cost of capital parameters. However, the transitional Rules lock-in the values for several of the key parameters.

[1] AER 2007, *Guidelines, models and schemes for distribution network service providers, Issues Paper*, November , p. 5

2.2 ActewAGL response to AER's preliminary position

ActewAGL generally supports the AER's preliminary position that the PTRM which the AER developed in accordance with Chapter 6A form the basis of the PTRM to be applied to it. However, ActewAGL takes this opportunity to raise important theoretical and practical issues associated with the proposed PTRM.

2.2.1 Opening RAB

A fundamental input into the PTRM is the opening regulated asset base value, and ActewAGL has the option to disaggregate this asset base into classes (most likely those set out in the relevant pro forma). These classes would form the basis for allocating capital expenditure, disposals, contributions and depreciating assets over time. For most distribution businesses they are simply transferred consistently from those classes used in the tax asset base calculation and the roll forward model for the current regulatory period.

However, in the case of the ACT review, the transitional Rules will stipulate that the roll forward model for ActewAGL will be the ICRC model used for the current determination. The ICRC model uses aggregated capital expenditure for each year of the regulatory period. This issue is mooted at 3.2.1 of the *Preliminary Position Paper*.

As a result, ActewAGL has developed a proposal for how the closing roll forward value should be divided into specific asset classes for the opening 2009-10 RAB, should ActewAGL decide to split its asset base into categories. The *Preliminary Position Paper* suggested two possible methods for dividing the RAB, neither of which is preferred by ActewAGL:

- On the basis of information in ActewAGL's asset register.

ActewAGL believes that this approach would be unnecessarily burdensome and administratively costly as the asset register at, say June 2007, would have to be divided accurately into stipulated asset classes.

- On the basis of relativities within the 1998-99 DORC valuation applied by the ICRC.

ActewAGL believes that this earlier valuation would not accurately reflect the nature of the current asset base.

If ActewAGL chooses to disaggregate the RAB into classes, ActewAGL proposes instead a pragmatic approach that bases the division on that attained in the tax asset base closing value for 2008-09. This would provide a more up-to-date reflection of the composition of the regulated asset base, without imposing an additional data requirement on the business. ActewAGL also notes that the asset lives used for calculating tax and economic depreciation are very similar.

2.2.2 Treatment of Capital Expenditure

The PTRM distinguishes between capital expenditure, asset disposals, and capital contributions on an "as incurred" and "as commissioned" basis. Depreciation is incurred as assets are commissioned, while a return is earned on capital expenditure as it is incurred (the ‘hybrid’ approach). This treatment is particularly relevant for TNSPs, who have a relatively small number of large assets, with project costs incurred often a number of years in advance of project commissioning.

However, ActewAGL notes that there is an insignificant difference between these two approaches for its capital expenditure programs, and would expect that this would also be the case for larger DNSPs. Almost all of ActewAGL’s capital projects are completed within 12 months and for this reason there is no significant distinction between these approaches when budgeting capital expenditure. To properly track these assets from an as-incurred approach to an as-commissioned basis requires either a significant upgrade of asset registers and business processes or requires a labour intensive reconciliation at the end of each year.

To avoid such administrative burdens entirely, ActewAGL instead proposes to equate capital expenditure, disposals and capital contributions for these two approaches. Otherwise, ActewAGL suggests that the AER consider a threshold for assets to be considered under the hybrid approach. For example, only projects over $10 million would be subject to the hybrid approach, with all other projects continuing to the subject to an “as-incurred” approach.

2.2.3 Depreciation

The AER has stated that straight-line depreciation conforms to the requirements in clause 6.5.3(b) of the draft transitional Rules and has implied, both through its issues paper and proposed PTRM model, that this is the method of depreciation to be used. However, this is inconsistent with clause 6.5.3(a)(2) of the draft transitional Rules, which allows DNSPs to use depreciation schedules nominated by them for each asset or category of assets, so long as it conforms with clause 6.5.3(b). ActewAGL seeks confirmation that the AER’s approach will be consistent with the transitional Rules in this aspect of the PTRM.

2.2.4 Capital Contributions

ActewAGL notes that capital contributions are to be removed from the net capital expenditure amounts. However they also need to be recognised as assessable income for the purposes of determining compensation for expected tax. Furthermore, capital expenditure for tax purposes should not be net of capital contributions. A minor modification therefore needs to be made to the PTRM to account for this requirement.

3. Roll forward model

3.1 ActewAGL response to the AER’s preliminary position

The roll forward model determines the closing RAB value for the current regulatory period, which translates as the opening RAB value for the next control period. As noted in the *Preliminary Positions Paper*, the transitional Rules will provide that the ICRC roll forward model for ActewAGL will apply, taking into account any written representations by the ICRC to ActewAGL before the commencement date of the amendments to the NER.

The *Preliminary Positions Paper* at 3.1.1 accurately sets out the mechanics of the ICRC roll forward model. The transitional Rules will also provide that the roll forward model for ActewAGL must take into account any written representations by the ICRC to ActewAGL.

4. Efficiency benefit sharing scheme

4.1 Current ACT arrangements and the NER requirements

The ICRC's final determination for ActewAGL's electricity distribution prices for 2004-09 does not include an efficiency benefit sharing scheme (EBSS).

While the ICRC decided against introducing an EBSS for the current regulatory period, it committed to further examine the case for introducing an EBSS, or efficiency carryover mechanism.

In December 2005 the ICRC released its final decision on incentive mechanisms. The ICRC concluded that there was no justification for the introduction of an efficiency carryover mechanism. It concluded that the required attributes of simplicity and unobtrusiveness, accuracy, being non-distortionary, equitability, and economic efficiency, would not be met by an efficiency carryover scheme[2]. The ICRC also noted the pending transfer of regulatory responsibility to the AER. It commented that the AER's transmission guidelines at that time included an efficiency carryover mechanism, and noted that this provided a potential indication of future arrangements under the AER.

In its submissions to the ICRC's 2005 review ActewAGL supported the introduction of an efficiency carryover mechanism. ActewAGL maintains its position that efficiency carryover mechanisms should be an integral part of the incentive regulation framework. Contrary to the ICRC's position, we believe that it is possible to develop an effective and workable scheme.

The amended chapter 6 of the NER requires the AER to develop and publish an EBSS (clause 6.5.8). However, the transitional Rules say that the AER *may* develop and publish a scheme to apply to the ACT and NSW DNSPs.

4.2 ActewAGL response to the AER's preliminary position

ActewAGL agrees with the AER that it is appropriate to develop an EBSS to apply to the ACT and NSW DNSPs, with financial penalties and rewards to apply from 2014.

Given the limited time before any new scheme must be published (by 1 March 2008), it is appropriate to base the new EBSS on an existing scheme, or one that has been developed through a thorough consultation process. ActewAGL agrees that the EBSS developed for transmission is the appropriate basis for the EBSS to apply to the ACT and NSW DNSPs.

[2] Independent Competition and Consumer Commission (ICRC) 2005, *Final Decision: Review of Efficiency and Service Standard Incentive Mechanisms*, Report 16 of 2005, December, p.19

ActewAGL supports the key features of the proposed model. These include:

- Application to operating expenditure only at this stage – application to capital expenditure and distribution losses would require further detailed consideration, which is not possible in the limited time, and there is no established Australian model on which to base the new model;
- Symmetric treatment of efficiency gains and losses;
- Treatment of year 5 efficiency gains or losses – assumed to be zero;
- The calculation of the incremental efficiency gain in year 6;
- 5 year carryover period; and
- Allowance for specified adjustments to actual and forecast operating expenditure so that the impacts of some factors, such as the impact of changes in capitalisation policies or differences between forecast and actual demand growth, are excluded from the calculation of efficiency gains and losses.

ActewAGL believes that a key aspect of the model requiring further development is the information requirements.

To allow appropriate adjustments to be made to actual and forecast operating expenditure the AER will require information from the DNSP's, in relation to the three default adjustment categories as well as any additional adjustments proposed by the DNSP. The AER does not address these requirements in the *Preliminary Positions Paper*, but it does note that an appropriate framework for the collection of relevant information will be developed by the AER in the future (p. 23).

ActewAGL notes that the AER discusses information requirements for the EBSS in the *Issues Paper* for the general distribution guidelines[3]. The AER lists the information that TNSPs are required to provide with their regulatory proposals, and says that similar evidence will be required from DNSPs. The required information includes:

- an explanation of the profile of operating expenditure sufficient to demonstrate that the operating expenditure incurred in the current regulatory period is related to operational needs as they arose and did not entail instances of cost-shifting;
- a detailed description of any changes in capitalisation policies during the current regulatory control period, or that are proposed to apply in the next regulatory control period accompanied by a calculation of the impact of those changes;
- the operating expenditure forecasts must include any necessary adjustments for changes in regulatory responsibilities;

[3] AER 2007, *Guidelines, models and schemes for distribution network service providers, Issues Paper*, November, p. 38

- the proposed basis for accounting for growth in demand in the next regulatory control period accompanied by evidence that the proposed adjustment mechanism accurately reflects the impact of changes in expected growth in demand on operating expenditure from a baseline forecast (positive and negative).

It is important for the AER to note that meeting information requirements the same as or similar to those in the transmission model will involve a substantial burden for the ACT and NSW DNSPs in the very limited time before the regulatory proposals must be submitted on 2 June 2008. ActewAGL believes that if an EBSS is to apply then the information requirements should be agreed and set out by 1 March 2008, otherwise the AER should use its discretion and not introduce a scheme.

5. Service target performance incentive scheme

5.1 Current ACT arrangements and the NER requirements

Pursuant to clause 6.10.5(d)(2) of the National Electricity Code, the ICRC was required to take into account service standards when setting a revenue cap for ActewAGL's distribution services. However, in its 2004 determination the concluded that there would not be a net benefit from applying a specific incentive component such as an S factor.

In 2005 the ICRC reviewed the case for introducing an S factor but concluded that there was no justification for the introduction of such a service standard incentive scheme at that time. ActewAGL agreed with the ICRC's conclusion, noting that this was consistent with their observation that the current service levels met or exceeded the specified standards and that no case had been presented that indicated the incentives under the current arrangements needed to be adjusted. ActewAGL explained in its submissions to the ICRC review that the high level of customer satisfaction indicated in its willingness to pay study implies that the current service levels are appropriate, and furthermore a service incentive scheme would be costly to establish and maintain.

The National Electricity Rules (clause 6.6.2) require the AER to develop a service target performance incentive scheme (STPIS). The AER has indicated that it will develop a generic STPIS, containing the high level principles and framework including a range of suitable measures, while specific measures, targets and attributes will be considered for each distributor[4].

The transitional Rules give the AER discretion to develop and publish a scheme to be applied for the 2009-14 ACT and NSW determinations. The STPIS must be published by 1 March 2008.

[4]AER 2007, *Guidelines, models and schemes for distribution network service providers, Issues Paper*, November , p. 5

5.2 ActewAGL response to the AER's preliminary position

ActewAGL supports the AER's proposal to not introduce a STPIS with a financial impact at the 2009 distribution determinations for the ACT and NSW. As the AER acknowledges, the task of developing a scheme will be challenging and complex and would require adequate consultation. Consultation on the national STPIS under the general Chapter 6 has begun and will not be complete until after 1 March 2008. Once the national scheme is developed, further consultation will be required to develop specific jurisdictional arrangements (referred to above). ActewAGL agrees with AER because as it would be inappropriate to short-cut this detailed process in order to finalise a new model for the ACT and NSW by 1 March 2008.

We agree with the AER's preliminary position that it is appropriate to limit the scope of a STPIS for 2009-14 to information monitoring and collection, consistent with the AER's obligations under the transitional Rules.

The AER also proposes that once a national scheme has been developed it will commence a paper trail based on that scheme. ActewAGL agrees that a paper trial may help to prepare for the implementation of a scheme for the 2014-19 regulatory period. We propose however that to maximise the value of the paper trial, it should be based not simply on the generic national model developed by the AER, but based on the specific service standard targets that should be applicable in the ACT. That is, an additional step – establishment of any DNSP specific features of the model – will be required, beyond the development of the generic national model, before an effective and useful paper trail can be introduced.

6. Control mechanisms for direct control services

6.1 Standard Control Services

6.1.1 Form of Regulation

The AER's guideline on direct control services will apply to standard control services only[5]. In the ACT standard control services are those currently known as prescribed services. The ICRC applies a maximum average revenue cap to prescribed services. The transitional Rules require the AER to apply a control mechanism to standard control services that is substantially the same as that determined by the ICRC for 2004-09. The AER sets out its understanding of the current approach in the *Preliminary Positions Paper*.

The AER's explanation of the ICRC's approach is not entirely correct and will need to be discussed further with ActewAGL to document this with precision. When the ICRC set the initial average revenue allowance for the first year of the current regulatory period (2004-05), it applied a full P_0 adjustment from the last year of the previous regulatory period (2003-04). Therefore the maximum average revenue allowance for 2004-05 is the real maximum average

[5] AER 2007, *Matters relevant to distribution determinations for ACT and NSW DNSPs for 2009-2014, Preliminary Positions Paper*, November, p. 37.

revenue for the current regulatory period, to which a CPI adjustment is applied annually. To determine the P_0 factor, the ICRC calculated a revenue requirement for prescribed distribution services for each year of the coming regulatory period using a building block approach.

6.1.2 Side constraints

The transitional Rules specify the formula for determining the maximum change in expected weighted average revenue, but allow the AER discretion to determine the detail of the side constraint mechanism for tariff classes[6]. ActewAGL notes that side constraints are not currently imposed by the ICRC and we do not favour their use. However, we accept the AER's proposed approach to applying the side constraints, as required by the transitional Rules. The AER's proposal to apply the side constraint to the distribution component of tariffs is appropriate.

However, ActewAGL is concerned that the AER's formula for the side constraints requires the use of 'audited' data on the quantity of each component of the tariff. It has not been ActewAGL's practice to audit the quantity of energy sold. This requirement would add to the cost of regulation (and prices) while providing limited, if any significant benefit to consumers.

6.1.3 Recovery of TUOS

The AER's explanation of the current situation needs to recognise that while TUOS costs are forecast for the coming financial year, DUOS charges are derived from actual sales in the previous calendar year. Therefore, the amount shown to be claimed for "Forecast TUOS charges $_{t}$" in Table 1 on page 80 of the *Preliminary Positions Paper*[7] should be the "Forecast TUOS charges $_{t\text{-}1\ \text{calendar}}$" (adjusted proportionately for the difference between forecast sales in the coming financial year and actual sales in the calendar year).

ActewAGL notes that the transitional Rules require that if TUOS revenue is greater than TUOS expenditure, then it must refund the difference and if TUOS expenditure is greater than TUOS revenue it is to recover the difference in TUOS prices in the subsequent year. ActewAGL notes this could create a degree of volatility in network prices, and proposes to assess and discuss with the AER if there is a superior and workable alternative to this process.

6.1.4 Pass-through arrangements

As for TUOS charges, ActewAGL adjusts the amount it claims in pass-through costs in the pricing process according to the difference in sales between the forecast in the coming financial year and the actual sales in the previous calendar year.

This means that the amount shown for "Allowed pass through amounts $_{t}$" in Table 1 on page 80 of *the Preliminary Positions Paper* should be the "Allowed pass through amounts $_{t\text{-}1\ \text{calendar}}$" (adjusted proportionately for the difference between forecast sales in the coming financial year and actual sales in the calendar year).

[6] AER 2007, *op cit*, p. 38.

6.2 Miscellaneous fees and charges

For regulatory pricing purposes, the revenue from miscellaneous fees and charges is calculated by applying the prices proposed for the next financial year to the actual quantity of services provided in the previous calendar year. This amount is deducted from the revenue cap for prescribed services to establish the cap for DUOS revenue from the proposed prices (applied to the actual sales in the previous calendar year).