

4 January 2008

Mr Mike Buckley
General Manager
Network Regulation North Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Mr Buckley,

Matters relevant to distribution determinations for ACT and NSW DNSPs for 2009-2014 preliminary positions paper

Thank you for the opportunity to comment on the AER's preliminary positions paper concerning matters relevant to the distribution determinations for ACT and NSW DNSPs for 2009-2014.

Detailed comments in relation to the issues raised are provided in Integral Energy's submission which is attached. In summary, Integral Energy submits the following:

- capex should be recognised in the regulatory asset base on an "as incurred" basis rather than the AER's proposed "hybrid" approach;
- the roll forward model (RFM) should be adjusted to include a \$67.625m upwards adjustment to the regulated asset base made by IPART during the 2004 revenue determination to restore the undepreciated value of capex over and above the allowance provided to Integral Energy as part of the 1999 determination;
- the tax value of distribution assets should be established from our most recent tax-equivalent accounts rather than by reconstructing the tax value of the asset base at the time the tax equivalents regime came into place (1 July 2001) and then rolling that asset base forwards;
- the proposed efficiency benefit sharing scheme (EBSS) should not be implemented on the basis that it hasn't been demonstrated that it would achieve the objectives required under the Transitional Rules, namely, to provide a net benefit to customers via a continuous incentive on the business to make ongoing efficiency savings. Application of the proposed EBSS would also increase regulatory risk and the associated administrative burden on the DNSPs; and

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- while the AER should undertake a paper-based trial of the proposed service target performance incentive scheme (STPIS) during 2009 to 2014, it should then carefully evaluate the effectiveness of the scheme before deciding whether or not to fully apply it during the 2014 to 2019 period. The scheme would also need to take explicit account of NSW licence conditions and the consultation to be undertaken by the AER in accordance with the general Rules.

Should you wish to discuss any aspect of this submission, please contact Michael Martinson on (02) 9853 4375.

Yours faithfully



Richard Powis

Chief Executive Officer

Integral Energy submission to the AER on matters relevant to distribution determinations for ACT and NSW DNSPs for 2009- 2014 preliminary positions paper

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Introduction

Under recent amendments to the National Electricity Rules, the Australian Energy Regulator (AER) will become responsible for regulating Integral Energy's distribution network, beginning with the 2009 to 2014 regulatory period.

In November 2007 the AER published a preliminary positions paper on a number of matters relevant to the distribution determinations for ACT and NSW Distribution Network Service Providers (DNSPs). The preliminary positions paper sets out the preliminary positions of the AER in relation to how the following matters will be applied in the AER's determination for ACT and NSW DNSPs for the 2009 to 2014 regulatory control period:

- post tax revenue model (PTRM);
- roll forward model (RFM);
- efficiency benefit sharing scheme (EBSS);
- service target performance incentive scheme (STPIS); and
- the control mechanism for direct control services.

The AER proposes to make final decision on these matters following consideration of any submissions.

Detailed comments in relation to the issues raised in the Preliminary Positions Paper follow.

Post-tax revenue model

The Transitional Rules require that the AER publish a PTRM that is to be used to perform the revenue building block calculations. The AER has indicated that it intends to use the PTRM published on 28 September 2007 for this purpose. Integral Energy's specific comments in relation to the PTRM appear below.

Timing assumptions and discount rates in relation to the building blocks calculation

With respect to the assumptions for recognising the timing of capital expenditure (capex), Integral Energy considers that the "hybrid" approach is inappropriate and that the full "as incurred" approach currently used by IPART is preferable for the following reasons:

- compared to transmission, distribution has a larger proportion of annual program work and a smaller proportion of multi-year projects – use of the hybrid approach would result in a larger amount of regulatory record-keeping for little difference in revenue dollar terms; and
- in theory assets start depreciating from the time they first contribute to service delivery. However, a large proportion of electricity assets begin to depreciate from the time of expenditure rather than the time they are first used. For example, poles and wires are

exposed to air and weather from the time they are constructed. It would be inappropriate to depreciate them only from the time that they are formally commissioned.

With respect to the discount rates, Integral Energy notes that, on the basis that the Transitional Rules prescribe an equity beta of 1.0, the reference in the WACC tab of the PTRM to the derivation of the equity beta from the effective tax rate should be removed.

Working capital

Integral Energy supports the approach to working capital used by IPART for the current regulatory determination, namely, that it be calculated by reference to a specified number of days of receivables less payables plus inventory. A return on working capital should be included in the PTRM building block calculations.

Capital contributions

Integral Energy supports the process outlined by the AER for dealing with capital contributions and notes that the PTRM needs to be modified to allow for this to occur. That is, capital contributions must be included in taxable income and subject to depreciation for tax purposes.

Pre- to post-tax cost of capital

In terms of the need to establish a tax base at the start of the upcoming regulatory period, Integral Energy does not support the AER's proposed approach of taking the value of a firm's assets from the date it first became subject to the tax equivalents regime and then rolling those values forward. This full reconstruction would involve a large and unnecessary volume of work that may also become further complicated should any issues arise associated with data unavailability and/or unreliability.

Instead, Integral Energy submits that it should be assumed that the DNSPs would have taken full advantage of changes to tax legislation that have occurred over the life of the assets using the different rates of depreciation permitted at the time investments were made. On this basis, a tax asset base established as at 1 July 2001 and rolled forward to 1 July 2009 should in theory be the same as a tax asset base established as at 1 July 2009. This would obviate the need for undertaking a complicated roll forward.

Other matters

The row "WAPC constraint" should be removed from the X factor calc tab of the PTRM as the price cap is not in fact a constraint on smoothed forecast revenues. On the basis that building block revenues will be smoothed on an NPV neutral basis, Integral Energy is indifferent to whether taxable income is based on smoothed or unsmoothed revenues. Should the AER choose the latter method, changes would need to be made to the PTRM to achieve this.

Roll-forward model

Integral Energy notes that the RFM will need to be amended to use the IPART full “as incurred” approach. As part of this, capital contributions will need to be detailed by asset class.

Integral Energy also notes that the RFM does not currently utilise the 1 July 2004 opening regulatory asset base (RAB) numbers specified in Schedule 6.2 of the Transitional Rules and adjusted as required. Rather, it uses the 2003/04 opening RAB and rolls it forward adjusting for the difference between forecast and actual expenditure for that year to arrive at a 1 July 2004 RAB. By doing so, this omits an adjustment of \$67.625m made by IPART to Integral’s opening RAB in its 2004 determination to restore the undepreciated value of capex over and above the allowance made in IPART’s previous determination for the 1999/04 regulatory control period¹. That amount forms part of the 1 July 2004 RAB specified in Schedule 6.2 and, to comply with the Transitional Rules, the AER will need to include it in the RFM.

Finally, Integral Energy notes the AER’s intention to “make minor adjustment to ensure the transition to PTRM is internally consistent with appropriate indexation applied”. Integral Energy considers that the AER should provide DNSPs with an opportunity to comment on the specific adjustments prior to finalisation of the RFM.

Efficiency benefit sharing scheme

As a broad policy principle, Integral Energy supports an incentive-based approach to regulation. However, Integral Energy continues to have serious reservations about the implementation of an EBSS in the form currently proposed by the AER.

Integral Energy agrees that where:

- there is scope to share between business and customers the benefits of operating cost efficiencies achieved during the regulatory control period beyond those forecast at the outset of the period; and
- those savings can be achieved while maintaining or improving the safe, secure and reliable delivery of services to those customers,

then it is appropriate, as part of a balanced regulatory package, to include a mechanism to reward businesses for finding those savings. It may also be appropriate to penalise a DNSP for failing to meet its forecast opex targets where there was no credible reason for doing so and where the imposition of a penalty would not jeopardise the delivery of services to customers.

These principles are reflected in the Transitional Rules which require inter alia that:

¹ IPART, *NSW Electricity Distribution Pricing 2004/05 to 2008/09 Final Report*, p 252.

- the AER may implement an EBSS to provide for a fair sharing between DNSPs and customers of any efficiency gains or losses derived from actual opex being, respectively, less or greater than forecast (allowed) opex; and
- before doing so, the AER must have regard to the need to:
 - ensure that the benefits to consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme for the DNSPs; and
 - provide DNSPs with a continuous incentive, so far as is consistent with economic efficiency, to reduce operating expenditure.

Integral Energy has the following concerns in relation to the AER's proposed EBSS.

First, it hasn't been demonstrated that the proposed EBSS provides a benefit to consumers sufficient to warrant any reward or penalty under the scheme. The basic intent of such a scheme is to remove the incentive on the DNSPs to "push" costs into the later years of the regulatory period since doing so allows the business to achieve returns greater than those allowed by the regulator. Delaying expenditure means that costs in later years are raised above efficient levels. However, the incremental approach proposed by the AER provides an incentive to "pull" expenditure forward to levels above the efficient costs associated with earlier years in order to generate a trend of increasing opex savings throughout the period. The AER indicated in its preliminary positions paper that it considered "the EBSS an important part of the regulatory framework encouraging DNSPs to reveal their efficient or true costs"². Integral Energy submits that, if it remains unclear whether the scheme encourages efficient, timely expenditure throughout the regulatory period, then it must also be unclear whether the EBSS provides a net benefit to consumers.

Second, and related to this issue, is the fact that the incremental approach proposed by the AER fails to provide a continuous incentive. This is because it *disincentivises* DNSPs from delivering opex savings earlier in the regulatory control period where these are likely to be larger than savings able to be achieved later in the period. In such circumstances, the business would be penalised for making negative incremental savings in the remaining years of the period whereas, were the larger savings made later, the penalty would not apply³.

It is true that an EBSS should provide an ongoing incentive to reduce unit costs over time. However, this should not be at the expense of making (and sharing the benefits with customers of) genuine savings whenever they arise, whether early in the period or not. Put another way, a continuous incentive does not necessarily mean only an incremental one and an effective scheme would recognise the need for balance between the immediate and the incremental. The

² Page 24.

³ Note that, while the EBSS proposed by the AER does not discriminate between making a one-off saving in any particular year of the regulatory period, this is only true when considered in isolation from opex being either over or under forecast values in other years of the period — the net incentive effect under the incremental approach makes the timing relevant.

AER itself noted the importance of this design objective in its June 2007 issues paper where it stated that:

the EBSS is therefore a mechanism that enable DNSPs to... face a more continuous incentive (*equal incentives in each year of the regulatory period*) to strive for efficiency gains⁴ [emphasis added]

To the extent that the proposed EBSS does not do so, it fails to address the considerations set out in the Transitional Rules.

It may be the AER's intention to address this problem by, on a case by case basis, adjusting the outcomes of the application of the EBSS to prevent the imposition of a penalty where larger, genuine early savings are made. However, this raises a third and broader issue concerning the AER's proposed ability to make ex-post adjustments to EBSS outcomes. The preliminary positions paper does not make it sufficiently clear in what circumstances such adjustments may be made. With four exceptions (changes in capitalisation policy, demand growth, recognised pass through events and uncontrollable factors nominated by the business in advance), the AER indicated that adjustments would generally only be permitted where the difference between forecast and actual expenditure lay "beyond the control of the DNSP"⁵. This raises the following concerns:

- the greater regulatory risk given the uncertainty of what constitutes the relevant circumstances — even the four exceptions are ill-defined in terms of their nature and threshold of application; and
- the increased regulatory burden arising from ex-post investigations and adjustments being made by the regulator — this raises the question as to what, if any, value can an EBSS be providing if a regulatory investigation is necessary whenever the business saves money?⁶

Integral Energy submits that, for the EBSS to have the potential to operate effectively, the AER would need to provide further clarity around the circumstances that would attract an ex-post review and the potential impact of, and processes involved in undertaking, such a review itself.

Fourth, Integral Energy remains concerned that the AER's proposal to treat EBSS carryovers symmetrically has the potential to significantly penalise customer service quality outcomes. As with the service target performance incentive scheme (STPIS), penalties should be capped in order to manage this risk. By contrast, positive incentives should not be capped. This is

⁴ AER, *Issues Paper, Electricity Distribution Network Service Providers, Draft Efficiency Benefit Sharing Scheme, June 2007*, p 3.

⁵ Page 23.

⁶ If an EBSS was in place and yet the AER remained concerned that savings achieved by the business early in a regulatory control period was the result of deliberately conservative forecasting, this would suggest that the EBSS has failed to address the problem it was intended to solve.

because, while it may be reasonably assumed that imposing a penalty based on what is considered by the regulator to be an efficient level of opex would impact service levels, it is inappropriate to assume that providing a reward for minimising costs will automatically lead to higher levels of service. Rather, the latter is more properly characterised as an incentive for the efficient use of funds.

Finally, and as noted in Integral Energy's recent submission in relation to the AER's November 2007 issues paper, the AER must ensure that the operation of the EBSS does not threaten incentives regarding the viability of non-network solutions.

Service target performance incentive scheme

Integral Energy supports the AER's proposed adoption of a paper based STPIS trial during the upcoming regulatory control period based on a generally-applicable scheme. This is appropriate in light of the AER's consultation obligation under the new Chapter 6 Rules. However, it is too early to say whether it would be appropriate to impose the trial in its full form on the NSW DNSPs in the subsequent regulatory period — the results of the paper-based trial would need to be carefully evaluated first. Any trial would also need to take full account of the relevant DNSP licence conditions.

Guideline on control mechanism for direct control services

Side constraints

There appears to be an inconsistency between the formula and the definitions for the side constraint on distribution component of individual network tariffs appearing on page 38 of the preliminary positions paper in that the reference in the definitions to q_k^{t-2} should read as follows:

q_k^{t-1} is the audited quantity of component k of the distribution tariff that was charged by the DNSP in year $t-1$ (being the year immediately preceding year t).

If this was in fact not a mistake but simply a partial update of the terminology as foreshadowed on page 41 of the paper, then the remainder of both the formula and the definitions need to be corrected to reflect this.

Integral Energy also suggests that the AER clarify that the right hand side of the formula " $1+\Delta CPI+L_{t+1}$ " is in fact calculated as " $(1+CPI)(1+L_{t+1})$ " where:

- L_{t+1} effectively combines X and a residual permitted real price change component; and
- the residual component is capped at two per cent in accordance with the Transitional Rules.

Integral Energy submits that the CPI indexation should be based on the most recently available statistics. The formula for ΔCPI appearing on page 39 should therefore be consistent with the IPART formula on page 85, namely that:

$$\Delta CPI = \left\{ \frac{CPI_{March, t-1} + CPI_{June, t-1} + CPI_{September, t} + CPI_{December, t}}{CPI_{March, t-2} + CPI_{June, t-2} + CPI_{September, t-1} + CPI_{December, t-1}} \right\} - 1$$

To be specific: given that prices for NSW DNSPs are set on financial years commencing 1 July, then t in this context should refer to CPI statistics available within the current financial year.

Integral Energy also notes that the above formula has been used in the draft Regulatory Information Notice issued on 21 December 2007.

TUOS recovery

Integral Energy notes the risk that actual TUOS over or under-recoveries may vary materially from their forecast amounts and that this may impact on both the DNSPs' revenue recovery and customer prices. Integral Energy submits that the AER provide a mechanism whereby DNSP's under and over account balances may be targeted to zero on a rolling basis over a number of years rather than requiring the full amount of the difference to be recovered or passed through in the subsequent year only.