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Mr Chris Pattas
General Manager
Network Regulation South Branch
Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

Email: aerinquiry@aer.gov.au

Dear Mr Pattas

PROPOSED ELECTRICITY DISTRIBUTION NETWORK SERVICE PROVIDER GUIDELINES

Thank you for the opportunity to comment on the Australian Energy Regulator's (**AER**) proposed distribution network service provider guidelines (**Proposed Guidelines**). CitiPower and Powercor Australia (**the businesses**) are Victorian electricity distributors transitioning to the national regulatory framework.

Please find attached a paper outlining the businesses' comments on the issues raised by the Draft Guidelines.

Should you have any further questions in relation to this submission, please do not hesitate to contact Brent Cleeve on (03) 9683 4465.

Yours sincerely

[signed]

Richard Gross
GENERAL MANAGER REGULATION

1. Efficiency benefit sharing scheme

The businesses believe a number of the features of the proposed efficiency benefit sharing scheme (**EBSS**) warrant further consideration. These include:

- the carry forward of negative amounts into the following regulatory period;
- the exclusion of capital expenditure from the EBSS; and
- the absence of incentives for distributors to continue to pursue further efficiencies.

Each of these issues is discussed in detail below.

1.1 Negative carry forward

Clause 6.5.6(c) sets the *operating expenditure criteria* the AER is to apply in considering a distributor’s forecast operating expenditure. Those criteria, amongst other things, require the AER to allow for ‘efficient and prudent costs’ of a distributor in meeting the *operating expenditure objectives* set out in clause 6.5.6(a). Applying the *operating expenditure criteria*, it must be assumed that at the conclusion of a regulatory review, the final operating expenditure benchmarks determined by the AER reflect the efficient and prudent costs of managing the distribution network.

Subsequent to the conclusion of a regulatory review, a distributor may be required to spend more than the AER approved benchmarks. This could arise through a variety of circumstances that may or may not result in adjustments to the AER determined benchmarks. Under such circumstances the distributor will be penalised at the time the overspend occurs, as it only receives the revenues commensurate with the AER determined benchmarks. In other words, it is immediately penalised through lower returns. In addition to this penalty, it will be penalised again under the Proposed Guideline through a negative adjustment to its revenues in the subsequent regulatory period.

The *Proposed Electricity Distribution Network Service Providers Efficiency Benefit Sharing Scheme Explanatory Statement* (**Explanatory Statement**) appears to suggest it has addressed the circumstances where an overspend is the result of factors outside the control of management. This is through the extension of adjustments to operating expenditure benchmarks to include agreed uncontrollable costs. This is not the case.

Implicitly or explicitly the process and principles to be applied in establishing expenditure benchmarks under the Rules involves an assumption – to the satisfaction of the AER - that all forward-looking efficiency gains will be realised. In practice, this typically involves adjusting a base level of operating expenditure by the CPI, which incorporates an economy-wide efficiency adjustment. Further, most Australian regulators have chosen to add on an explicit efficiency or productivity factor, over and above that implied by the CPI. These adjustments are in generally applied over and above the operating expenditure forecasts submitted by the distributor that, in themselves, have been prepared by reference to the efficient and prudent benchmark to gain AER acceptance.

This process has the consequence that the operating expenditure benchmarks approved by the AER are already ‘loaded’ against the distributor. In other words, given that they already potentially include both implicit and explicit assumptions with respect to productivity (which of themselves are subject to error), there is a real possibility (likely to be around 50 per cent) that a negative carry over will arise not by virtue of the distributor failing to achieve efficiencies, but rather because it was unable to match the efficiency assumptions made by the AER, which the price determination has ensured will already been returned to customers.

In reaching the conclusion that negative pass through amounts should be carried forward, the AER has made reference to clause 6.5.8(c)(3) that refers to the desirability of both rewarding and penalising distributors for efficiency gains/losses. It has also made reference to clause 6.5.8(c)(2) that requires a continuous incentive to reduce operating expenditure (the AER has inferred this clause requires symmetry of the scheme although this is not stated in the clause).

The businesses contend that neither of the requirements of these clauses can be met if productivity or efficiency assumptions are implicitly or explicitly included in the approved operating expenditure benchmarks. This is because distributors are only rewarded for the portion of efficiencies over and above that assumed by the AER. Such a scheme cannot be considered symmetric since, on the balance of probabilities, an efficiency loss (as measured against the operating expenditure benchmark) has the same or similar likelihood of occurring and should this circumstance occur, there is effectively a double penalty through lower returns in the immediate regulatory period and a negative carryover in subsequent regulatory periods.

The AER states that even allowing for negative carryover amounts, the overall permitted revenue allowance may still be commensurate with providing distributors a reasonable opportunity to recover its efficient costs. This position holds true only if operating costs in the next regulatory period are determined by reference to revealed fourth year costs. Such an outcome can not be guaranteed since the AER must be satisfied that future operating expenditure meets the 'efficient and prudent costs' standard, as provided for in clause 6.5.6(c) of the NER. The AER confirmed at recent Guidelines Forum held on 23 April that it would not necessarily be using fourth year costs as representative of the starting point for operating expenditure in the next regulatory period.

On this point, it is also worth drawing a distinction between the approach taken by the Essential Service Commission of Victoria (**ESCV**) and the AER. The ESCV model is predicated on the acceptance of outturn costs in the fourth year. It has not contemplated or sought to impose averaged costs or alike as the basis for establishing future operating costs. The NER does not bind the AER to use outturn fourth year costs nor has the AER sought to bind itself. Thus, the same risk identified by the businesses in relation to the Issues Paper remains. That is, operating costs maybe established by alternate means to outturn fourth year costs resulting in a less than reasonable revenue allowance.

The AER states it is concerned the requirement of 6.5.8(c)(2) is not met in the absence of a negative carry forward as distributors would have an incentive to shift costs into the fourth year of the regulatory period. Such a conclusion implies the AER will accept costs that are not otherwise prudent and efficient which is inconsistent with the AER requirements under the *operating expenditure criteria*. The businesses therefore believe the AER has powers to make adjustments to fourth year outturn operating expenditure should it believe the costs are not efficient or prudent hence it can address any inappropriate incentives. In other words, there already exist, within the NER provisions, tools to address the incentive issues raised by the AER.

The Proposed Guidelines are ambiguous as to the period over which any negative carry over will be carried forward. The businesses seek clarity that the Proposed Guidelines will apply only from commencement of the next regulatory period (in Victoria's case 2011-15) and that the efficiency carry over calculations for the current regulatory period will be governed by the relevant jurisdictional regulator decision at the previous price reset.

1.2 Including capital expenditure in the EBSS

The businesses believe that the AER's conclusions with respect to the inclusion of a capital element in the EBSS have ignored the realities faced by distributors operating under such schemes. For example:

- deferral of capital expenditure remains an option only to a certain point, after which service standards start to decline resulting in offsetting penalties through the Service Incentive Scheme and low levels of public satisfaction with the distributor's performance;
- capital expenditure EBSSs operating in Australia have been relatively low powered, incorporating only the time value of the capital deferred for 5 years; and
- in determining capital expenditure for subsequent regulatory periods, regulators have invariably considered outturn capital expenditure in the previous regulatory period as a basis for the next regulatory period, eliminating the possibility of 're-submitting' deferred projects.

The businesses reiterate that the efficient deferment of capital expenditure is in the long term interest of consumers as it lowers the cost of providing network services. Deferment can only have a negative consequence to consumers if it results in lower levels of network service performance. This concern has been addressed by the AER through the proposed service incentive scheme which ensures that networks have a strong incentive to maintain (and when feasible improve) network service performance.

1.3 Sharing of efficiency gains

One of the key arguments presented for not allowing multipliers or a longer carryover period relate to the proposed EBSS excluding capital expenditure. The concern cited is that with the exclusion of capital expenditure from the EBSS, increasing the sharing ratio for operating costs efficiencies may result in the inefficient substitution of operating expenditure by capital.

While this may be true, it should not be a basis for stifling the pursuit of further efficiencies in the distribution sector. The businesses believe that as the industry matures, the scope for large and cost effective efficiency gains will diminish. This increases the importance of having adequate incentives for both operating and capital expenditure efficiency. In the absence of a multiplier scheme the efficient frontier will stagnate to the detriment of the community and industry.

2. Service incentive scheme

2.1 Exclusions

The Proposed Guidelines propose the exclusion of Major Event Days defined in the IEEE standard 1366-2003, *IEEE Guide for Electric Power Distribution Reliability Indices*, to limit a distributor's exposure under the Service Incentive Scheme to extreme weather and other events. As the businesses understand it, the IEEE standard is based on SAIDI.

The businesses agree that SAIDI is the single best indicator of the magnitude of an event but also believe such an approach has a serious deficiency in that it may overlook widespread events affecting a large number of customers for relatively short duration which may nonetheless be very significant in terms of customer cost of unreliability. A refinement to address this concern could include separate SAIFI and SAIDI thresholds (SAIFI > "X" or SAIDI > "Y") to identify the events to be excluded using the 2.5 beta method described in Appendix D of the proposed Service Target Performance Incentive scheme. This approach could take into account the type of event that may be very widespread but of relatively short duration in addition to events that are less widespread but may be associated with long duration times. For example, the catastrophic loss of a single zone substation due to some completely unforeseeable cause should be considered for exclusion but would be unlikely to trigger the SAIFI criterion. However, it may have a long duration and therefore trigger an appropriate SAIDI criterion.

It is also understood that the IEEE standard 1366-2003 is based on SAIDI measured over a day defined as a 24 hour period commencing and ending at midnight. Experience in Victoria has demonstrated mandating commencement and end dates may result in arbitrary outcomes that can bias against individual distributors. For example, a storm front may commence passing through western Victoria at 9 am reaching the east of the State by 9pm. In this example the distributor in the west of the State may be successful in getting an exclusion because the impact of the storm falls within a single day but the distributor in the east, where the impact of the storm may be spread either side of midnight, may be unsuccessful because the impact of the storm is spread across 2 days. Such an outcome is manifestly arbitrary hence the businesses believe the measure should be amended to avoid this risk To avoid excessive data overheads it may be practical to design an exclusion mechanism based on a rolling 24 hours based on two periods of 12 hours each or a rolling 48 hour period based on two periods of 24 hours.

2.2 Supply interruptions caused by a failure of upstream connected network

For the same reasons a distributor should not be liable for failure of the transmission network and transmission connection assets, it should not be held responsible for the failure of any other upstream network such as an inter distribution connection.

The businesses note such an approach is consistent with that of the United Kingdom Office of Gas and Electricity Markets who exclude the failure of 'other connected networks' from Service Incentive Scheme on the basis the event is outside the distributor's control[1].

2.3 Inclusion of planned interruptions

The Proposed Guidelines state an intention to include planned SAIDI as part of a total SAIDI measure. The businesses do not believe planned SAIDI should form part of the Service Incentive Scheme as it creates a clear tension with safe work practices i.e. may encourage the greater use of 'live line' techniques and the increase in safety initiatives across the industry. This argument was accepted by the ESCV at the 2006-10 EDPR and planned SAIDI was subsequently removed from the Service Incentive Scheme.

Inclusion of planned SAIDI may also create incentives for distributors to inefficiently defer maintenance on the network. Before undertaking work on the network, the distributor would need to consider the impact of that work on the Service Incentive Scheme against, in the absence of that work proceeding, the possible impact of an outage. It is generally accepted that customers value a reduction in unplanned interruptions more than a reduction in planned interruptions. To the extent the same incentive rate applies to planned and unplanned SAIDI (as is proposed) this may result quite distorted outcomes from a societal perspective.

If the AER wishes to persist with planned SAIDI, it should be included as a separate indicator rather than a combined measure as the customer impact of planned interruptions is significantly less than for unplanned interruptions, and therefore the incentive rate for planned SAIDI should be less than for unplanned SAIDI.

2.4 Interaction of the Service Incentive Scheme with P_0 adjustments

A P_0 adjustment is designed to bring final year tariffs back into alignment with out turn costs. However in the case of Victoria, which already operates a Service Incentive Scheme, the use of final year tariffs as a starting point, which includes a revenue reward (penalty) for improved (deteriorating) service performance will effectively remove any benefits (penalties) derived by the distributor from service improvements (deterioration) made.

To preserve the incentives of the Service Incentive Scheme, the AER needs to ensure its Guideline specifies an adjustment to either the P_0 (as was the approach adopted by the Essential Services Commission of Victoria at the 2006-10 EDPR) or to the S factor applied in the subsequent regulatory period such that the dollar impacts of the S factors are consistent across regulatory periods.

2.5 Revenue at risk

The proposal provides that "the sum of all the S-factors for all parameters must lie between +3% and -3%". It should be made clear that the "sum of all the S-factors" is

1 Ofgem Final Proposals 265/04 (section 4.20)

a reference to the S'_t term in equation 4 of Appendix C and not to the S_t term in equation 1, otherwise the constraint may unintentionally become binding due to the effects of past years or the operation of the S-bank.

2.6 Customer service component

The businesses note the inclusion of “response to written enquiries” and “notice of planned interruptions” as possible parameters for inclusion in a performance incentive scheme.

The businesses receive relatively few written enquiries. The vast majority of enquiries are received through the call centre, which is already included as part of the Service Incentive Scheme. This parameter would not seem to be worthy of inclusion in a performance incentive scheme.

The notice of planned interruptions is a regulatory obligation to be complied with at all times. It is difficult to see how this could fit into an incentive scheme as there is simply no headroom for improvement above the regulatory floor.

Section 5.3.2 of the Proposal provides for an incentive rate for the telephone answering parameter of .040. Given that the formulation of the S'_t equation is based on (Target – Actual), this incentive rate should be expressed as a negative number to provide a positive incentive for improved performance.

2.7 Guaranteed service levels (GSLs)

The Proposed Guidelines include as part of the GSL scheme response to written enquiries. The businesses do not support the inclusion of such a measure as it is potentially open to abuse and does not reflect how the majority of customers interface with distributors today.

The businesses receive relatively few written enquiries. The vast majority of enquiries are fielded through the call centre, which is already included as part of the Service Incentive Scheme. Should response to written enquiries form part of the GSL scheme there is a potential incentive for a minority of customers to commence making written enquiries which maybe of a frivolous nature in order to secure multiple $50 payments. It is not in the interests of the majority customers or the business for payments to be made in such circumstances.

As a consequence the businesses believe responses to written enquiries should be removed as a potential GSL.

2.8 The AER would like views on its proposal to set the overall cap on the s-factor at 3% of revenue.

The businesses believe this is a practical measure to cap the risk faced by distribution businesses, particularly if there are two abnormally bad years in succession such as may occur due to weather. It also helps to limit the adverse effects of the asymmetry inherent in the way the S-factor is incorporated into the price control.

2.9 The AER would like views on how the s-factor should be incorporated into the form of control

The businesses note that the form in which the S-factor is incorporated into the price control is essentially asymmetric. For example, starting with a unit price of 10 and an S-factor of minus 20 per cent due to bad weather, the subsequent price is reduced to 8. Assuming a subsequent recovery to the original performance level, this would provide an S-factor of plus 20 per cent resulting in a price of 9.6 rather than the 10 expected under a full recovery scenario.

This issue has been of concern to the businesses in relation to the current Victorian S-Factor scheme, however its effect is significantly mitigated by the proposed +/-3% cap on the S-factor impact for any year.

2.10 The AER would like views on the proposed timing of the incentive and the impact of requiring all reporting on a calendar year as proposed.

The businesses have no issues with the proposed timing assuming that a 12 month delay means, for example, that the out-turn results for the year ended 31 December 2007 will affect the prices from 1 January 2009.

The businesses also draw to the AER’s attention a typographical error in table 2 which provides a date of 1 January 2010 as the start of the next regulatory period for Victoria, this should be 1 January 2011.

3. Cost allocation guidelines

With respect to the Victorian Cost Allocation Guideline, the businesses are unclear as whether it is intended to apply to every line item on the Profit and Loss Statement, Balance Sheet and Cash Flow Statement or only to those items that are required by the AER to implement the NER.

The NER do not appear to require information on items such as actual tax expense, deferred tax asset, deferred tax liability, borrowings, interest, contributed equity, reserves, retained profits, dividends, cash, receivables, creditors, prepayments, derivatives, retirement benefits, bank overdraft, etc, but rather only on items relating to operating, maintenance and capital expenditure