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10 January 2008

Mr Steve Edwell
Chairman
Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

Dear Mr Edwell

AER Preliminary Positions Paper
Matters relevant to distribution determinations for ACT and NSW DNSPs for 2009-2014

EnergyAustralia is pleased to respond to the AER's preliminary positions paper (Paper) on guidelines, schemes and models that it is required to consider for the NSW/ACT businesses under the new National Regulatory Framework.

The matters on which the AER is seeking feedback form an integral part of the regulatory regime and the regulatory proposal that EnergyAustralia will be required to submit to the AER in June 2008. EnergyAustralia looks forward to working closely with the AER on these issues and other elements critical to the development of our regulatory proposal.

I wish to raise the following concerns in respect of this Paper and the AER's consultation processes:

- The recent Gazettal of the Transitional Rules under which the 2009-2014 distribution determinations will be conducted has required the AER's consultation to be carried out in an extremely compressed time frame. Notwithstanding the AER's efforts in conducting less formal consultation with stakeholders over recent months, the time available to review the preliminary positions has not been sufficient for EnergyAustralia to undertake a comprehensive review.
- The AER has stated in some forums that any response must acknowledge the precedent provided under regulatory arrangements for Transmission. EnergyAustralia believes previous consultation on some similar matters in relation to transmission (Chapter 6A) should not be construed to be relevant to the current consultation, in view of the significant differences between transmission and distribution networks and the overall lack of engagement of other DNSPs in the transmission consultation process.
- Likewise, consultation with the NSW and ACT DNSPs in developing the transitional Rules should not be construed to be part of the consultation under Chapter 6.

I note that this Paper is the first and only opportunity to formally consult with stakeholders, however EnergyAustralia is pleased that the AER has undertaken to continuously discuss matters with stakeholders until the AER is required to make its final decisions between 1 February and 1 March.

Partner

EnergyAustralia's detailed comments on the AER's Paper are included as an attachment to this letter. Recognising the importance of the matters covered and the need for further discussion and clarification on matters of detail, EnergyAustralia intends to make full use of the open dialogue foreshadowed in the Paper.

If you have any questions concerning EnergyAustralia's response, please feel welcome to contact me on 02 49519411 or Mr Harry Colebourn on 02 9269 4171.

Yours sincerely,

Geoff Lilliss
A/ Managing Director

Attach

Attachment: EnergyAustralia's comments on the AER Preliminary Positions Paper Matters relevant to distribution determinations for ACT and NSW DNSPs for 2009-2014

1. Introduction

EnergyAustralia is pleased to respond to the AER preliminary positions paper (the Paper) on guidelines, schemes and models that it is required to consider for NSW/ACT businesses under the new National Framework.

The matters the AER seeks feedback on form an integral part of the regulatory regime and the regulatory proposal that EnergyAustralia is required to submit to the AER in June. EnergyAustralia looks forward to working closely with the AER on these issues and other elements critical to the development of our regulatory proposal.

Given the short turnaround for responses, particularly in light of the recent Gazettal of the Transitional Rules under which the 2009-2014 distribution determinations will be conducted the AER's Paper and EnergyAustralia's response has not received the detailed consideration it deserves. Our response therefore represents a preliminary view from EnergyAustralia. We note that this Paper is the first and only opportunity to formally consult with stakeholders, however EnergyAustralia notes that the AER has undertaken to continuously discuss matters with stakeholders until the AER is required to make a final decision by 1 March.

Recognising the importance of the matters covered in the Paper and the need for further discussions and clarifications of matters of detail and areas of suggested changes in this response EnergyAustralia intends to make use of the open dialogue promised in the Paper.

2. Regulatory framework for ACT and NSW 2009-2014 distribution determinations

The release of this Paper establishing the AER's preliminary positions, rather than seeking general comment prior to the AER developing its initial positions, appears to be predicated on the basis that the topic areas have been consulted on previously as part of the Chapter 6A transmission arrangements.

EnergyAustralia recognises the significant work undertaken by the AER in preparing these and other guidelines to meet the incredibly tight deadlines imposed under the Rules. We have also appreciated early engagement on these guidelines with AER staff. These time frames are constricting on all stakeholders.

Whilst recognising constraints placed on the AER under the timetable imposed under the Rules, EnergyAustralia has reservations with the characterisation and focus of the AER's Paper and the level of consultation on those position papers.

EnergyAustralia is well aware of the similarities and fundamental differences between distribution and transmission networks. These differences cannot be adequately addressed if the AER's approach to transmission regulation under Chapter 6A is simply applied to distribution regulation under Chapter 11 without modification. EnergyAustralia is particularly concerned that as the transitional Rules were only Gazetted on 20 December 2007, it has not been able to satisfy itself that the all matters covered in this submission fully reflect and are fully compliant with Chapter 11 of the Rules. EnergyAustralia will continue to review the preliminary positions (particularly the PTRM and RFM) for consistency with the Rules. As a result, EnergyAustralia intends to avail itself of the AER's commitment in the paper that it will continue to consult with stakeholders until a final decision is made.

Recognising that there are material differences between the Chapter 6A and Chapter 11 Rules and between transmission and distribution networks, EnergyAustralia does not believe that it is appropriate to place significant weight on previous transmission consultations undertaken by the AER on the matters covered by the Paper. Similarly, the matters discussed at the consultation session held on 21 June 2007 (referred to in section 1.3 of the paper) were under embargo and in

any case had not been developed to incorporate or reflect the transitional arrangements which had been announced by the MCE, and in any case the timing of this consultation obviously mean that it did (and could) not be directly related to the Rules that will now apply to the forthcoming review process. That consultation session was therefore of very limited relevance and utility. EnergyAustralia believes that the current round of consultation by the AER should be considered as the first real opportunity for stakeholders to comment on these matters, and should be characterised as such.

EnergyAustralia recognises that the AER has consulted on many of these matters previously with the transmission networks, and although EnergyAustralia has been involved in these discussions are concerned at the potential for the AER to give this undue weight, given the differences between distribution and transmission networks and the overall lack of engagement in this debate by other DNSPs.

EnergyAustralia has been an active participant in discussions with the AER and the submitting DNSPs on the transitional arrangements over the past 6 to 12 months, and has welcomed the opportunity to discuss issues affecting DNSPs that the AER has not had to address previously. EnergyAustralia would like to note however, that the consultation to date has been focused on the transitional phase and that this consultation and the transitional arrangements should necessarily establish regulatory precedent for the approach to be adopted under Chapter 6 of the Rules.

EnergyAustralia accepts that the timing of decisions imposed on the AER by the Rules has necessitated truncated consultation for these matters. However, EnergyAustralia is firmly of the view that such an approach should not establish a precedent for future consultations.

3. Post tax revenue model

EnergyAustralia has a range of comments arising from the most recent version of the PTRM and AER's Paper. As discussed above, EnergyAustralia must emphasise that while it provides these comments it has been unable to undertake a full review of the PTRM within the context of the transitional Rules Gazetted 20 December 2007. EnergyAustralia will continue to review the PTRM and will continue to maintain an open dialogue with the AER on these matters, until such time as it makes a formal decision on the PTRM as required by the transitional Rules.

The following comments are directed at various sections within the Paper, using the same headings.

2.1 Requirements of the NER

The purpose of the PTRM is to set out the manner in which the DNSP's annual revenue requirement for each regulatory year of the regulatory control period is to be calculated. This may not precisely equate to a model to be used to perform building block calculations as stated at 2.1 of the Paper.

Specifically, this comment recognises that the PTRM as constructed by the AER is merely a default model for performing the building block calculations. As was raised by EnergyAustralia with respect to the development of the PTRM for transmission under Chapter 6A the Rules specify the requirements for calculating the building blocks. In applying those requirements there are several areas where more than one method of calculation will in fact be compliant with the Rules, the most obvious being the approach to calculating depreciation. It is well known that there are a range of methods that businesses can adopt to recognise the consumption of the economic potential of assets over time. Each of these methods will be compliant with the Rules in the appropriate circumstances. Therefore as part of their regulatory proposal, DNSPs will be required to submit their forecasts of depreciation to be included in the calculation of the annual revenue requirement and ensure that the method used to derive that forecast is documented and compliant with the Rules.

Therefore it is clear that the PTRM, while providing a Rule compliant calculation methodology that may be used by DNSPs, does not provide all available methods that the Rules allow to undertake the building block calculations.

For the sake of certainty, EnergyAustralia believes that the AER should clearly articulate those areas of the PTRM where the AER has made a policy decision as to its preferred approach to calculating the building blocks, but are nonetheless merely a default compliant approach to calculating the building blocks.

2.1.1 Building blocks – appropriate method to determine inflation to be submitted as part of a DNSP's regulatory proposal, not determined through a guideline

As part of making a building block determination, the AER must specify the appropriate method for indexing the regulatory asset base. This would include the appropriate measure of inflation for the period and must be made in the context of the regulatory proposal. EnergyAustralia believes the RIN and these guidelines must allow DNSP as part of its regulatory proposal to establish what it believes it the appropriate measure of inflation. The consideration of the inflation approach should therefore be outside the guidelines.

EnergyAustralia understands that this is consistent with the AER's approach to including forecast inflation within the PTRM where it will be an input provided by the DNSPs and will not be specifically calculated by the PTRM.

2.1.4 Pre-tax to post-tax

EnergyAustralia supports the approach proposed by the AER that firm specific issues within the context of the National Tax Equivalent Regime (NTER) should be accepted when forecasting the corporate income tax expense over the 2009-2014 regulatory period.

EnergyAustralia also supports the AER not considering adjustments to future revenues based on differences between the AER's approach to calculating income tax expense and those of previous regulators which would not be permissible under the Rules.

2.1.3 Capital contributions

The requirements of the Rules as described by the AER are consistent with the current treatment of capital contributions under the IPART regulatory regime. It should be noted that EnergyAustralia does not include capital contributions as part of its capital expenditure, as capital contributions do not involve expenditure by EnergyAustralia, rather they are reported separately. In the most recent PTRM, it would appear that the AER has assumed that capital expenditure is inclusive of capital contributions, which in EnergyAustralia's case it clearly is not. EnergyAustralia proposes that it is appropriate for it to continue its reporting of capital expenditure exclusive of capital contributions and to report capital contributions received separately. Therefore EnergyAustralia submits that the AER should review its PTRM accordingly to maintain consistency with the current arrangements and to preserve transparency in annual capital expenditure and capital contributions received.

While many of these assets form part of the standard control service, Part K does not allow DNSPs to recover regulated revenue from assets contributed by users. These assets contributed by owners are therefore excluded from the RAB for the purposes of determining allowed revenues. However any investment by the DNSP to maintain, augment or replace the asset is recoverable. The approach under Park K is consistent with the current arrangements relating to contributed assets in NSW.

EnergyAustralia seeks clarification from the AER that this approach is consistent with the AER's understanding of the Rule provisions and that asset related costs for contributed assets is limited to the return on and of capital associated with the assets and does not include direct operating expenditure incurred in maintaining contributed assets.

EnergyAustralia strongly supports the AER's appropriate recognition of the corporate income tax implications of the receipt of capital contributions. However, EnergyAustralia believes that the formulas used by the AER to calculate corporate income tax expenses need to be reviewed to ensure that the appropriate treatment and calculation of the tax paid on capital contributions and the

associated income tax deductions. EnergyAustralia intends to discuss these technical modelling aspects with the AER further as they are difficult to articulate clearly in a submission format.

The following comments are directed at various sections within the Paper, using the same headings.

2.2.3 Cash-flow timing issues

Consistent with previous EnergyAustralia submissions, EnergyAustralia is of the view that a simple, transparent and well understood approach to recognising the timing of cash flows is preferable over a highly technical treatment which is difficult to articulate in public discussions. Moreover, EnergyAustralia is keenly aware that attempting to generate greater precision can become an end in itself, and is unlikely to ever deliver fully satisfactory approaches for all stakeholders. Therefore EnergyAustralia supports the AER's deferral of the review of the timing assumptions, until such time as the debate can be undertaken with sufficient time to carefully analyse the issues rather than implementing a potentially erroneous change in the rush to meet the exceptionally tight publication date imposed on the AER by the transitional Rules.

2.2.4 Depreciation

EnergyAustralia accepts the AER's assessment that the straight-line method for calculating depreciation will satisfy the requirements of the transitional Rules. However, as discussed above it is clear that a range of depreciation methods are either generally compliant with the Rules or would be compliant with the Rules in specific circumstances. Therefore, EnergyAustralia understands that the use of straight-line depreciation in the PTRM represents a default methodology for calculating the building block and that the DNSPs will be responsible for proposing Rule compliant depreciation method(s) and the resulting forecast depreciation as part of their regulatory proposals.

EnergyAustralia submits that for the sake of clarity, the AER should identify areas such as depreciation where a range of Rule compliant methods of calculating the building blocks may exist when it publishes the PTRM. It should also be made clear that providing an alternative, but nevertheless Rules compliant methodology would be considered to be compliant with the PTRM.

While EnergyAustralia is satisfied that the straight line method for calculating depreciation is generally consistent with the Rules, it is not immediately obvious that the manner in which the PTRM calculates depreciation is consistent with the Rules. This is due to the weighting process applied to assets within a class to develop average remaining lives. It is unclear at this stage whether the combination of the PTRM and RFM will ensure that assets are in fact depreciated over their economic lives in a manner that reflects their use. EnergyAustralia intends to discuss this matter further with the AER before it will be in a position to arrive at a considered assessment of the compliance of the PTRM with the Rules.

2.2.5 Capex recognition

Consistent with the comments above EnergyAustralia believes that the requirements of the Rules to depreciate an asset over its economic life do not necessarily require the asset to be commissioned.

For example, EnergyAustralia submits that the economic life of assets purchased for emergency spares, such as transformers reasonably, commences from the date the assets are acquired, consistent with the "as incurred" methodology. This is because from the date that the assets are acquired they are providing a very real reliability service to customers, in that by having such assets in store transformer failures can be relieved much faster than if EnergyAustralia had to wait for a replacement transformer to arrive from the manufacturer. Furthermore EnergyAustralia's experience shows that the serviceable life of transformers reduces while they are held in its stores. While this is a clear example of assets providing a service while not yet "commissioned", and a consumption of economic life, EnergyAustralia believes that there are potentially many other examples where the Rules would support alternative timing for the recognition of capital expenditure.

Therefore EnergyAustralia submits that the recognition of capital expenditure proposed by the AER is a default compliant position, but that the recognition of capital expenditure in the PTRM should enable a DNSP's regulatory proposal to reflect an alternative model of "economic life" as part of the building block calculations, consistent with the arrangements for depreciation above.

Within the PTRM EnergyAustralia notes that AER has assumed that the regulatory values for capital expenditure as commissioned will equate to values that should be used for corporate income tax purposes. EnergyAustralia does not believe that this will necessarily be the case and will discuss these technical modelling aspects with the AER further as they are difficult to articulate clearly in a submission format.

2.2.6.1 Setting the tax base

EnergyAustralia's interpretation of the Rules is that the DNSP will propose an estimated cost of corporate income tax subject to the provisions of 6.5.3. The Rules do not permit the AER to establish a separate tax asset base. Similarly, the Rules specify that the PTRM include the manner in which corporate income tax is to be calculated and do not require an AER determination on the opening asset base for tax.

EnergyAustralia is concerned that the AER is inadvertently extending its mandate through this guideline and the PTRM. Based on its experience through the development of the Rules and the transitional arrangements over the past two years, EnergyAustralia believes that if the guidelines were expected to set the method of calculation, or if the AER was to be required to establish the opening tax value, the policy makers would have ensured that the Rules clearly articulated such a requirement.

EnergyAustralia's review of the Rules does not lead it to believe that the Rules include such a mandate, but instead provides an approach where the business submits the estimated corporate income tax of a benchmark DNSP and the AER assesses this in accordance with 6.5.3. Therefore EnergyAustralia submits that the PTRM should remain consistent with this approach and be restricted to the calculation of the estimated taxable income, tax rate and imputation credits

2.3 Preliminary position

EnergyAustralia supports the AER in ensuring that the PTRM is modified to accommodate EnergyAustralia's peculiar circumstances of owning and operating both transmission and distribution network assets. EnergyAustralia is keen to engage further with the AER on the development of the PTRM to accommodate both its transmission and distribution assets into a single PTRM. However, we are cognisant that there remains little time for further modifications and consultation to be undertaken for the PTRM to be ready for publication by 1 February as required by the Rules.

Of particular concern is to ensure that EnergyAustralia has been able to comment on the proposed modifications and the informational needs that those modifications may require of EnergyAustralia.

4. Roll forward model

EnergyAustralia notes that many of the issues discussed above in respect to the PTRM are equally applicable to the RFM, as the AER has appropriately ensured that the two models are aligned to maintain synchronism between rolling forward the RAB and the approaches used to forecast the building blocks. Therefore EnergyAustralia's comments below are only on those matters that have not been raised above in relation to the PTRM.

As discussed above, EnergyAustralia must emphasise that while it provides these comments it has been unable to undertake a full review of the RFM within the context of the transitional Rules Gazetted 20 December 2007. EnergyAustralia will continue to review the RFM and will continue to maintain an open dialogue with the AER on these matters, until such time as it makes a formal decision on the RFM as required by the transitional Rules.

The following comments are directed at various sections within the Paper, using the same headings.

3.2.2 NSW distribution roll forward model

Recognising the differing treatment of assets under the transmission and distribution regimes in the current regulatory period, EnergyAustralia is assuming that the transmission asset base and distribution asset base will be rolled forward using separate models to establish an opening RAB for the network as a whole.

On a technical matter, EnergyAustralia observes that because of the delay in finalising the current ACCC determination for Transmission, the opening 2004 RAB amount included in the Rules is the actual transmission amount, and therefore does not require any further adjustments. To determine the difference between actual and estimated opening RAB for the distribution network, the AER will need to remove values associated with any transmission or public lighting assets before applying the calculations required by Rules to establish the actual opening 2004 RAB.

3.3 Preliminary positions

EnergyAustralia is concerned that the application of CPI in rolling forward the RAB does not comply with the requirements of the Rules, specifically clause 6.5.1(e)(3) where it requires that the CPI used to roll forward the RAB must be consistent with the approach applied for the control mechanism.

EnergyAustralia understands that the roll forward model applies the year-on-year approach to calculating the annual change in CPI. EnergyAustralia is also aware that the WAPC control mechanism applies the average of four quarters method for calculating the annual change in CPI.

EnergyAustralia also believes that the approach in the current control mechanism is, in the absence of the full year CPI actuals, to use the most recent CPI observations as a proxy for the actual rate. For the purposes of calculating actual inflation between years, the Rules require the AER to use the average of four quarters between July and June of that year. It seems inappropriate and entirely inconsistent with the current control mechanism and the Rules to use proxy or lagged rates where actuals are available.

Given this difference in approach and the requirements of clause 6.5.1(e)(3), EnergyAustralia submits that for the roll forward model to be compliant with the Rules that the inflation indexation method must be changed to be consistent with that used for the WAPC.

Tax roll forward model

EnergyAustralia does not believe that it is either appropriate or practical for the AER to attempt to maintain a roll forward model for the purposes of maintaining a tax asset base. If the objective is to ensure that the calculation of income tax depreciation deduction is consistent with the corporate income tax legislation, the aggregated data that is being used within the AER's models will not provide an accurate reflection of the actual income tax deductions that can or will be claimed by the DNSPs.

It must be remembered that the income tax depreciation deductions for an asset are locked in at the time the business first claims tax depreciation deductions for that asset. Therefore, within each class of assets there will be a range of profiles that cannot be adequately captured or replicated by the AER in the proposed tax roll forward model at the level of detail being used. The issue inherent in the use of aggregated data is that tax lives (remaining and standard) have to be a weighted average for the asset class. This is clearly inconsistent with any treatment of depreciation for income tax purposes that would be acceptable to the ATO as the process of developing a weighted average for the class will generate forecast tax depreciation rates that are inconsistent with the rates or methods used when the underlying assets were first claimed as a deduction by the DNSPs.

Therefore, EnergyAustralia believes that the AER should rely on the DNSPs' corporate income tax records to annually update the current tax position of its assets. These records will necessarily be at a sufficiently detailed level as to maintain the integrity of their annual income tax deductions with the method used when the depreciation deductions were first claimed.

5. Efficiency benefit sharing scheme

EnergyAustralia has previously provided comments to the AER on the operation of the EBSS during consultation on its application to transmission networks under Chapter 6A. EnergyAustralia does not believe that the concerns expressed in that submission have been specifically, or adequately, addressed by the AER as yet. As the AER is aware of EnergyAustralia's earlier concerns, this response to the Paper seeks to advance the discussions, with the benefit of the transitional Rules.

The following comments are directed at various sections within the Paper, using the same headings.

4.3 Considerations

EnergyAustralia notes that, although the AER has repeated the requirements of the Rules regarding those matters it must have regard when developing an EBSS, the AER has not specifically addressed or demonstrated precisely how the proposed EBSS meets the requirements of the Rules. Furthermore, it appears that the decision to introduce the EBSS is primarily based on the strength that it is the same scheme as was developed for transmission.

EnergyAustralia does not believe that it is sufficient for the AER to simply rely on consistency with transmission as adequate justification to introduce an incentive regime that has never been applied in NSW. This is particularly the case, when the AER has discretion as to whether a scheme should be introduced, compared to the mandatory requirement to introduce the EBSS under Chapter 6A. Indeed, the mere fact that an EBSS was mandated for transmission under Chapter 6A and not as part of the transitional distribution arrangements is a clear indication that mere alignment between distribution and transmission regulatory regimes is not sufficient justification to introduce an EBSS into the distribution regime.

4.3.1 Adjustments to forecast and actual operating expenditure

The consultation process conducted on the EBSS for transmission under Chapter 6A identified the importance of adjustments being made to the forecasts to accommodate matters outside of the control of the network, but nonetheless imposed costs on the network. It is clear that those discussions have informed the development of the AER's commentary on adjustments for the proposed distribution EBSS.

One of EnergyAustralia's primary concerns with implementing an EBSS is to ensure that the incentives relate to those matters over which the DNSP has sufficient control of costs to be able to adequately respond to the EBSS incentives. Moreover, for the EBSS to achieve the stated objectives, those incentives should also only apply to those costs that represent improvements or reductions in efficiencies. EnergyAustralia has argued previously, and maintains its concerns, that a simple increase or decrease in the annual costs does not necessarily represent efficiency improvement or deterioration.

There are several examples of where changes in operating expenditure are unrelated to operating expenditure efficiencies, including:

- Operating expenditure changes that are a result of changes to the DNSP's capital expenditure program;
- Operating expenditure changes arising from substituting a network capital expenditure option for peak demand growth for a non-network option that requires annual operating expenditure payments by the DNSP;

- Operating expenditure changes arising from input price variations outside the control of the DNSP as has been observed, and recognised by the AER in its decisions, over recent years; and
- Changes to the volume of activities undertaken in response to other imperatives, such as network reliability obligations.

Therefore EnergyAustralia submits that the AER should expand the scope and nature of those matters that would be eligible for adjustments for the purposes of the EBSS. EnergyAustralia believes that if the EBSS is ultimately imposed, at the very least the AER should expand the list of adjustments to enable the DNSPs and the AER to make common sense adjustments to address matters that should not be captured by the EBSS. From previous regulatory experience, EnergyAustralia is keenly aware that unless there is adequate capacity to address unforeseen matters in a common sense manner, the regulator will be constrained to perpetuate the inappropriate regulatory treatment of events.

EnergyAustralia believes that the EBSS should have the capacity to adjust the forecast and actual operating expenditure for additional matters beyond those discussed by the AER, including:

- Changes to the capital expenditure program. The level of capital expenditure will have a direct and identifiable impact on the level of maintenance expenditure over the 2009-2014 regulatory period. Therefore, any changes to the forecast capital program either in magnitude or timing will have an impact on the actual operating expenditure over the regulatory period. While EnergyAustralia recognises that it will not be appropriate to make adjustments for all changes to the capital program, there will likely be some circumstances where this will be appropriate and the AER should make provision for the DNSPs to present its reasons why such adjustments should be made over the course of the regulatory period;
- Asset age and condition have a significant impact on the level of maintenance expenditures, and therefore should there be changes to the forecast asset age and condition that formed the basis to the operating expenditure forecasts there should be scope to make commensurate adjustments to ensure that the EBSS does not internalise forecast errors;
- Demand management operating expenditure has the potential to displace capital expenditure for a period of time. It should be noted that the demand management incentive scheme as currently applied only supports those activities that demonstrate greater efficiency than the network capital solution. Therefore it is critical for the continued regulatory support of efficiency delivering non-network activities that the EBSS has the capacity to be adjusted for demand management activities;
- Input cost growth. It is commonly understood that some of the input costs faced by network businesses over recent years have not only significantly outstripped the general rate of inflation, but that this level of escalation was not anticipated. In recent decisions, the AER has recognised that such levels of cost increases have been borne by networks and future cost increases above the general rate of inflation have been allowed. Such changes in input costs are uncontrollable and do not relate to the relative efficiency of the networks' operating expenditure programs, as the costs are market driven. It is clear that the EBSS should not capture changes to operating expenditure that are a result of input price movements as they do not relate to the stated efficiency objective of the scheme; and
- A general adjustment that provides for the DNSPs to seek adjustments to the EBSS for changes in the key assumptions that are identified as part of the regulatory proposal. While the DNSPs will undertake all reasonable steps to provide the most robust cost forecasts, those forecasts will be based on the key assumptions that underpin the capital and operating programs. Therefore, any changes to those assumptions will deliver a capital and operating program that differs from the forecast. It must be emphasised again that mere differences between actual and forecast costs are not of themselves evidence of changes to the efficiency of the expenditure programs. Indeed, this appears to be well accepted by the

AER, as it has already included an adjustment as part of the EBSS for changes between forecast and actual in peak demand, one of the key assumptions that all networks will likely include in their regulatory proposals. Therefore, having accepted the principle that changes to key assumptions are outside of the control of the network, EnergyAustralia believes that changes to all key assumptions should likewise be removed from the calculation of the EBSS.

4.3.6 Continuous incentive

As discussed above, the AER has not clearly articulated how the proposed EBSS will practically meet the range of matters that it must consider in developing the EBSS. For example, it is not clear that the AER has demonstrated how the scheme will provide a continuous incentive for efficiency gains, recognising that the mechanism relies simply on the rate of change in operating expenditure between years and appears to have no regard to the overall level of operating expenditure over the regulatory period. It is not clear to EnergyAustralia whether the mathematical construction of the scheme provides the same incentive to seek efficiency gains in all years of the regulatory period or if in fact the scheme merely changes the incentive to achieve efficiency gains from the start of a regulatory period to the end.

An understanding of the AER's detailed analysis and modelling of this and the other factors that it is required to consider would assist EnergyAustralia being satisfied that the AER proposed a scheme that will deliver the outcomes required by the Rules. In particular, EnergyAustralia believes that the AER should document and make available for comment the scenario and sensitivity analysis that has been conducted by the AER to ensure that the scheme is robust and will operate effectively under a range of operating expenditure trends.

4.3.7 Desirability of providing rewards and penalties

EnergyAustralia believes that any penalties arising from the operation of the EBSS over the 2009-2014 regulatory period should not be automatically applied to adjusting the forecast operating expenditure over the 2014-2019 regulatory period, but rather they should be rolled forward and offset against any efficiencies achieved over that period. This approach is consistent with EnergyAustralia's understanding of the operation of the EBSS to apply to transmission networks over this same period.

Moreover, as this EBSS has not been applied in NSW previously, this approach would afford a reasonable transition period over which the businesses and the AER can review the operation of the incentive and make any necessary adjustments to ensure that the reviewed EBSS is appropriate for longer term application.

4.3.8 Interaction between opex and capex

While EnergyAustralia recognises the concerns of the AER relating to the potential incentive to re-categorise operating expenditure as capital expenditure as a result of the operation of the EBSS, EnergyAustralia is concerned that the AER has not recognised the cost driver relationship between capital and operating expenditure.

As discussed above, there is a direct relationship between capital and operating expenditures, whereby operating expenditure, particularly maintenance expenditure, has a direct functional relationship to the level of capital expenditure over a given period.

In simplistic terms, maintenance expenditure will generally fall in relative terms with increases in the ***replacement*** capital program, and increase with increases in the number of elements added to the network through augmentation capital expenditure. Therefore the complexity of the relationship between capital and operating expenditure means that a key assumption underpinning operating expenditure forecasts is the capital expenditure forecasts. As discussed previously, EnergyAustralia believes that the EBSS should include an adjustment to take into account the impact that unexpected variations in the capital program will have on the operating program.

4.3.9 Effects on incentives for non-network alternatives

As discussed above EnergyAustralia believes that efficient investment in non-network alternatives will be best facilitated by the AER expanding the list of adjustments to explicitly recognise non-network and demand management expenditure.

Of necessity, EnergyAustralia forecasts the network needs on a supply side basis, since alternative options to the identified network needs can only be sought from the market closer to the time they are required. Therefore any operating expenditure incurred as a result of undertaking or facilitating non-network alternatives is a substitution of operating expenditure for capital expenditure. It must be reiterated that the undertaking of non-network and demand management activities requires the alternative option to demonstrate that it can meet the network need to the appropriate level of reliability and be more cost effective than the network option. Therefore, if the EBSS does not have an explicit adjustment that allows for such activities to be removed from the calculation of the EBSS incentive, the scheme has strong potential to reduce the overall efficiency of the capital and operating programs rather than improve them.

4.3.10 Capex and distribution losses

EnergyAustralia supports the AER taking a considered and measured approach to developing any incentives relating to distribution losses. This issue is indeed complex and has many interrelationships with other elements of the financial and technical regulations that apply to EnergyAustralia and other DNSPs. EnergyAustralia looks forward to discussing the issues relating to network losses when the AER begins consideration of whether to apply an incentive under the general Chapter 6 arrangements.

In this context, there are some salutary lessons to be gained from previous regulatory attempts to incentivise losses. The distribution loss incentive applied in 1996 by IPART was reversed in 1997, proved unworkable and was finally abandoned. Furthermore, the mechanism currently applied to the UK DNSPs by Ofgem has produced unexpected outcomes; the incentive has resulted in unexpectedly large payments. It is strongly recommended that due regard be given to the expertise of the DNSPs in this area.

4.3.11 Expenditure allowances for next regulatory control period

EnergyAustralia does not believe that the proposed approach to setting the forecast operating expenditure for the 2014-2019 regulatory period is consistent with the Rules. The Rules require the AER to make a decision on forecast operating expenditure based on the DNSP's forecast in its regulatory proposal.

While EnergyAustralia recognises that such an approach has its attractions to reviewing the operating expenditure forecasts submitted by DNSPs, it is only feasible where there is stability both in input prices and homogeneity in the capital program over time. EnergyAustralia does not believe that either pre-condition currently exist.

EnergyAustralia is all too aware that input prices have been anything but stable in recent times. The cost of some raw materials, such as copper, and completed components have been subject to unprecedented price increases as a result of international pressures over the past few years. Furthermore, EnergyAustralia has commenced a renewal program of assets commissioned in the 1950s through to the 1970s. This program will take several years to complete and, as discussed above, will have significant implications for the operating expenditure profile over this period. Therefore, given the lack of a steady-state environment, EnergyAustralia does not believe that a simplistic arithmetic approach to reviewing forecast operating expenditure should be applied for well over a decade.

In addition to these concerns, EnergyAustralia notes that using the most recent operating expenditure as a guide to future operating expenditure requirements will likely internalise the operation of the ex ante incentives, creating a regulatory discrepancy with the underlying needs of

the network. EnergyAustralia is concerned that the operation of the ex ante incentives in conjunction with the EBSS could result in operating expenditure deferrals being undertaken to fit within the incentives despite the fact that such operating expenditure activities may be required by the network.

The deferral of required operating expenditure is most likely where there are not sufficient adjustments available for the network to avoid the double jeopardy of the ex ante and EBSS incentives for increases in uncontrollable costs or forecast errors.

Finally, EnergyAustralia believes that the AER should not presume to use the fourth year's actual operating expenditure as the basis for setting the forecast operating expenditure as: it is not consistent with the Rules; may not have sufficient regard for the interaction of market prices and the forecast capital expenditure program; and may inappropriately capture operating expenditure deferrals resulting from the operation of short term incentives rather than reflecting the true needs of the network.

4.4 Preliminary position

EnergyAustralia does not believe that the AER has sufficiently articulated how the proposed EBSS will achieve the required outcomes as discussed above. Without a well articulated discussion on how the scheme can and will achieve the required factors, it is not clear whether the preliminary position is based on detailed analysis or simple faith. Before the AER Board approves the imposition of the EBSS, EnergyAustralia submits that stakeholders should be provided with the detailed analysis undertaken by the AER with respect to each of the required factors and be given the opportunity to provide the AER with their comments.

EnergyAustralia believes that if the AER implements an EBSS scheme, it should as a minimum have sufficient flexibility to address a range of uncertainties in its initial application to distribution in NSW. Previous regulatory history has illustrated that when developing regulatory schemes it is critical that the regulator provides sufficient scope to make common sense adjustments for unforeseen events. Without this capacity to manage unexpected events in a common sense way, the schemes can deliver perverse outcomes that can work counter to the policies that led to the development of the incentives.

6. Service target performance incentive scheme

AER Preliminary Position

EnergyAustralia supports the preliminary position proposed by the AER to the development and application of the STPIS as it is to apply to its network for the 2009-2014 regulatory period.

Since the publication of the Paper, IPART has released an information paper on the operation of the paper trial for the current regulatory period[1]. EnergyAustralia observes that, whilst both SAIDI and SAIFI results were reported in IPART's information paper, only SAIDI was assessed under the paper trial incentive mechanism. Reliance on a single "average" annual performance measure such SAIDI is problematic. Average measures are attractive as they are generally available and measure the performance of the system as a whole. However, for incentive purposes such measures are particularly weak for two main reasons.

6.1 Average performance measurement

Past submissions on service incentive frameworks in NSW have documented that the simple arithmetic approach to calculating measures such as SAIDI creates the potential for perverse incentives. Establishing financial incentives based on an average performance measure such as system SAIDI or feeder category SAIDI can result in investment decisions in areas of "low hanging fruit" where large customer-minute savings can be made for relatively little expense. For example,

[1] NSW Electricity Information Paper No 3/2007 – IPART's Trial of a service quality scheme for NSW electricity distributors: results to date, IPART, November 2007.

inexpensive reliability improvements gaining large customer-minutes in higher customer density areas at the start of feeders are preferred over more expensive improvements in the lower customer density tail-ends of feeders for far less customer-minute savings. The higher density areas generally already experience better than average reliability service whereas the customers towards the ends of the feeders usually experience worse than average performance. Therefore, the incentive promotes service improvements to customers that are already enjoying better than average performance at the expense of customers connected to less densely populated feeders that generally have lower than average performance. This outcome is not desirable, and is the reason why the NSW Design, Reliability and Performance Distribution Licence Conditions include a focus on under performing feeders where customers are receiving poor performance compared to the average. It is socially desirable for any STPIS to provide positive incentives for the network to undertake investments in areas with poor customer reliability of supply, and not for customers where performance may already be acceptable.

6.2 Stochastic variation effects

Furthermore, as can be observed from the IPART information paper, average performance measures can be subject to substantial annual stochastic variations that are unrelated to the underlying performance that the network is delivering. The standard processes of calculating SAIDI and other average measures attempt to normalise some of the larger uncontrollable events, such as natural disasters, however the normalisation process does not mitigate the general impact of random events on the reported performance. The statistical variability inherent in calculating average performance measures means that a STPIS that relies heavily on annual average performance measures has the potential to produce random bonus and penalty outcomes from year to year, with little transparency as to whether the STPIS has provided incentives that directly contribute to the customer experience or not. It is desirable for any STPIS to utilise a performance measure that shows a true underlying performance trend, while revealing and accounting for any impact of stochastic variation.

6.3 Further engagement

In summary, EnergyAustralia proposed to engage AER and other DNSPs in developing appropriate measures and STPIS mechanisms to ensure true trends in reliability performance are monitored and that the DNSPs are given incentives to undertake those investments that are appropriate for the achievement of the purpose of the STPIS, without distraction by random variation, and where valid investment in improving customer satisfaction in poor performance areas is prioritised.

EnergyAustralia is keen to ensure that the future STPIS avoids the concerns identified above and is consistent with the NSW Distribution Licences.

EnergyAustralia Specific Matters

In relation to the EnergyAustralia specific matters raised regarding the STPIS EnergyAustralia notes that EnergyAustralia's transmission support network is only deemed to be part of EnergyAustralia's distribution network for the purposes of Chapter 6 including the transitional rules and Chapter 6A. It is still regarded as a transmission network for other purposes, such as those contained in Chapter 5 of the Rules for example.

7. Guideline on control mechanisms for direct control services

EnergyAustralia has identified several areas of concern contained within the guideline where it seeks clarity and review, and indeed the guideline has raised concerns with the operation of some key developments of the Rules.

EnergyAustralia is concerned that the guideline inappropriately includes elements that are not properly part of the control mechanism. In particular the guideline presumes that the pricing side constraints included in the transitional Rules relate to the control mechanism, being the WAPC.

While compliance with the side constraints will be required on an annual basis as part of the annual price change process, EnergyAustralia believes that the side constraints relate to pricing provisions under Part I, not the control mechanism.

Furthermore, EnergyAustralia is concerned that the side constraint compliance formula in the guideline does not fully articulate how it will be calculated. Specifically, the formula includes an L term that is defined as being the permissible real percentage change in an individual distribution tariff. EnergyAustralia believes that the definition of this term should be expanded to capture the two side constraints included in the Rules so that interested parties can confirm the mathematical accuracy of the two limits within the price compliance formula.

In reviewing the AER's guideline, EnergyAustralia has identified several practical concerns with applying side constraints under the transitional Rules. These issues, while not relevant to the control mechanism per se, are still critical from a compliance perspective and therefore EnergyAustralia has included its review of the issues and EnergyAustralia's understanding of how the Rules appropriately apply in practice in the following Appendix: Application of side constraints (tariff rebalancing) for NSW DNSPs under the Transitional Rules.

Appendix: Application of side constraints (tariff rebalancing) for NSW DNSPs under the Transitional Rules

Introduction

The application of tariff rebalancing to any control mechanism requires careful consideration when applied to Clause 6.18.6(b) and the application of the side constraint to the prices proposed by a DNSP in any year of the regulatory control period. EnergyAustralia has considered several issues in the context of its transitional regulatory control period. These issues (and we believe the correct application under the Clause) are outlined below.

Determining "expected weighted average revenue" under the Rules

Part I of the Transitional Rules applies to pricing arrangements for distribution. It should be noted that the consideration and approval of pricing arrangements is separate to the making of a distribution determination (with the exceptions tariff assignment or reassignment under 6.18.4). Therefore, for the most part, the issues considered under part I will relate to the annual pricing proposal submitted to the AER under 6.18.2.

Clause (b) of 6.18.2 sets out a number of elements that must be contained in a pricing proposal. Included within this Clause is a requirement that a pricing proposal must:

> *"set out, for each tariff class related to standard control services, the expected weighted average revenue for the relevant regulatory year and also for the current regulatory year"*

The terms expected weighted average revenue is not a term which is in use or has a generally understood meaning in the context of the current regulatory determination applying to DNSPs in NSW. The term also appears in Clause 6.18.6:

- To establish the additional side constraint (tariff rebalancing) allowed in the Rules;
- To define the linkage between allowed revenues between periods through the CPU-X constraint.

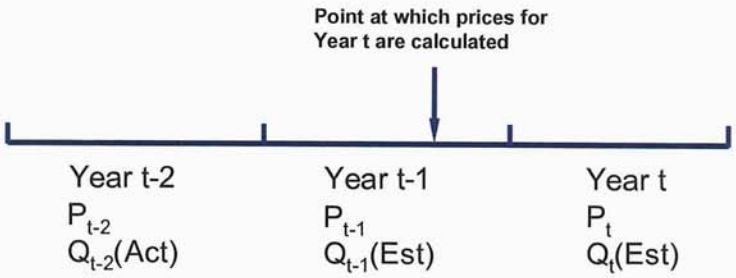
EnergyAustralia believes the terminology arises from reference to NERA's report to the Network Policy Working Group on the Distribution Pricing Rule Framework. In this report they note that the "Victorian tariff rebalancing constraint is applied as a single constraint of CPI+2% on the aggregate weighted average tariff revenues for each tariff class. " They note further that:

> *"In our opinion, side constraints should be applied to the aggregated weighted average tariff revenue for each tariff class."*

It is critical that the term is applied appropriately and consistently in the context of the application of the WAPC control mechanism by the AER so that there is no scope for an incorrect interpretation or application of this term. For example, if "expected" were interpreted to mean "forecast" the application of 6.18.6 would be a very different proposition to what NSW DNSPs (or any other DNSPs for that matter) currently apply in respect of tariff rebalancing.

In fact, wrongly interpreting this clause as per the above example would result in DNSPs being subject to a separate revenue cap on each tariff class in respect of a side constraint in addition to the price cap under the determination (calculated on a hybrid weighted average basis). This is clearly not what was intended by the rules.

Consider the diagram below:



An out of context reading of the side constraint obligation in the Rules could be read as requiring an assessment based on the formula of:

$$\frac{P_t \times Q_t(\text{Est})}{P_{t-1} \times Q_{t-1}(\text{Est})}$$

That is, forecast quantities for Year t applied to the proposed prices for that year, divided by forecast quantities for the current year applied to the current prices. Such an approach is problematic since:

1. Quantities used are forecast and therefore subject to debate as to their validity
2. Any growth in volumes may possibly take up any opportunity to increases prices. For example, if the side constrain is 4%, and volume growth is forecast to be 5%, prices would be required to be decreased to accommodate the side constraint, since growth alone will give you a weighted average revenue increase of 5%.
3. Such an approach is inherently a constraint on revenue, not price and contrary to the rationale of a weighted average price cap.

In EnergyAustralia's view the only way to interpret part (b) of this clause is in the context of the control mechanism that applies.

CPI-X limitation representing the increase "expected weighted average revenue" between years

As noted above, Clause 6.18.6(c)(1) notes that the CPI-X limitation represents the increase of the DNSP's expected weighted average revenue between 2 regulatory years.

In the case of a weighted average price cap control mechanism, a "cap" on price movements between years is determined by the AER at the beginning of a regulatory control period based on:

- the revenue requirements of the DNSP; and
- the expected volume movements between each year.

Using this interpretation, when making a final determination, the AER determines the expected weighted average revenue for each year of the control period in the form of a price cap. Therefore in a WAPC form of control, the expected weighted average revenue is the relevant quantities associated with each tariff (expected volume) multiplied by the price. In the case of NSW, relevant quantities are always on the last observable (and hence auditable) quantity which is usually the year immediately preceding the current regulatory year.

Of course, volume will vary in any given year from what was assumed (or expected) at the time of the determination.

But the price limit (CPI-X) is not adjusted to reflect any change to forecast volumes. It remains as per the determination. The DNSP is subject to the weighted average price movement irrespective of whether actual volumes are greater than or lower than those expected at the time of the determination. This is demonstrated in the following formula

$$\frac{P_t \times Q_{t-2}}{P_{t-1} \times Q_{t-2}}$$

The expected weighted average revenue in the current year is increased up to the limit imposed weighted average price control to derive the expected weighted average revenue in the next year. The WAPC control mechanism is demonstrated by holding the quantity constant and showing that the increase in the weighted average revenue does not exceed the CPI-X control.

Such an approach constrains price only, since the quantities used in both the numerator and denominator are the same. Any growth factor in volume cancels out, allowing the WAPC with its implicit expected volume growth to provide the necessary constraint. This approach is then:

- consistent with a price cap form of regulation;
- uses auditable quantities that are not subject to debate or controversy;
- utilises the hybrid form of control mechanism (WAPC) to constrain DNSPs rather than expanding the control mechanism to include an additional revenue cap constraint on tariffs (in effect over-riding the WAPC control between years).

Tariff rebalancing based on "expected weighted average revenue" between years

A simple deduction from the above necessitates an interpretation of 6.18.6(b) that is relatively consistent with the current approach to tariff rebalancing in New South Wales.

Under 6.18.6(b) the side constraint applies to tariff classes as opposed to total revenue allowed under the WAPC. However the tariff rebalancing should be seen as an extension to the control mechanism applied to by the AER. There is nothing in the Rules which suggests that the side constraint should mandate a different control mechanism to the one already applied by the AER. Instead, 6.18.6 allows some flexibility for the DNSP to increase prices in some tariff classes above that allowed through the control mechanism but restricted by the permissible percentage.

Tariff rebalancing within the WAPC is therefore not based on forecast prices or quantities but on actual quantities increased by allowed weighted average price movements (the allowed price movement based on expected quantities at the time of the determination). In other words:

The expected weighted average revenue for the current year is the most recent (auditable) quantity of each tariff multiplied by the allowed price of each tariff.

For EnergyAustralia and other DNSPs this means that the DNSP has the right to rebalance tariffs using price (but holding actual quantities constant) subject to a constraint of CPI-X-2%. Again this appears to be the only interpretation consistent with 6.18.6(c)(1) which indicates that the CPI-X limitation represents the increase of the expected weighted average revenue between two regulatory years.

This supports the approach taken by NERA in its report to the MCE on distribution pricing.

NERA also believes that tariff rebalancing should be applied by basing it on observable historic quantities:

> *"In our opinion the distribution pricing rules should use audited historic charging parameter quantities as a proxy for current charging parameter quantities. The requirement for use of audited quantities provides several key benefits in that it:*
>
> - *offers simplicity of application;*

- *limits the scope for manipulation of pricing outcomes within the price control and side constraint;*
- *reduces the compliance costs for DNSPs by removing the need to generate and substantiate sales forecasts; and*
- *reduces the compliance assessment costs for the AER by removing the need to obtain verification of the reasonableness of forecast methods and estimates."*

This interpretation would also be consistent with the application of tariff rebalancing in Victoria.

Summary

The expected weighted average revenue is calculated by increasing the most recent observable control parameter by the predetermined control mechanism. In the context of the WAPC it refers to the last observable actual quantity measurement multiplied by price. In the current year it represents the sum of the last observable volume quantities multiplied by the last approved prices. In respect of the next year it represents the increase in prices (while holding quantities constant) subject to the WAPC control