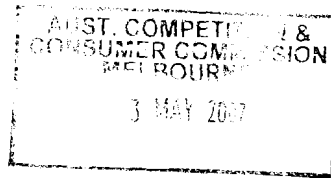


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1 May 2007

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Dear Ms. Groves

Michelle

ELECTRICITY TRANSMISSION REGULATION: EFFICIENCY BENEFIT SHARING SCHEME AND SERVICE INCENTIVE SCHEME

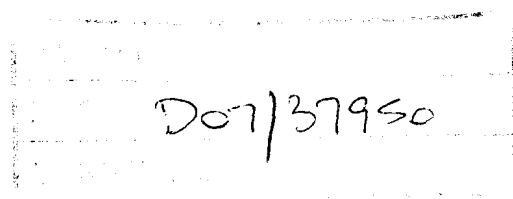
The AER has recently released a number of consultation papers relating to its approach to the economic regulation of electricity transmission network service providers. The Essential Services Commission of SA ("the Commission") has reviewed these papers, and would like to provide the AER with submissions to the Issues Papers relating to the Efficiency Benefit Sharing Scheme and Service Target Performance Incentive Scheme.

The Commission's submissions to these papers are enclosed with this letter.

If you would like to discuss the Commission's comments, please contact Nathan Petrus, Manager Pricing and Access in relation to the proposed Efficiency Benefit Sharing Scheme on (08) 8463 3767 or Bob Burgstad, Director Technical in relation to the proposed Service Target Performance Incentive Scheme on (08) 8463 4353.

Yours sincerely,

Pat Walsh
CHAIRPERSON





**First Proposed Electricity Transmission Network Service Provider
Efficiency Benefit Sharing Scheme**

Submission from Essential Services Commission of SA to AER Issues Paper

Question 1: *Would the carry-over of efficiency losses be inconsistent with the AER's requirement to provide TNSPs a reasonable opportunity to recover efficient costs, and to make allowance for the value of transmission network assets under section 16(2) of the NEL?*

Commission's response:

In the development of its own electricity distribution efficiency carryover scheme, the Commission acknowledged that there is the potential for net negative carryover amounts to lead to a reduction in total revenue such that it does not recover the efficient costs of operating the network business. The Commission has addressed this issue by developing a scheme that allows the regulator the discretion to defer any net negative amount to a subsequent regulatory period in which a positive carryover is calculated.¹

This deferral scheme is seen by the Commission as alleviating any concerns over the impact that a negative carryover may have on the financial viability of the business, while retaining the symmetric properties of the incentive scheme (by providing for both rewards and penalties). The AER may wish to consider such an approach in the development of its transmission efficiency benefit sharing scheme.

Question 2: *Would the prospect of not penalising TNSPs for inefficiencies reduce the incentives of the benefit sharing scheme?*

Commission's response:

The Commission is of the view that an asymmetric scheme does not provide continuous incentives for the regulated business to achieve efficiencies. By rewarding efficiencies but not penalising inefficiencies, the regulated business may have an incentive to not achieve efficiencies in the latter part of the regulatory period, if its performance over the period is such that it is likely to incur a negative carryover irrespective of how efficient it is for the

¹ Refer Essential Services Commission of SA, *Electricity Distribution Efficiency Carryover Mechanism 2005-2010: Final Report*, March 2007 (available at <http://www.escosa.sa.gov.au/webdata/resources/files/070315-R-EffCarryMechanismFinalReport.pdf>).

remainder of the period. This incentive is strengthened if operating expenditure forecasts are set on the basis of actual expenditure in the latter part of the previous regulatory period.

The Commission believes that only a symmetric scheme can deliver continuous incentives for achieving efficiency gains.

Question 3: Should the scheme allow the AER to use its discretion when applying large positive carry-over amounts and consider the resulting impact on network users?

Commission's response:

All else being equal, the carryover of any positive efficiency amount will lead to an increase in total revenue, and an increase in network prices. The AER is presumably concerned that this may create a price shock to network users.

However, it must be remembered that the benefit sharing scheme is itself designed to provide incentives for the regulated business to achieve cost reductions throughout the regulatory period, and that these incentives are weakened in the absence of such a scheme. The positive carryover resulting from the efficiency benefit sharing scheme represents a share of the benefits to the TNSP of such efficiencies, with the remaining share going to network users.

It should also be noted that in determining allowed revenue, any significant increases in one particular building block may be offset by decreases in another, and that the total revenue requirement across the 5 year period is able to be smoothed through the use of the X factor.

Question 4: Is the five year carry-over period and the resulting 50:50 sharing of gains/losses appropriate?

Commission's response:

The Commission notes that a five year carryover period is equivalent to a sharing ratio between a TNSP and users of 30:70. This sharing ratio may be appropriate for TNSPs, but will ultimately depend on assumptions made on the responsiveness of the TNSP to changes in the share of efficiency gains it receives and also on a view as to the appropriate trade-off between the extent of the efficiency gains made and the speed with which such gains are passed through to customers. To the extent that the relationship is expected to exhibit diminishing returns (ie, efficiency gains from increasing the share of gains retained by the business diminish as the share retained by the business increases) that would imply that the optimal share retained by the business would be below 50%. In this circumstance, a five year carryover may be appropriate.

Question 5: Should the scheme define what events and associated cost increases/decreases are to be excluded from the calculation of efficiency gains and losses?

Commission's response:

The Commission acknowledges that it is desirable for an efficiency benefit sharing scheme to differentiate between efficiencies that result from business initiatives and those that result from events that are outside the TNSPs control. However, it is difficult to draw such distinctions in practice. The Commission would recommend an administratively simple scheme that does not draw such distinctions. This recognizes that external events may lead to either an over or underspend and that there are other arrangements in place to deal with external events that have a material impact on expenditure (eg. pass through arrangements).

Question 6. What are the processes and considerations by which the AER should determine whether the impact of a certain event is excluded from the calculation of efficiency gains and losses?

Commission's response:

As discussed above, the Commission would recommend not excluding certain events on the basis that it is difficult to differentiate between management induced efficiencies and efficiencies resulting from events outside the TNSPs control.

Question 7. Is the proposed approach consistent with relevant aspects of the regulatory regime, such as pass through provisions, reopening provisions and the forward looking nature of the ex ante incentive framework?

Commission's response:

The Commission agrees that expenditure treated as a pass through should not be subject to the efficiency benefit sharing scheme, given that the scheme is primarily designed to correct for the weakening of incentives that arise towards the latter part of the regulatory period. This timing issue is not particularly relevant to pass through expenditures.

Other Matters: Capital Expenditure

The Commission believes that the efficiency benefit sharing scheme is an integral part of incentive based regulation, and would support such a scheme extending to capital expenditure as well as operating expenditure. Application of the scheme to capital expenditure is appropriate, where capital expenditure forecasts are informed by historical capital expenditure incurred by the TNSP.



First Proposed Electricity Transmission Network Service Provider Service Target Performance Incentive Scheme

Submission from Essential Services Commission of SA

The comments provided below relate to the document "First Proposed Electricity Transmission Network Service Providers Service Target Performance Incentive Scheme" Version No: 01, January 2007.

1. Clause 2.5 (d) and (g). Data that forms the basis of the proposed values for parameters is required to be reliable and accurate, and to be consistently recorded based on the appropriate definitions. TNSPs should be required to submit independent audit certification to this effect.
2. Clause 2.5 (j). The proposed performance targets may be subject to reasonable adjustments to accommodate various factors. The Commission does not disagree with the principle of such adjustments, but suggests that they should be transparent, and be considered as part of the independent audit process.
3. Appendix A - Parameters 1 & 2. So-called "3rd party system" exclusions should be thoroughly investigated and, if possible, be agreed to between the TNSP and the "3rd party". The Commission can cite one example of an exclusion of this type by ElectraNet in 2005/06 (agreed to by the AER) where the "3rd party" (ETSA Utilities) disputed that the outage was caused by its equipment. This comment applies also to various ElectraNet parameters (Appendix B, Part 2).
4. Appendix A – Parameters 2 & 3. The exclusion of planned outages is acceptable provided customers are given adequate notice. The Commission suggests that this should be at least 5 days so that the distributor (ETSA Utilities in SA) can meet its notification obligations if required, as a result of any TNSP planned outages.
5. Appendix B: Part 2 ElectraNet - Parameter 2. It is unclear to the Commission as to why the definition of "system minutes" is based on peak demand at entry points and unsupplied energy at exit points.