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EnergyAustralia™
We're on it

16 February 2009

Ms Michelle Groves
Chief Executive Officer
Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

Email to: Aerinquiry@aer.gov.au

Dear Ms Groves

EnergyAustralia's submission on AER's draft decisions for other network service providers

EnergyAustralia welcomes the opportunity to make a submission in relation to the AER's Draft decisions with respect to NSW, ACT and Tasmanian network service providers. This submission also responds to some issues incorporated in the revised regulatory proposals lodged by these network service providers. Our submission is attached to this letter.

The attached submission refers to material that has been provided by EnergyAustralia in the context of our own regulatory proposal and submissions made in relation to the AER's draft decision with respect to EnergyAustralia. Please advise whether you require separate copies of any of this material to be provided again to support this submission. We note that the material has already been submitted to the AER in the context of EnergyAustralia's regulatory proposal.

Please do not hesitate to contact Catherine O'Neill, Executive Manager, Network Pricing & Regulation on 02 9269 4171 should you wish to discuss any aspect of our submissions.

Yours sincerely

TREVOR ARMSTRONG
Executive General Manager (Acting)
System Planning and Regulation

Partner

Submission on the AER' draft determination for other network service providers

February 2009

1 Decisions to which this Submission Applies

This document is EnergyAustralia's submission in relation to the AER's Draft decisions for NSW, ACT and Tasmanian network service providers with respect to the following:

- "Integral Energy draft Distribution determination 2009-10 to 2013-14", published 28 November 2008.
- "Country Energy draft Distribution determination 2009-10 to 2013-14", published 28 November 2008.
- "ActewAGL draft Distribution determination 200910 to 2013-14", published 28 November 2008.
- "TransGrid Transmission Determination 2009-10 to 2013-14" published 28 November 2008.
- "Transend Transmission Determination 2009-10 to 2013-14", published 27 November 2008.

This submission also responds to the revised regulatory proposals lodged by these network service providers where specified.

2 Structure and Approach of Submission

This submission addresses the following matters:

- Energy Forecasts for Distribution Businesses (see section 3).
- Pass Through Events for Distribution Businesses (see section 4).
- Debt and Equity Raising Costs for Distribution (and Transmissions) businesses (see section 5).
- Rate of Return for Distribution (and Transmission) Businesses (see section 6).
- TransGrid's contingent project (see section 7).
- Reasonable estimates for the control mechanism for NSW Distribution businesses (see section 8).

Each section of the submission specifies the decision(s) to which each part of our submission relates.

3 Energy Forecasts for Distribution Businesses

This part of the submission is being made in relation to each of the NSW distribution determinations specified in section 1.

EnergyAustralia wishes to bring to the AER's attention a number of differences in the approaches used by EnergyAustralia, Integral Energy and Country Energy to forecast energy volume, and in particular, the treatment of electricity price movements over the 2009-2014 determination period.

In its revised regulatory proposal and interim submission, EnergyAustralia outlined its approach that incorporated the impact of forecast electricity price changes in its revised proposal. Our approach entailed the following steps:

Step 1: Develop, for each year of the determination period, an estimate of the expected real change in average retail electricity prices. EnergyAustralia's analysis considered the following components that could influence future electricity prices:

- The Carbon Pollution Reduction Scheme (CPRS);
- The AER's draft determinations for EnergyAustralia and TransGrid;
- Initiatives in the form of changes to levies and coal royalties which were announced in the NSW Mini-Budget of November 2008; and
- The current IPART retail price determination.

Step 2: Obtain reliable estimates of the price elasticity of electricity. EnergyAustralia ultimately relied on price elasticity estimates published by NEMMCO, noting that the AER's forecasting consultants, MMA, appeared to have used the NEMMCO elasticities in analysis contained in its review of EnergyAustralia's June 2008 volume forecasts.

Step 3: Overlay the result of the product of the NEMMCO elasticities, multiplied by the estimated annual real price changes, to a "reference" volume forecast. The reference forecast chosen by EnergyAustralia for residential energy was the residential forecasts that the AER relied on in its draft determination. For non-residential energy the adopted reference case was a version of the draft determination forecast, updated for more recent economic activity projections.

Integral Energy's treatment of the impact of price changes on volumes appears to differ from EnergyAustralia's approach in the following ways:

- Integral Energy appear to have considered the impacts of carbon dioxide abatement policies on prices, but it is not clear whether the impacts of other drivers of price (AER determinations, NSW Mini-Budget initiatives) have been considered; and
- The assessed impacts of carbon dioxide abatement policies (presumably the CPRS) on electricity prices have been factored into the economic growth projections. EnergyAustralia can understand that this treatment would directly flow through to non-residential energy forecasts. However, it is not clear how the CPRS impacts have been factored into the residential forecasts.

EnergyAustralia acknowledges that Appendix A of Integral Energy's revised proposal, which EnergyAustralia has not yet seen, may clarify the apparent differences noted above.

Country Energy's revised proposal expressly states that its demand forecasts incorporate the assessed implications of the CPRS on volumes. As with the Integral Energy forecasts, it is not clear whether Country Energy's forecasts explicitly considerer the impacts of other drivers of price (AER determinations, NSW Mini-Budget initiatives). However, EnergyAustralia has not yet seen Appendix A of Country Energy's revised proposal, which may clarify this issue.

EnergyAustralia raises these apparent differences in approach between the three NSW distribution businesses to highlight the need for the AER (and its consultants) to understand the drivers of difference between the forecasts before making conclusions that one is more/less accurate or conservative than another.

Furthermore, as EnergyAustralia noted in its revised proposal, there is:

- significant uncertainty with regard to the impact of climate changes policies on energy volumes;
- diverse opinion in relation to the elasticity of consumers demand response to these policies; and
- diverse opinion about the economic forecasts and how the economic circumstances will influence energy growth.

EnergyAustralia noted that the level of uncertainty with regard to forecast has never been higher. This was the primary driver of EnergyAustralia's proposal for a G-factor to be utilised in the next period in the absence of a 'look back' mechanism that mitigated the uncertainty surrounding volume forecasts. We do not believe it is open for the AER to ignore the current environment and the impact it will have of future energy volumes purely on the basis of its inherent volatility and uncertainty.

EnergyAustralia requests that the AER take care to recognise the differences in approach taken between the DNSPs and the legitimate variance in outcomes incorporated in these forecasts. In doing so, we submit that the G-factor proposed by EnergyAustralia is a mechanism through which the AER may mitigate the effect of variation in the forecasts and allow each DNSP's forecast to be accepted, in the context of a G-factor mechanism that provides insurance amid forecast uncertainty for both businesses and customers.

We request that the AER take into account the materials presented as part of EnergyAustralia's revised regulatory proposal and its further submission[1] as well as the consistent views presented by each of the distribution businesses when making its final decision on this issue.

[1] EnergyAustralia, Revised Regulatory Proposal and Interim Submission, January 2009, in particular Chapter 13 pp 115-122, Chapters 4-5 (Part II) pp 162- 164 and the attachments and other material referred to in those Chapters; EnergyAustralia, Further Submission on the AER's draft determination, February 2009, in particular the Further Submissions on Chapter13 and attachments and other material referred to in those sections.

4 Pass Through Events for Distribution Businesses

This section relates to the distribution determinations specified in section 1 above (i.e. both NSW and ACT DNSPs).

The Transitional Rules provide for the distribution determination made by the AER to provide for additional pass through events to apply for a regulatory control period, see clause 6.12.1(14). To support this decision, Sch 6.1.3(2) requires a building block proposal to contain a proposed pass through clause and a proposal as to the events that should be defined as pass through events. These provisions are replicated in the main Chapter 6 Rules.

This is a clear acknowledgement from the MCE policy makers who developed both the Transitional Rules and the general Chapter 6 Rules that there would be circumstances relevant to individual DNSPs that would give rise to pass through events that may not be caught by the general definitions of pass through events in the Rules. This is supported by the material set out in EnergyAustralia's June 2008 Regulatory Proposal at Chapter 15 and the additional material set out in (and referred to) in its January 2009 revised regulatory proposal (see page 140 and footnotes 260 and 261). We request that the AER have regard to this material when making its final decision with respect to the other distribution determinations referred to in this submission.

Each of the distribution businesses developed thoughtful proposals in relation to pass through events appropriate for their businesses. Whilst there were some differences between the various proposals, there were also some common elements. In particular each of the proposals sought to identify events that were:

- uncontrollable and uncertain;
- could not be otherwise provided for or mitigated against;
- would have cost impacts for the delivery of standard control services if they occurred; and
- had not been included when calculating the forecast capital or operating expenditure of the DNSP.

The criteria developed by the AER to assess the proposed pass through events were generally consistent with the approach adopted by the businesses. Unfortunately the AER does not appear to have applied its criteria in a consistent and reasonable manner to the specific pass through events sought by each business.

In many cases the AER has rejected pass through events which meet its own criteria. The AER's rejection of EnergyAustralia's "compliance event" and Country Energy's equivalent "changes in risk assessment costs due to court cases and other legal obligations" is an example. Both pass through events relate to events that may or may not occur, but if the event did occur, it would have significant cost impacts on the business that have not been incorporated in the forecast.

In the case of EnergyAustralia's dead zone event and ActewAGL's equivalent transitional period event, the AER has incorrectly taken the view that the circumstances which these events are designed to address cannot be accommodated under the Rules.

Chapter 15 of EnergyAustralia's revised regulatory proposal and interim submission and EnergyAustralia's further submission [2] outline EnergyAustralia's concerns with the AER's application of criteria to EnergyAustralia's proposed pass through events and, in relation to the proposed dead zone event, why it believes that its approach to the proposed dead zone event is incorrect.

EnergyAustralia submits that the AER should give further consideration to each of the events proposed as pass through events by the distribution businesses in light of the matters raised in this submission, EnergyAustralia's revised regulatory proposal and interim submission, and EnergyAustralia's further submission.

Applicability to Alternative Control Services

ActewAGL and EnergyAustralia[3] both proposed that the pass through provision of the transitional Chapter 6 Rules apply to alternative control services as well as standard control services.

[2] EnergyAustralia, Revised Regulatory Proposal and Interim Submission, January 2009, specifically chapter 15 and the attachments and other material referred to in that Chapter; EnergyAustralia, Further Submission on the AER's draft determination, February 2009, specifically the further submission on Chapter 15 and the attachments and other material referred to in that further submission.
[3] EnergyAustralia June 2008 Proposal, Chapter 7 of Part II, p 200-201.

The AER agreed in principle that these provisions should apply [4], but formed the view that, legally, they already applied because the "…NER relating to pass through events refer to direct control services which include both standard and alternative control services" [5].

In EnergyAustralia's view, the AER's interpretation of the Rules is not correct. The existing Rule provisions do not allow, or require, positive or negative pass through amounts to be determined by the AER with respect to alternative control services. There are a number of reasons for this.

First, Rule 6.6 is headed "Adjustments after making of building block determination" and is located in Part C of the Transitional Rules which relates to building block determinations for standard control services. This would appear to indicate that these provisions apply in the context of a building block determination only. This is supported by the provisions themselves:

- Clauses 6.6.1(j)(2) and (3) refer to standard control services.
- Clause (j)((7) refers to the provider's annual revenue requirement.

Secondly, the references to direct control services are in the definitions of the various events; not in the provisions in Rules 6.6 which allow an application for pass through to be made. This is appropriate so that that pass through arrangements are capable of being applied to alternative control services, but this does not of its own result in a right to seek approval for the pass through of a positive pass through amount, or an ability for the AER to require a negative pass through amount to passed through, for the alternative control services.

Finally and most conclusively, it is clear from clause 6.2.6 of the Transitional Rules that the policy intent of the rule makers was that Rule 6.6 would not automatically apply to alternative control services. Clause 6.2.6 imposes requirements in relation to the control mechanism for alternative control services. It provides that the control mechanism for alternative control services may utilise elements of Part C. A note to that provision indicates that the control mechanism might be based on the building block approach and the distribution determination might provide for the application of clause 6.6.1 to pass through events with necessary adaptations and specified modifications.

In light of the above, EnergyAustralia strongly submits that the AER should reconsider its decision in relation to the application of the pass through provisions to Alternative Control Services. We submit that the AER should include in its distribution determination, a specific provision applying clause 6.6.1 of the Transitional Rules to any pass through event which occurs in the provision of alternative control services provided by a distribution business. EnergyAustralia's further submission addresses this issue more specifically for the alternative control services provided by EnergyAustralia.

[4] AER Draft Determination for NSW Distribution businesses at p 286, AER draft determination for ACT at p 171.
[5] Ibid.

5 Debt and Equity Raising Costs for Distribution and Transmission Businesses

This part of the submission is being made in relation to each of the distribution and transmission determinations listed in section 1 above.

We note that the businesses have generally maintained their original proposals that:

- the cost of debt and equity raising should include direct and indirect costs; and
- the cost of debt raising should be set at 15.5 basis point per annum and the cost of a seasoned equity offering should be 7.6%.

We also note Integral Energy and TransGrid's revised proposals identified an error in the AER's cash flow modelling used to determine the cost of equity raising. This error relates to the failure of the AER to recognise a cash outflow for the repayment of debt in its cash flow modelling. Integral Energy also identified an additional modification to the cash flow modelling to recognise the cost of using internally generated funds.

EnergyAustralia's further submission includes additional evidence to support matters raised by Integral and TransGrid[6].

We submit that each of the businesses' responses to the AER's draft decisions on the cost of debt and equity raising are consistent with our own response on these matters and are supported by independent expert advice submitted by the businesses.[7] We request that the AER take into account the materials presented as part of EnergyAustralia's revised regulatory proposal and its further submission[8] as well as the consistent views presented by each of the distribution businesses when making its final decision on this issue.

6 Rate of Return for Distribution and Transmission Businesses

This section of the submission is being made in relation to each of the distribution and transmission determinations specified in section 1 above.

EnergyAustralia notes that the AER did not agree with the proposed averaging periods of EnergyAustralia, Integral Energy, Country Energy, Actew AGL, TransGrid and Transend on the basis that the proposed dates of the periods were too far removed from the final determination date and the commencement of the regulatory control period. The AER's draft determination for each business noted that the AER had substituted a new averaging period for each business which was closer to the final determination date.

The businesses' proposals raise similar issues to those raised in EnergyAustralia's revised proposal including:

- the AER's specified averaging period is affected by abnormal financial market conditions; and
- problems with using underlying data to estimate corporate bond yields.

With the exception of Transend, all businesses revised their proposed averaging period. The businesses referred to evidence that the AER's specified period is affected by current abnormal financial market conditions and will provide a rate of return under the Transitional Rules which is materially biased below the rate of return required by investors

[6] EnergyAustralia, Further Submission on the AER's draft determination, February 2009, specifically the further submission on Chapter 3 and the attachments and other material referred to in that further submission.

[7] Please refer to Attachment 3O and 3P to our revised proposal and interim submission of January 2009.

[8] EnergyAustralia, Revised Regulatory Proposal and Interim Submission, January 2009, in particular chapter 3 pp 42-48, chapter 9 pp 104-107 and the attachments and other material referred to in those chapters; EnergyAustralia, Further Submission on the AER's draft determination, February 2009, in particular the further submissions on Chapters 3 and 9 and attachments and other material referred to in those further submissions.

in a similar commercial business. This was based on expert evidence provided by CEG which was referenced in, and attached to, the revised proposals of the businesses.

EnergyAustralia supports proposals which adopt an averaging period ending before 5 September 2008, an important milestone in the global financial crisis.[9]

We note that Integral proposed a second (and less preferred) option of a twelve month averaging period, ending on 20 March 2009 which includes observations affected by abnormal financial market conditions. We note that the AER's predecessor, the ACCC, and other regulators in other decisions have preferred to remove anomalous observation periods when setting an averaging period, rather than smooth them over a longer period. EnergyAustralia prefers an option which removes the anomalous period over a smoothed averaging option as it leads to a more appropriate rate of return outcome commensurate with the Rules. It is also difficult to support Integral's smoothed averaging option on the basis of regulatory precedent (which was a determinative factor in the AER's decision to withhold our original proposed averaging period).

We note that Transend did not revise its averaging period and instead proposed that the AER use the market derived inflation forecast (by applying the Fisher equation) as the method that should be used for estimating inflation.

Transend noted that the adoption of a nominal risk free rate (based on the observed nominal CGS yield) and an inflation forecast that does not have proper regard to bond market data (that is by using an independent forecast of inflation) would result in a material and unjustifiable downward bias in the effective real risk free rate and the return on equity. TransEnd consequently adopted the market derived inflation forecast of 1.94 per cent to address the 'current dislocation in the bond market'. In revising its inflation forecast, Transend stated[10]:

> ".. Transend's proposed inflation forecast of 1.94 per cent does not correct for the depressed yield on indexed CGS and therefore, in terms of the resulting real risk free rate, the proposed inflation forecast is almost certainly too high… Transend has adopted a pragmatic approach given the unusual current market conditions"

EnergyAustralia agrees with Transend's comment above. We do not think that observations of the nominal risk free rate in a period of abnormal market conditions will provide a rate of return required by investors in a similar commercial business.

This particular issue was raised in our revised proposal. We stated that if the AER does not accept EnergyAustralia's revised proposed period, it must make an adjustment to the rate of return that is calculated using the AER's specified period in order to ensure that the rate of return applied to EnergyAustralia is consistent with the Rules and NEL. In the absence of such an adjustment, the 10 year estimate of inflation and the 10 year nominal risk free rate will be applied inconsistently in the PTRM.

Similar to Transend, we noted that one such adjustment the AER could make to remove the inconsistency is to adopt the break even inflation rate as its best estimate of expected inflation. Alternatively we identified that the AER could use the 10 year indexed CGS bonds as a proxy for market observations of the real risk free rate and add the 10 year RBA estimate of inflation to determine a nominal risk free rate. However, in respect of these adjustments, we observed that[11]:

> "… (the adjustments) will likely underestimate the true nominal risk free rate given the fact that, as noted by the AER in the draft determination, indexed CGS yields are artificially depressed by a lack of supply. Noting also that the yield on indexed CGS has not changed materially in the last six months."

EnergyAustralia's view is consistent with CEG's report. In contrast to these adjustments, an averaging period that does not include a period of abnormal financial market conditions will more likely provide a rate of return required by investors in a similar commercial business.

We also note that the revised proposals of EnergyAustralia, TransGrid, Transend and ActewAGL also raised issues relating to the appropriate underlying data for calculating the debt risk premium. We referred to evidence indicating that the global financial crisis may also be affecting the underlying data used to estimate corporate debt yields. We noted CEG's advice that CBA Spectrum observations are now estimating yields on BBB+ bonds that are 1.55 per cent higher than what Bloomberg is estimating for riskier BBB bonds.

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[9] An announcement was made on 7 September 2008 that two largest buyers and securitisers of US mortgages ('Fannie Mae' and 'Freddie Mac') were placed in conservatorship.

[10] TransEnd, Revised revenue proposal for the period 1 July 2009 to 30 June 2014, January 2009, p49.

[11] EnergyAustralia, Revised Regulatory Proposal and Interim Submission, January 2009, p70.

We noted that under current market conditions neither Bloomberg of CBA Spectrum data is likely to provide a reliable estimate of corporate bond yields. EnergyAustralia's revised debt risk premium relied on the advice of CEG who noted that an alternative approach to relying on one of the other of these data services would be to take a simple average of Bloomberg and CBA Spectrum data.

We note that businesses proposed different methodologies for addressing underlying data issues. TransEnd and TransGrid adopted the averaging approach proposed by EnergyAustralia while ActewAGL proposed to use CBA Spectrum data. We note that TransGrid, Transend and ActewAGL have provided analysis to support their proposals, including the advice of CEG.

EnergyAustralia noted in its revised regulatory proposal and interim submission that, on the basis of advice of CEG, the AER may be persuaded to apply a consistent approach to observing data for the debt risk premium and in this case, CBA spectrum may still provide a realistic reflection of market conditions and compare well to a hybrid of two data observations. In any case we believe the Bloomberg data observations, on their own, are not reflective of an annualised corporate bond rate for corporate bonds with a maturity of 10 years.

Integral and Country Energy did not depart from the AER's draft decision to use Bloomberg data. However, it is not evident that Integral Energy or Country Energy gave consideration to the analysis and issues raised in CEG's paper on this issue.

We therefore request that the AER consider the material presented as part of EnergyAustralia's revised proposal and interim submission as well as its further submission[12] (including CEG's report) when assessing the proposals of all businesses.

[12] EnergyAustralia, Revised Regulatory Proposal and Interim Submission, January 2009, specifically chapter 8 and the attachments and other material referred to in that chapter; EnergyAustralia, Further Submission on the AER's draft determination, February 2009, specifically the further submission on chapter 8 and the attachments and other material referred to in that further submission.

7 Contingent projects for transmission businesses

This part of the submission is being made in relation to the AER's draft determination in respect of TransGrid.

EnergyAustralia does not agree with the AER's draft decision not to accept TransGrid's proposed contingent project expenditure associated with the CBD and inner metropolitan project.

The proposed contingent project is the outcome of joint planning between TransGrid and EnergyAustralia. The project involves advancing the commissioning date of the CBD and inner metropolitan project to enable EnergyAustralia to defer expenditure on replacing 132kV cables between Lane Cove and Dalley Street zone substations. This was the least cost option for augmenting the network based on joint planning studies between TransGrid and EnergyAustralia.

Advancing the CBD project would require TransGrid to undertake capital expenditure in the 2009-14 regulatory period. The AER's draft decision not to include a contingent project means that TransGrid would be unable to recover its efficient capital costs if required to invest in the CBD and inner metropolitan project in the 2009-14 regulatory period.

It is also important to note that EnergyAustralia's forecast capital expenditure assumed the retirement of the 132kV cables in the 2009-14 period and therefore did not include any forecast replacement expenditure for these cables. EnergyAustralia is concerned that if TransGrid did not agree to undertake the investment, we would be required to undertake (inefficient) investment by replacing the 132kV feeders in the 2009-14 regulatory period without an opportunity to recover the efficient costs of the investment.

This situation illustrates why EnergyAustralia included a pass through event for joint planning. In our revised regulatory proposal, we noted that disincentives to efficient network development can arise where the various regulatory determinations for the participants involved in joint planning do not provide the requisite funding for all parties involved in the development of the project. This is addressed further in EnergyAustralia revised proposal and interim submission and its further submission[13]. We request that this material be considered in the context of the AER's final transmission determination for TransGrid.

[13] EnergyAustralia, Revised Regulatory Proposal and Interim Submission, January 2009, specifically chapter 15 and the attachments and other material referred to in that Chapter; EnergyAustralia, Further Submission on the AER's draft determination, February 2009, specifically the further submission on chapter 15 and the attachments and other material referred to in that further submission.

8 Reasonable Estimates for control mechanism for distribution businesses

This part of the submission is being made in relation to the NSW distribution determinations identified in section 1.

EnergyAustralia notes Integral Energy's comments on forecasting reasonable estimates when implementing a new tariff or tariff component. Integral Energy's first example relates to moving volume from an any time demand component to a peak period demand component. EnergyAustralia has in the past defined these as separate tariff components with respect to volume transfers, rather than as the same component as Integral Energy has proposed. For EnergyAustralia, such an example would involve two transfers to take place: anytime demand volumes are being moved between tariffs, and also separate peak only demand volumes are being moved between tariffs. We consider that there is no need to define these two transfers as the same volume transfer under the current reasonable estimates framework proposed by the AER. Therefore, there should be no revenue at risk as long as they are defined as separate component types. .

With respect to Integral Energy's second example of reduced volumes under dynamic peak pricing tariffs, EnergyAustralia's agrees that the current reasonable estimates framework does not adequately accommodate these tariffs. Because the "origin" tariff and "target" tariff volumes must match under the current approach, it is impossible to achieve this match if there is a marked volume reduction in dynamic peak events (which is what these tariffs are designed to achieve). The volume that would have existed under a standard tariff, is simply conserved under a dynamic tariff and as such, there is a genuine net reduction in consumption. This is not accommodated for within the reasonable estimates framework which demands that the origin and target tariff volumes must match.

EnergyAustralia submits that the AER needs to take these reductions in volumes, and the classification of volume transfers into consideration in delivering a robust reasonable estimates framework.