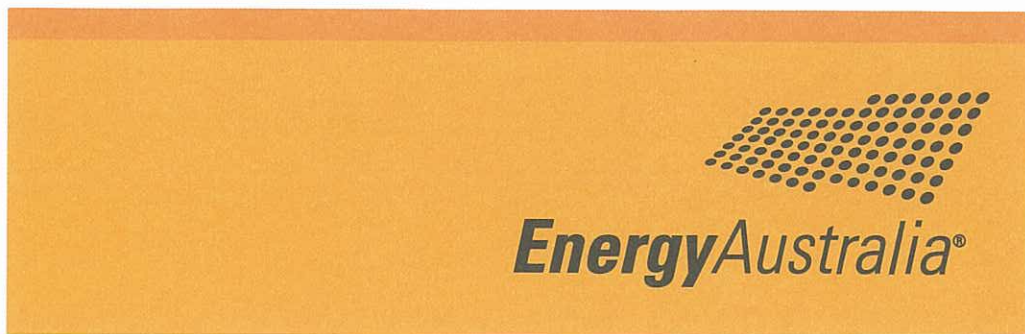


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19 August 2010

Mr Chris Pattas
General Manager
Network Regulation South
Australian Energy Regulator
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By email to: AERInquiry@aer.gov.au

Dear Mr Pattas

EnergyAustralia submission on AER draft regulatory determination for Victorian distributors

EnergyAustralia has a strong commercial interest in the processes, approaches and methods used by the AER to make regulatory decisions, particularly if the AER should apply similar approaches in assessing EnergyAustralia's regulatory proposal for 2014-19. For this reason, our submission identifies areas of concern with the decision making process undertaken by the AER in its draft regulatory determination and draft decision for Victorian distributors, published by the AER on 4 June 2010.

Our submission focuses primarily on constituent decisions made by the AER in respect of total forecast operating (opex) and capital expenditure (capex). We consider that the AER's decisions do not satisfy the National Electricity Objective or the Revenue and Pricing Principles in the National Electricity Law. In particular, we consider the average cuts of 36 per cent to the proposed investment programs, and 26 per cent to operating expenditure, will very likely:

- adversely impact the quality, reliability, safety and security of electricity supply of Victorian distribution networks;
- not provide Victorian distributors with the opportunity to recover at least the efficient costs the operator incurs in providing direct control network service; and
- create significant regulatory uncertainty in investment markets, particularly where the AER's assessment process lacks rigor and transparency.

We submit that the AER's decisions have not given proper regard to the assessment framework prescribed under the National Electricity Rules (NER), and that the AER has consequently rejected expenditure that satisfies the criteria under the Rules. Further, we note that the new models and high level tests developed by the AER do not provide a reliable or robust method for determining forecast expenditure requirements. These two issues are briefly discussed below, and expanded upon in the body of our submission.

In addition to these matters, EnergyAustralia submits that the AER should improve the transparency and predictability of its decision making. In particular, the AER has developed new approaches and tests without consulting stakeholders, and has relied on analysis which has not been published as part of this draft determination.

Decision making approach not in accordance with the Rules

We note this is the fourth regulatory determination process the AER has undertaken since assuming responsibility for regulating distribution networks. Over this time, we have observed a tendency for the AER to bypass the requirements and discretions set out in the NEL and NER. In particular, we are concerned that the AER's approach to assessing proposed capex and opex do not reflect the assessment process set out under Chapter 6 of the NER.

Our key concerns are that the AER:

- has not given proper regard to the method and details underlying a distributor's regulatory proposal;
- substitutes the DNSP's inputs (which have often been supported with independent expert analysis), without clearly demonstrating why the DNSP's inputs are unreasonable or why its own consultants substituted inputs are superior;
- has derived a substitute of total capital expenditure that has not been amended from the basis of a distributor's proposal; and
- has inappropriately developed sub-criteria for assessing expenditure that does not fully reflect the criteria set out in the Rules, and accordingly excludes efficient and prudent expenditure.

Unlike other regulatory regimes, the NER deliberately gives very considerable weight to the business experience, calculations and judgments of the distributor.¹ The role of the AER is in large measure to assess reflectively whether those decisions, calculations and judgments are outside a range of reasonableness, rather than for it simply to make whatever decision it considers best. As noted by the Australian Competition Tribunal in 2009:

"...the AER should be very slow to reject a DNSP's proposal backed by detailed, relevant independent advice, because the AER, on an uninformed basis takes a different view"²

This principle was clearly stated by the AEMC in its final determination on the Rule to apply to economic regulation of transmission networks³:

"Under the Revenue Rule, the AER is required to exercise judgement in deciding whether it is satisfied that the forecasts reflect the specified criteria, having regard to the specified factors. However, the exercise of that judgement is constrained and guided by the need to be satisfied as to the efficiency and prudence of the forecast and that cost forecasts reflect realistic expectations. In exercising its judgement the AER must also have regard to the information provided in the TNSP's proposal and the other evidentiary considerations specified in the Rule. That is, the AER is not at large in being able to reject the TNSP's forecast and replace it with its own. It must also provide reasons in terms of the decision criteria and the factors for both a rejection of the forecasts and their replacement with forecasts that it considers do meet the requirements of the Rule."

EnergyAustralia is concerned that the AER's approach for assessing capital expenditure did not adequately consider the basis, method and details underlying the proposals submitted by distributors. Instead the AER's assessment process considered the "case put by the Victorian DNSPs for increases

¹ See decision by Australian Competition Tribunal, *Application by EnergyAustralia and others (includes corrigendum)*, 1 December, paragraph 201.

² *Ibid*, paragraph 190.

³ We note that the Rules for assessing capital and operating expenditure are very similar under Chapter 6A and Chapter 6 of the NER.

or changes in requirements that would justify a large increase in capital expenditure over the forthcoming regulatory control period.”⁴

The Rules do not require a distributor to justify an increase in requirements from the previous period. Rather, a distributor must propose a forecast of capital expenditure requirements that satisfies the capex expenditure objectives in the Rules. The AER is required to assess the proposed expenditure in accordance with the capex criteria identified in the Rules, having regard to the capex factors. Accordingly, the AER’s obligation is to assess the merits of the proposal, rather than to base its assessment on the construct of whether a distributor justified a deviation from historical expenditure.

On a related matter, we note that the AER has not appropriately applied its discretion under the Rules when deriving a substitute amount of capital expenditure. The Rules require that the substitute amount or value be determined on the basis of the current regulatory proposal, and be amended from that basis only to the extent necessary for it to be approved in accordance with the Rules.⁵ However, as part of its draft decision, the AER has derived a substitute amount based on previous levels of expenditure, when (appropriately) this was not the method or approach used by Victorian distributors to forecast capex requirements.

A further area of concern is that the AER is developing its own alternative sub-criteria for assessing elements of expenditure, that supplement the opex and capex criteria set out in the Rules. In particular, the AER has developed its own criteria for assessing proposed step changes, which requires that the expenditure be related to a change in regulatory obligation and/ or change in operating environment.

As a general point, we consider there is no basis for applying alternative criteria to the assessment of forecast expenditure, or any part of it. Further, we submit that the AER’s step change criteria is too narrow, and has the effect of excluding expenditure that would otherwise have satisfied the opex criteria in the Rules. For instance, prudent and efficient costs relating to a change in function (for example, risk mitigation costs) would not satisfy the step change criteria unless the expenditure is related to a change in regulatory obligation or operating environment.

With that in mind, we are increasingly concerned with the tendency for the AER to supplant its own alternative sub-criteria in favour of codified Rule requirements on the basis of what appears to be a false logic; that is, that meeting or not meeting the sub-criteria is equivalent to meeting or not meeting the criteria in rule requirements. We demonstrate below that this is a problem if the assessment and substitution does not lead to robust, reliable or consistent findings. This problem is amplified to the extent the AER can seemingly change the hurdle and evidentiary basis between determinations (or between draft and final determinations) while the substantive criteria in the Rules does not change.

If the AER is uncomfortable with the Rule requirements for assessing a regulatory proposal it should seek remedy through a Rule change, rather than attempt to seek remedy through its own sub-criteria which only leads to regulatory uncertainty and ultimately regulatory error.

Issues affecting quality of decision making

EnergyAustralia notes that the AER has developed high level tests and models to reject expenditure forecasts submitted by distributors. It has also used the outcomes of its analysis as a basis for deriving substitute amounts. While it is open for the AER to use such approaches as part of its assessment process, we consider that the techniques used by the AER do not result in reliable or robust findings.

⁴ AER, Victorian electricity distribution service providers, Distribution determination 2011 – 2015, 04 June 2010, page VII

⁵ See clause 6.12.3(f) of the NER

Our primary issue concerns the appropriate role of high level tests and models in the assessment process. In its draft determination the AER appears to suggest that it wishes to develop high level models to avoid the difficulties associated with reviewing detailed models submitted by distributors. For instance, in respect of its replacement capex model, the AER stated:

“...the model provides a useful reference to assess regulatory proposal, and allows a common framework to be applied without the need to be overly intrusive in data collection and assessment of asset management plans.”

EnergyAustralia considers that such 'high level' approaches are dangerous. They discourage distributors from developing sound processes and models to support expenditure proposals. Our experience is that 'best practice' planning methods result in optimal investment decisions that can be verified by the regulator.

We are therefore concerned that the AER is not willing to engage with the material put before it, and instead is increasingly relying on high level indicators to assess forecast requirements. We consider that top down models are an inferior basis for estimating capex requirements, and should only be used to guide further investigation into a distributor's proposal.

It is also clear that the top down models and tests applied by the AER are not 'fit for purpose' in respect of reliably forecast expenditure requirements. For example:

- The AER has applied a high level equation to derive substitute 'network scale escalators' for operating expenditure. The equation predicts the change in operating expenditure based on the change in customer numbers and line length. This does not adequately account for the full suite of workload drivers impacting forecast opex requirements, and does not take into account how those drivers impact particular activities;
- The AER has applied a 'top down' method to estimate the change in maintenance requirements that arises as a result the replacement program. It is unclear how this model accounts for the aging of assets on the network, or the nature of assets being replaced on the network; and
- The AER has benchmarked 'total' capital expenditure of distributors and used this to conclude that the historical level of expenditure incurred by Victorian distributors is efficient relative to their peers. We believe that no meaningful conclusions on efficiency can be drawn from comparisons of total capital expenditure. Capital expenditure is driven by business specific factors such as available capacity on the network, condition of assets, changes in licence conditions, and the capital contributions framework applying to each jurisdiction.

We also note that the underlying method and data of the AER's models and tests are statistically invalid. For example, the AER's consultant (Nuttall) had to re-calibrate the replacement capex model due to anomalous results indicating a three-fold increase in replacement expenditure. Due to this anomaly, Nuttall Consulting re-calibrated the data to derive a more 'reasonable' estimate of expenditure requirements. While it is unclear how the data was adjusted by the consultant, the assumptions underlying the re-calibrated model appear to be unrealistic, for instance estimating that the average life of an asset on Citipower's network is 77 years of age.

The AER's 'test' of the validity of its network scale equation is another example of the AER using a statistically flawed approach as part of its decision making. The AER compared the growth in operating expenditure for all Victorian distributors between two points in time (2003 and 2007) and then compared the results to the predicted value of its network scale equation. This is a very poor basis for validating the outcomes of its model, as we demonstrate in the body of our submission.

As such, we consider that the AER should only use high level tests, models and analysis as a 'sanity check' and as a guide for further examination of the detailed proposals submitted by distributors. The

AER should also demonstrate that the techniques are 'fit for purpose' and result in statistically valid outcomes.

Transparency and predictability of decision making

EnergyAustralia notes that the AER has introduced new criteria, tests and models in this draft decision without consulting the affected businesses or stakeholders. For instance, the AER has applied a replacement capex model which was first developed in September 2009, but did not inform stakeholders until the draft decision. Another example is the AER's narrowing of the step change criteria from that used in previous decisions. We question whether Victorian businesses were made aware of the criteria prior to submitting the regulatory proposals.

We consider that a cornerstone of the current regime is an increased emphasis on predictable and transparent decision making, providing greater certainty for future investment. When the AEMC developed the Rules to apply to regulation of transmission services, it noted that:

"The Rules have continued to build on previous regulatory practice by providing forclear guidance on the processes and procedures to be adopted by the regulator; and the development of guidelines by the regulator regarding the exercise of discretion in specified areas."

EnergyAustralia considers that it is essential that stakeholders, and the regulated entity itself, should be afforded an opportunity to comment on new approaches before the technique is applied in a regulatory decision.

We also note that the AER has not published analysis underlying its decisions. For example, the AER did not publish the functional form and data underlying its replacement capex model. This does not give stakeholders an opportunity to fully comment on the analysis used by the AER.

Finally, we note that the AER has not published the Excel models for the national or transitional Efficiency Benefit Sharing Scheme and the Service Target Performance Incentive Scheme. This does not assist a distributor in understanding the implications of its actions, and consequently does not enable it to respond effectively to the incentives. To the extent that there are no issues of confidentiality, we request that the AER publish the Excel models for the schemes that apply to each distributor.

We have expanded on these issues in the attached document while also providing additional comment on other decisions made by the AER, particularly where we have concerns that the AER will apply a similar approach in our 2014-19 determination.

If you have any questions, please contact Jane Smith, Executive Manager Regulation and Pricing, on (02) 9269 4171.

Yours sincerely



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