13 September 2013

Mr Chris Pattas
General Manager, Network Operations and Development
Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

Dear Chris

Draft Shared Asset Guidelines

SA Power Networks, CitiPower, and Powercor Australia (**the Businesses**) welcome the opportunity to make this submission to the Australian Energy Regulator (**AER**) in relation to its Draft Shared Asset Guidelines.

The Businesses are broadly supportive of the Draft Guidelines and note the AER's proposed implementation of the Guidelines as detailed in the accompanying Explanatory Statement.

The Businesses also support the matters raised by the Energy Networks Association in its response to the Draft Guidelines.

Definition of Shared Asset Unregulated Revenues

The Businesses note that the guidance provided by the AER in respect of the assessment of the value attributable to "shared asset unregulated revenues" in the Draft Guidelines' cost reduction method[1] (the substance of the materiality test in the method) will be crucial to ensuring that the use of revenue as a materiality test is appropriate.

The AER has defined shared asset unregulated revenue as "revenues paid to a distributor for unregulated services provided using the distributor's shared assets".[2]

The AER has provided additional guidance in section 3.3.1 of the Explanatory Statement, recognising that unregulated services may use shared assets in a very limited way. The AER has indicated that in such cases service providers should focus on the unregulated revenue stream derived from an unregulated service, and apportion unregulated revenues to reflect the extent to which unregulated services rely on shared assets. Service providers will need to set out their reasons for apportioning revenues and the basis on which they have done so. Where the apportionment reasonably reflects shared asset use, the AER will accept it as an element of their cost reduction determination.[3]

1 Draft guidelines, section 4.1.b.iv.
2 Draft guidelines, Glossary.
3 Explanatory statement, p21.

The Businesses support the concepts expressed in this section of the Explanatory Statement. As noted above, a reasonable apportionment of revenue is crucial to ensuring that the use of revenue as a materiality test is appropriate, and to give effect to clauses 6.4.4(c)(1) and (3) of the National Electricity Rules.

The Businesses also support the propose/respond framework for the apportionment of unregulated services revenue to appropriately reflect the relative recovery of shared asset costs. Service providers should be allowed the flexibility to present and support their proposals in the way most appropriate to the services concerned.

The Businesses believe that for clarity, the guidance provided in section 3.3.1 of the Explanatory Statement should be included in the Final Guidelines.

Example of shared asset unregulated revenue

The Businesses understand that in practice, therefore, shared asset unregulated revenue would be the sum of:

- all of the unregulated revenue earned from services that rely on the use of regulated assets (such as pole rental and other facilities access or asset rental services); and
- for each unregulated service that uses regulated assets only marginally or occasionally (such as the use of vehicles or buildings to provide unregulated project management, maintenance, or external training services), the portion of that revenue that reflects the extent to which the service recovers the asset costs of relevant shared assets.

As noted in the following section, the separation of the two classes of shared asset services into those that rely on regulated assets and those that do not, is a necessary component for the valuation of shared asset unregulated revenue.

Draft methodology for apportioning revenue where the unregulated services use shared assets only marginally

The Businesses have given a significant amount of consideration to potential methods for the apportionment of revenue from shared asset services that are consistent with the Draft Guidelines and Explanatory Statement, and with the Rules.

The Businesses note that for unregulated services that use shared assets only marginally, it is important that the method of apportionment be transparent and clearly appropriate to the task, which is effectively to determine a fair rent for the use of assets that reflects the asset cost recovered through unregulated services revenue.

The Businesses' unregulated services that use shared assets only marginally are diverse, and are neither uniform nor regular in their use of shared assets. For the sake of simplicity therefore, the Businesses would prefer an apportionment methodology that is based on the regulated assets used, and which is appropriate for application to unregulated services consistently, whether they are aggregated or separately identified.

Clause 6.4.4(a) of the Rules says that the AER *may* reduce the ARR by an amount it considers *reasonable* to reflect the costs of an asset the Network Service Provider (**NSP**) is recovering by charging for an unregulated service. The Businesses believe the use of the words may and reasonable in this clause gives the AER significant discretion to approve a simple, reasonable, and effective revenue apportionment methodology.

The Businesses consider that a methodology such as the one outlined in Table 1 is appropriate for the apportionment of unregulated revenue from services not reliant on regulated assets for the purpose of valuing shared asset unregulated revenue.

Table 1. Apportionment of unregulated revenue to determine shared asset unregulated revenue

1) Identify all unregulated services

2) Identify unregulated services that use shared assets

3) Classify shared asset unregulated services as either reliant on the use of shared assets or using shared assets only marginally

4) Allocate 100% of the revenue of shared asset unregulated services reliant on the use of shared assets to shared asset unregulated revenue

5) Apportion the revenue of shared asset unregulated services using shared assets only marginally as follows:

   a) Identify whether the service uses any of regulated buildings, information technology, or vehicles (asset class), e.g.

Regulated Asset Class	*Service 1*	*Service 2*	*Service 3*	*Service n..*
Buildings	Y	Y	N	..
Information Technology	Y	Y	Y	..
Vehicles	Y	N	N	..

   b) Identify the revenue received that is relevant to the regulated assets being utilised (i.e. the "Y"s above). In many cases this will be a cost build-up calculation as this is likely to reflect how the prices for these services are determined, and therefore how the subsequent revenue is actually recovered.

6) Allocate 100% of the total calculated at 5) b) to shared asset unregulated revenue

7) Shared asset unregulated revenue will be the sum of steps 4) and 6) above.

The Businesses believe that the above methodology is appropriate for its intended purpose and will deliver reasonable outcomes. It is functionally simple and it focuses on revenue. It reasonably reflects the recovery of asset costs via the revenue from unregulated services. It is consistent with the Businesses' derivation of unregulated revenue.

Cost reductions method

The Businesses are broadly supportive of the cost reduction method set out in the Draft Guidelines, subject to the cost sharing proportion being appropriate.

The cost sharing proportion is the critical element of the methodology. The Draft Guidelines have proposed a sharing proportion of 10%. The Businesses believe that reducing service providers' annual revenue requirements by 10% of shared asset unregulated revenue is at the upper limit of what could be considered reasonable.

The cost sharing proportion of the cost reduction method appears to be the Draft Guidelines' only practical manifestation of the first shared asset principle[4] that service providers should be encouraged to offer additional services from shared assets while not prejudicing the provision of

4 Clause 6.4.4(c)(1) of the Rules.

direct control services. As noted below, to the extent that the Guidelines are inconsistent with this principle, they will drive inefficient outcomes that will be detrimental to all stakeholders.

The Businesses believe that any sharing proportion higher than 10 per cent of shared asset unregulated revenue is unreasonable, given that the Draft Guidelines' cost sharing method does not have regard to the incremental costs, including corporate tax, associated with the provision of shared asset unregulated services.

The Businesses believe that larger sharing proportions will act as yet further disincentives for service providers to offer unregulated services and this will likely drive inefficient behaviours which are inconsistent with the National Electricity Objective.

Excessive sharing proportions will cause service providers to inefficiently substitute away from the use of regulated assets that are not relied on for the provision of unregulated services. Further, NSPs, where contractually possible, will withdraw from the provision of unviable unregulated services. These outcomes will be detrimental to both service providers and regulated services customers, as fixed overhead costs otherwise allocated to these services will have to be met fully by regulated services customers rather than be shared with unregulated services.

In addition, the use of a bright line, revenue-based materiality threshold creates similar issues. NSPs close to the materiality threshold which face an excessive sharing proportion are also likely to exhibit similar inefficient behaviour (ie substituting away from use of shared assets for the provision of unregulated services).

The cost sharing proportion is the manifestation of a number of simplifying assumptions. It applies to all unregulated shared assets services, and it is based on revenue rather than actual physical use. The Businesses believe that for the sharing proportion to work effectively as the AER intends and to give effect to clauses 6.4.4(c)(1) and (3) of the Rules, it must be set at a reasonable level to reflect the relative cost and risks of providing these services and that service providers have significantly diverse portfolios of these services.

Confidentiality of information

The Businesses note the proposed information reporting requirements set out in the Draft Guidelines. We firmly believe that all financial and contractual information provided to the AER in connection with shared asset unregulated revenues must be treated as strictly confidential.

We would be pleased to discuss this submission, or any of the recommendations made in it, at your convenience.

Yours sincerely

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