13 September 2013

Mr. Chris Pattas
General Manager – Network Operations & Development
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Mr Pattas

NSW DNSP Submission on AER Draft Shared Asset Guidelines

Ausgrid, Endeavour Energy and Essential Energy ('the NSW DNSPs') appreciate the opportunity to respond to the Australian Energy Regulator's (AER's) draft Shared Asset guidelines. We welcome the AER's inclusive and ongoing consultation with stakeholders in developing the draft guidelines and look forward to further discussions on key issues.

In previous consultations, we have advocated that the guidelines should give effect to two key principles. Firstly, the guidelines should ensure that our customers are compensated on a fair and reasonable basis for the shared use of assets that derive unregulated revenue. At the same time, the guidelines should preserve commercial incentives for network service providers (NSPs) to provide unregulated services in a way that promotes greater utilisation of network infrastructure for societal benefit.

Our attached submission notes that the guidelines broadly seek to give effect to these principles. The guidelines propose a simple method to assess materiality and calculate a proportionate cost reduction to be applied to the annual revenue requirement. While we support the proposed mechanism, we trust that the AER has satisfied itself that the approach accords with the requirements of the Rules. The Rules allow the AER to reduce the Annual Revenue Requirement (ARR) of an NSP by such amount that it considers reasonable. This would be to reflect such part of costs of an asset that the DNSP is recovering through charging for a service that is other than a standard control service (i.e. an unregulated service).

A key point raised in our submission is that the AER's method should not apply in cases where the payments we receive from an external party relate to compensation, rather than charges for the use of the asset. In these cases, we would not receive a benefit pertaining to the use of shared assets and could not pass this through to customers via lower prices. Attachment A to our submission provides further information to the AER on these types of issues. We request that the report remain confidential.

A key example would be potential service arrangements for telecommunication carriers where the legislative framework limits the incentives and opportunities for entering into commercially based arrangements. In our view, the existing legislative framework is a broader issue that requires re-examination by policy makers. We note that Schedule 3 of the Telecommunications Act effectively limits our bargaining power to charge cost-reflective charges to telecommunication carriers for the use of shared assets.

The implication is that electricity customers would most likely subsidise the costs of telecommunications carriers. This means that we are not in a strong position to bargain with telecommunication carriers on behalf of our customers, and therefore do not receive a benefit that we can then pass onto our customers. We believe this does not result in a long term benefit to customers who otherwise would have received lower electricity prices as a result of a fair bargaining process.

We intend to raise our underlying concerns with the ACCC and policy makers to ensure that our customers can receive a fair share of the benefits from telecommunication access arrangements. In any case, our view is that until there is legislative change, a DNSP should be able to propose to exclude such payments from the operation of the cost reduction method.

Our submission also comments on other key elements of the AER's draft guidelines including:

- Application of the shared asset mechanism – We support the AER's view that a shared asset only arises when the use of a regulated asset changes after its initial cost allocation at the time of initial investment. Our view is that assets which were initially allocated to unregulated services under the CAM should be exempt from the operation of the cost reduction mechanism.

- Materiality – The AER will make cost reductions in advance for each year where unregulated revenues earned from shared assets are expected to exceed 1% of regulated revenue from standard control services. We support this approach to materiality, but request clarity on the formula to be adopted.

- Cost reduction method – The AER proposes to determine cost reductions using a formula based on a proportion of the total revenue earned from the use of shared assets. The AER would reduce the revenue associated with standard control service revenue by an amount equal to the cost reduction determined. We support the use of a 10 per cent sharing proportion used in the AER's calculation, noting that a higher sharing ratio would potentially limit the ability of an NSP to recover its efficient costs.

- Use of alternative methods – The AER considers that alternative methods can only be used if the result leaves consumers no worse off than under the method set out in the guidelines. A 'no worse off' definition of consumer interests may lead to an arbitrary test. We consider the relevant test of an alternative method should be the long term interests of consumers consistent with the National Electricity Objective.

- Annual reporting requirements – The AER has outlined annual reporting and specific information requirements for regulatory determinations. While we acknowledge the need for reporting, we note that revenue and volume forecasts will be uncertain and subject to change.

If you would like to discuss our attached submission further, please contact Mr Jim Battersby, Chief Engineer at Endeavour Energy on (02) 9853 6162 or Mr Michael Martinson, Group Manager Network Regulation at Networks NSW on (02) 9249 3120.

Yours sincerely

Vince Graham
Chief Executive Officer
Ausgrid, Endeavour Energy and Essential Energy

Attachment A – Energeia Review of costs and impacts associated with a communications infrastructure rollout report (Confidential)

Joint Submission of NSW DNSPs – Response to AER draft Shared Asset guidelines

Our submission provides comments on key elements of the AER's draft guidelines. At a high level we support the administrative simplicity and proportionate calculation of the AER's cost reduction method. We note, however, that the calculation may not be appropriate in all circumstances, particularly when the nature of the payment may not reflect a charge for the use of a shared asset. In these cases, we consider that the guidelines should allow a DNSP to exclude a particular service from the AER's calculation.

Our submission provides comments on the application of the shared asset mechanism, the materiality calculation, the cost reduction method, alternative methods, and reporting arrangements.

Application of shared asset mechanism

The AER states that *'the shared asset mechanism relates to assets whose costs were initially allocated to regulated services but come to be used to provide unregulated services as well. This change from expected use means the assets are earning both regulated and unregulated revenues. The assets therefore have become shared assets'.*[1]

We support this consideration, but suggest that the AER provide more clarity on the situations when the shared asset mechanism would apply. In our view, the mechanism should not apply to assets where a proportion of the capex had been allocated to unregulated services at the time of investment.

We are concerned with the AER's statement that assets may become subject to the shared asset mechanism when unregulated revenues vary compared with the asset's initial cost allocation. We consider that if the asset has already been allocated under the CAM, the assets should then not be subject to the shared asset mechanism. We consider that the application of the scheme in such instances would add significant complexity, given that the expected use of an asset for unregulated services is likely to vary from year to year.

If the AER were to consider including such assets within the scheme, there should be demonstration that the expected use of the asset has changed substantially since the initial allocation under the CAM.

We also wish the AER to confirm other instances where the mechanism should not apply:

- When transitioning to a new classification – In this case, the value of the standard control services asset base would already have been reduced to remove the newly classified assets from the standard control service asset base.

- Ancillary service fees - There could be instances where the revenue earned from the provision of unregulated services may include fees for ancillary services. For example, design related services for telecommunication carriers. We consider that these fees should be excluded from the scope of unregulated revenues earned from shared assets.

[1]Draft Shared Asset Guidelines, p7

Materiality

The shared asset principles state that a shared asset cost reduction should be applied where the use of the asset other than for standard control services is material. The guideline uses unregulated revenue earned from shared asset as the measure to indicate use of the asset and a threshold of 1% of annual revenue requirement as the threshold.

We support this approach to determining materiality. For certainty, we suggest the AER outline the formulae used in calculating the materiality threshold. Our understanding is that materiality is calculated by dividing the unregulated revenue from shared assets over the total annual revenue.

Cost reduction method

The NSW DNSPs support the inclusion of a transparent method for any cost reductions in the guidelines on the basis that it provides certainty to stakeholders. The AER has identified the following formula to calculate a deduction from the Annual Revenue Requirement. The formula equates to approximately a 9% reduction of unregulated revenue earned from shared assets. The AER also note the upper limit on potential cost reductions is a service provider's reasonable estimate of the regulated returns it earns from its shared assets.

*[0.1 * (unregulated revenue from shared assets/total asset revenue)] * (return on capital and return of capital from the regulated asset base).*

We support the AER's proposed method on the basis that it will be relatively simple to administer and will provide certainty to stakeholders. In our view, the administrative costs and complexity of adopting a more detailed method may outweigh the benefits of doing so.

While we support the simplicity of the scheme, we note that the method is relatively arbitrary as it does not give consideration to the underlying costs involved in providing the service. To understand our concerns in more detail, we note the AER's proposed method presumes that a DNSP will be earning a positive return from the use of a shared asset in all cases.

This assumption is not valid where there are high incremental costs in providing certain services. In these cases, the cost reduction method would result in a deduction in annual revenue that exceeds the actual benefit accrued by the NSP. This would provide poor incentives for the NSP to pursue such commercial incentives.

We would also not receive a positive return when the nature of a payment we receive from an external party is not based on a commercial arrangement for the use of an asset. A key example for NSW DNSPs is the arrangements under the Telecommunications Act for carriers to access facilities such as electricity networks. Whilst it is open for carriers and network owners to enter into commercially negotiated agreements for access, in the absence of such an agreement carriers may seek access on the basis of a facility access permit under which carriers are only required to compensate owners of facilities for "financial loss or damage to property".

Consequently while there is no restriction on carriers entering into commercially based arrangements for access, the default position under the legislative framework limits the incentives and opportunities for such arrangements. To provide the AER with more information, we have outlined the basis of our service arrangements with telecommunication carriers in Box 1 on the following page.

To address such situations, we consider that a DNSP should be allowed to exclude the revenue from the application of the shared asset guideline (including the materiality threshold) where the cost reduction exceeds the benefit derived from the shared asset. To do otherwise would lead to a DNSP being penalised through a reduction in the annual revenue requirement, without receiving a corresponding benefit. A DNSP would need to prove the application of the guideline would lead to an unfair outcome. Telecommunication carriers is a case in point, but the same principle should apply to any other case where costs are high relative to income or where costs exceed income.

In any case, we note that the sharing benefit ratio should be capped at 10 per cent to mitigate the risks arising from the arbitrary nature of the AER's proposed method. A higher sharing proportion would lead to the following risks:

- Reduce or eliminate the incentive for NSPs to provide unregulated activities, in which case we would not be able to share any benefits with our customers.
- Not meet the revenue and pricing principles in the National Electricity Law in relation to the opportunity for an NSP to at least recover its efficient costs.

Alternative methods

We seek clarity from the AER on the flexibility an NSP has to propose an alternative cost reduction method. Our understanding is that an alternate method also includes the varied application of the AER's proposed method to recognise particular circumstances of the DNSP. We would support this principle. This would provide a mechanism for a DNSP to demonstrate when a type of payment received from an external party (such as telecommunication carriers) is not appropriate to be included in the cost reduction method proposed by the AER.

We are concerned that the AER proposed to assess alternative methods using a poorly defined 'no worse off' definition of consumer interests. We consider this may lead to an arbitrary test where the alternative method is compared to the outcomes of the AER's default method, and will only be accepted if the customer is better off. In our view the test for an alternative method should be based on satisfying Rule 6.4.4 and the shared asset principles. Such a test would be undertaken with regard to the National Electricity Objective, taking into account the Revenue and Pricing Principles.

Box 1 - Telecommunication service arrangements

The Telecommunications Act 1997 (the Act) and its subsequent amendments conveys current and past Federal Government Policy to facilitate competition in the Telecommunications Industry and expedite the rollout of infrastructure. It has bestowed special powers upon Telecommunications Carriers over Public and Private parties with respect to their land and asset tenure rights and compensation requirements.

Specifically, Schedule 3 of the Act provides rights for Telecommunications carriers to enter land to inspect, maintain and install certain types of facilities. This includes land and assets owned by Electricity Network Operators. These rights apply to 'Low Impact Facilities' as designated by the Telecommunications (Low-Impact Facilities) Determination 1997 (the determination).

Schedule 3 of the Act specifies the Network Operator is entitled to recover the demonstrable loss and damage incurred from the carrier exercising such immunities and powers. If an appropriate amount of compensation cannot be agreed upon the amount is determined by the courts. This Act may lead to the telecommunications customers paying less than the marginal cost of using the electrical asset as many of these costs are difficult to itemise or are of an indirect nature.

The determination and Telecommunications Regulations 2001 were amended in December 2011 The changes specifically increased carriers powers to deploy fibre in the street, connect premises and locate equipment in multi-unit buildings. A further amendment was made to the determination in 2012 to include ancillary facilities needed to support the operation of a low-impact facility.

A number of operating agreements currently exist between Telecommunications carriers and Network Operators influenced by the terms of the prevailing legislation of the time and as current. In light of the powers and immunities of the carriers, the agreements entered into have been done from a limited position of bargaining power and are reflective of this circumstance. Such arrangements are generally established without any triggers for renegotiation of the costs or charges recovered from Telecommunications Carriers reflecting the bargaining power at the time the arrangements are made.

Reporting requirements

The draft guideline includes an outline of the annual and determination specific reporting requirements. We seek clarity on the reporting mechanisms that the AER intends to use. Currently the guidelines note the information will be gathered via the annual Regulatory Information Notices (RINs) and *'other appropriate mechanisms'*.

The NSW DNSPs acknowledge the need to provide this information to allow the AER to understand the unregulated services subject to sharing and confirm the associated revenues. However, it should be noted that revenue and volume forecasts will be uncertain and subject to change.

The NSW DNSPs also note that some of the information required may be commercially sensitive or subject to non-disclosure agreements. The NSW DNSPs will provide information within these constraints and endeavour to ensure the AER can make an accurate assessment.