

Australian Energy Regulator

Comments on the

AER Guidelines, models and schemes

for

electricity distribution network service providers

by

The Major Energy Users Inc

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CONTENTS	Page
Executive summary	3
1. Introduction	4
2. Post tax revenue model	5
2.1 Consistency between the PTRM for transmission and distribution regulation	7
2.2 Distribution specific issues	9
3. Roll forward model	13
3.1 Consistency between the RFM for transmission and distribution regulation	13
3.2 Distribution specific issues	14
4. Cost allocation guidelines	15
5. Efficiency benefit sharing scheme	17
5.1 Incentives to defer capex	20
5.2 Impact of the EBSS on incentives to undertake demand side responses and invest in distributed generation	20
5.3 other issues regarding inclusion of capex	22
5.4 Treatment of distribution losses	22

Executive Summary

The Major Energy Users Inc (MEU) welcomes the opportunity to provide its views on the AER's Issues Paper on 'Guidelines, models and schemes for electricity distribution network service providers'.

The MEU has already provided its comments to the AER on many similar issues with respect to the proposed guidelines for the transitional NSW/ACT distribution reviews.

The AER proposals, in the main, contain biases in favour of the DNSPs. These biases are identified and discussed in this submission. Against this background the AER is urged to assess these 'biases' in totality and then seek to rebalance these perceived 'biases' to arrive at a 'reasonable' outcome.

Whilst it is noted that the AER appears keen to develop a range of incentive schemes e.g. for capex, DSR and DG, the MEU would urge caution and counsel a need for more consideration and discussion before proceeding with such schemes at this stage, valuable though they are in principle.

The MEU provides comments on most of the major questions raised by the AER and these follow the structure of the Issues Paper.

1. Introduction

The Major Energy Users Inc. (MEU) welcomes the opportunity to provide comments on the AER's Issues Paper on 'Guidelines, models and schemes for electricity distribution network service providers.'

The MEU observes that many of the comments made by it to the proposed guidelines for the transitional NSW/ACT distribution review are similar to its views for the national guidelines. Additionally, MEU has already responded to the issues paper on the STPIS guidelines, and its responses to this issues paper should be read in conjunction with the earlier response.

The MEU notes that a number of the approaches proposed by the AER have an effective bias benefiting the DNSP, at the expense of the consumer. The MEU suggests that the AER should calculate the total effect of all the biases made in favour of the DNSPs and then to assess this against an overall bias which is seen as being reasonable. The MEU has a strong belief that the implicit bias towards regulated businesses is much larger than anyone (including the DNSPs, governments and the AER) recognises.

MEU comments below on each major issue follow the structure of the AER's Issues Paper.

2. Post tax revenue model

Q. The AER seeks comment on whether other rule provisions exist that are relevant to developing the PTRM for electricity distribution.

Q. Comments are also invited on whether the provisions mentioned here may require a different approach or have different meaning in the context of distribution and transmission regulation

- The MEU is not aware of any other provisions in the Rules that are relevant to developing the PTRM for electricity distribution.

- With the loss of being able to use the difference between indexed CGSs and nominal CGSs, the AER has lost the ability to develop an independently assessed inflation rate. This has two major impacts for the PTRM, viz:
 - Identifying the inflation figure is used to develop the forward estimate of nominal revenue needed to indicate nominal revenue requirements and the X factor used to smooth nominal revenue.
 - If a “real” based PTRM is used (as in certain jurisdictions) then the loss of an independently assessed inflation figure becomes critical in the absence of an indexed CGS, as the regulator attempts to identify that part of the nominal CGS that is inflation so that a “real” WACC can be developed,

In this regard, the AER advises that it uses a “nominal” PTRM and therefore uses the nominal CGS to set the risk free rate. If the AER does use the nominal CGS and does not use an assessed inflation figure to set WACC then the MEU has less of a concern about the loss of the ability to independently set inflation, as the MEU notes that actual inflation is used during a regulatory period to adjust tariffs.

The MEU requires confirmation that the AER will use a nominal WACC (ie using only nominal CGS amounts to set a nominal risk free rate and not adjusting these to develop a “real” risk free rate) for generating allowed revenue.

- The MEU reiterates its concerns¹ that the transition from a pre-tax to post-tax model will provide a net benefit to DNSPs as the AER’s calculations do not make adjustments to the RAB to discount the double benefit DNSPs will probably secure as a result of the change in the treatment of depreciation. Accordingly, the AER would need to re-balance this benefit when assessing the permitted revenue for a DNSP.
- **It is noted that under clause 6A.5.3 of the Rules, the PTRM for transmission must specify the maximum allowed revenue and the X factors. However, the PTRM for distribution is not required to specify such a maximum allowed revenue, but attempts to control tariff movements through a price control mechanism. This difference in approach is regrettable as the approach for DNSPs (which are much more complex organizations to regulate compared with TNSPs) and which due to this complexity have the strongest possibility for disadvantaging consumer interests by utilising its price cap approach to game the regulatory bargain by tariff manipulation after the tariff control mechanism is set**

Accordingly the MEU suggests the following:-

- **The AER devote considerable effort to ensuring the prices/tariffs set are at or close to cost reflectivity**
- **Require the DNSPs to fully substantiate the changing of tariffs (ie minimise the elimination of “redundant” tariffs)**

¹ Interim Distribution Guidelines for ACT/NSW DNSPs. Comments on the Preliminary Guidelines by Major Energy Users Inc, January 2008, page 8.

by requiring DNSPs to develop their pricing methodologies and thereby reducing the ability of DNSPs to chop and change

- **Advising DNSPs that the AER will investigate the actual revenues earned by DNSPs and assessing these against actual volume changes. If the AER notices that there is a significant variation between the actual revenue and the assessed revenue adjusted for volume change, then the AER will more closely examine the price control mechanism at the next review and perhaps advise that it will impose more stringent reporting requirements by providing a detailed development of the revenue achieved so that a more cost reflective outcome is achieved.**

2.1 Consistency between the PTRM for transmission and distribution regulation

Q. The AER seeks comment on whether the PTRM developed for electricity transmission provides a suitable basis for distribution regulation.

Q. If not, what particular features or aspects of the PTRM need to be amended?

Depreciation Methods: The MEU notes that DNSPs are much more complex organizations to regulate compared with TNSPs. Accordingly, the MEU considers that:

- any depreciation method proposed by the DNSP must not allow for front-loading or back-loading of depreciation as by doing so, it will reflect on the costs borne by current and future consumers. The AER should make a clear statement that this would not be permitted.

- the DNSP must not be allowed to change its depreciation method or approach between regulatory resets, as it could use changes in depreciation to affect the costs impact borne by current and future consumers. The AER should make a clear statement that this would not be permitted.

Capex recognition: The MEU had supported the use of a ‘hybrid’ approach to recognizing capital expenditure in regulating TNSPs and, initially, in regulating DNSPs. However, it is recognised that there are:

- additional regulatory costs in moving away from an ‘as-incurred’ basis. If the ‘as incurred’ approach is used, then there should be no allowance included for working capital, as this would constitute a “double dip”.
- determining depreciation on an ‘as-commissioned’ basis is consistent with Australian Accounting Standards
- the ‘as-incurred’ approach is simpler to model and should also strengthen the incentive properties of the ex-ante capital allowance framework.

The MEU notes that the hybrid model provides the DNSP with the “best of both worlds” by a later start to depreciation but an earlier start to recognising capital spend. This should be recognised by the AER as a bias towards the DNSP.

Inflation bias: As noted above, if the AER uses a nominal approach for setting WACC, then the inflation bias between nominal and indexed CGSs has a much lesser impact than if the AER uses a “real” WACC. This matter needs to be clearly stated by the AER before the MEU can provide its views on how best to address this matter of inflation bias.

Cash flow timing: The MEU notes that the AER does not recognize working capital in the PTRM as all cash-flows (except capex) are assumed to occur on the final day of each year. With regard to TNSPs, the AER has noted that it intends to consider these timing assumptions further and may amend the PTRM in the future. The MEU considers that the AER approach developed for TNSPs is a suitable basis for regulating DNSPs.

The MEU commits to working with the AER in the future when it reviews the impact of cash flow timing. In this regard the MEU notes that accounting standards do make this assumption and therefore this is at the basis of all financial reporting.

The AER should note that financial reporting is the basis for how the market perceives a business, and it is the perception of a business performance that sets its share price. Therefore, accounting practices lie at the fundamentals of the size of the market risk premium used in the WACC development under CAPM, and therefore the AER must ensure that its assessments are consistent with the derivation of the WACC used to reward regulated businesses.

2.2 Distribution specific issues

Q. The AER seeks comment on how the PTRM could be modified to recognize the treatment of capital contributions, or whether it may be more suitable to deal with this during reset processes.

Capital contributions: The MEU supports, in principle, a national approach to economic regulation of DNSPs, but recognizes that different jurisdictions have applied different approaches to date. It would be more practicable to deal with this issue during the next part of the process.

Cash-flow timing issues:

Q. Do the PTRM's current timing assumptions result in any systematic bias in favour of service providers?

Q. If so, is there merit in considering modifications to the PTRM to remove this bias, for example, in the form of present value adjustments discussed here?

Q. To what extent would these adjustments increase the administrative burden and complexity of the modeling?

As noted above the MEU sees that the cash flow timing does provide a bias in favour of the DNSPs. As a matter of principle all biases should be eliminated when they are identified. The MEU supports the AER in looking to remove this bias.

If the AER elects to retain this bias, then it should include this as part of the overall assessment of biases included in a regulatory decision, and adjust this overall amount to be no more than a set figure.

The MEU also notes that inflation figures are provided on a quarterly basis so that any refinement in adjusting for cash flow timing would have to recognise this constraint.

Forms of control:

Q. Stakeholders are invited to comment on the benefit of incorporating indicative X factor calculations in the PTRM under common forms of price control, namely revenue caps (as per the existing PTRM), weighted average price caps, and revenue yields

The MEU considers that it is important, for network users, to have calculations of the X factors. This allows end users to see the outcomes of the different approaches used.

However, in raising this, the Issue Paper raises an important matter – is the current use of three different forms of price control appropriate for a national regulatory approach. The MEU considers that a single approach is preferable. This is to avoid ‘shopping’ for the most advantageous outcome.

In addition to the differing mechanisms currently used, the MEU notes that regardless of the form of control a DNSP is incentivised to use the form of control set, to maximise its revenue. Bearing this in mind the AER should examine each of the forms currently used to identify which is least able to be used by a DNSP to game the system.

In this regard the MEU notes that the closer tariffs are to being cost reflective, and where the DNSP is heavily constrained in being able to change tariff structures (ie make some redundant and/or to introduce new tariffs structures), then the less the form of control permits a DNSP to game the form of control imposed.

Linkages with information requirements:

Q. Stakeholders are invited to comment on other likely information requirements associated with the PTRM.

The MEU accepts that there will be additional and different data for DNSPs to collate and report on, and that this will result in some costs. Ultimately, these costs are paid by consumers. This cost will be “once only” and the outcome will be a more accurate representation of the cost to provide the service.

Major Energy Users Inc

MEU Comments:

AER Guidelines, models and schemes for Electricity distribution network service providers

The MEU considers that the additional costs incurred for accurate and comprehensive reporting is a small price to pay for the certainty that DNSPs are only receiving a reasonable reward for the service provided, and that they are not levying any monopoly rents.

3. Roll-forward model

Q. The AER seeks comment on whether other rule provisions exist that are relevant to developing the RFM for electricity distribution.

Q. Comments are also invited on whether the provisions mentioned here may require a different approach or have different meaning in the context of distribution and transmission regulation.

The MEU is unaware of any other provisions of the Rules that would impact on the approach used to develop the roll forward model for the asset valuation.

3.1 Consistency between the RFM for transmission and distribution regulation

Q. Stakeholders are invited to comment on whether there are any impediments to using the AER's transmission RFM as a basis for the distribution model.

The MEU notes that it is the application of depreciation to the various asset classes that impact most greatly on the roll forward of the RAB from one review to the next.

To ensure there is equity and no gaming implicit in this aspect of a regulatory review, the MEU recognises that the development of the model will require a high degree of detail, and it is recognised that the build up of assets and their allocations for a DB is much more complex than for a TNSP.

The MEU considers that the AER should err on the side of requiring more detail than too little in the build up of the individual assets and asset classes, rather than seek to eliminate the necessary detail in order to simplify the roll forward process.

Subject to the above comments and observations, the MEU agrees with applying the RFM developed for TNSPs to be the basis for that used for DNSPs.

3.2 Distribution specific issues

Q. The AER invites comments on whether the adoption of existing models is appropriate and whether there are specific issues regarding these models, and current jurisdictional revenue determinations, that the AER needs to consider in performing its first round of roll-forward calculations in each jurisdiction.

The MEU agrees with the AER proposed approach.

4. Cost allocation guidelines

Q. Written comments from interested parties are sought on the following:

- **Given the similarity between the respective NER provisions for transmission and distribution, to what extent should the AER adopt a similar approach to cost allocation between distribution and transmission businesses?**
- **Are the proposed general principles discussed above for the provision of information for cost allocation in the distribution sector appropriate?**
- **Should any other general principles and or requirements be reflected in the distribution cost allocation guidelines?**

The MEU points out that correct and accurate cost allocation is the first step to ensuring that the tariffs developed are as close to cost reflective as possible. It was with this concern in mind that the MEU strongly encouraged policy makers that the distribution Rules included the clause 6.18.5(b)(1):

“6.18.5(b) A tariff, and if it consists of 2 or more *charging parameters*, each *charging parameter* for a *tariff class*:
(1) must take into account the long run marginal cost for the service or, in the case of a *charging parameter*, for the element of the service to which the *charging parameter* relates...”

The expected outcome of the cost allocations will be that tariffs will reflect LRMC of the service offered.

The MEU expects that the AER will consult with the jurisdictional regulators to identify the methods use by each of them in developing the cost allocation principles. From this review, the AER should implement the method(s) that provide the greatest

Major Energy Users Inc

MEU Comments:

AER Guidelines, models and schemes for Electricity distribution network service providers

certainty that tariffs will reflect LRMC and that there is no cost subsidization between users of the networks.

Subject to the comments made above, the MEU agrees with the approach proposed by the AER.

5. Efficiency benefit sharing scheme

Q. Is it reasonable to apply to DNSPs an EBSS with the same general approach as the transmission EBSS?

Q. Are there any significant differences between transmission and distribution businesses that would require a different general approach?

The MEU considers that the same general approach on an EBSS apply to DNSPs as to the TNSPs. There should not be any significant difference between TNSPs and DNSPs that would require different approaches.

In face to face discussions with the AER in relation to the opex EBSS proposed for the NSW/ACT review, the AER provided some considerable effort into demonstrating that the opex EBSS proposed for the NSW/ACT review would result in the anticipated outcome. The MEU had noted that its main concern related to the proposal to use the fourth year data as the base opex and then assess step changes from this level of opex.

In the discussion the AER advised that the proposed opex EBSS would achieve the goal of encouraging the DNSP to seek the most efficient opex level provided that certain preconditions were met. These are that:-

- a) The scheme must be symmetrical in that there must be a carryover of losses as well as profits
- b) The DNSP must be aware that there will be no suspension of the carryover of losses for any reason
- c) There is no cash benefit in loading the fourth year opex in order to get higher opex in the next period, because the opex EBSS would create a zero sum game even if the following period opex

was artificially inflated as a result of loading the current fourth year opex.

- d) Whilst there may be a small benefit from a cash flow timing by reducing opex in years 1 and 2 of a period, over the whole period this benefit is lost.
- e) The AER will demonstrate these outcomes of the EBSS model to DNSPs to show there is no benefit from attempting to game the opex EBSS.

On this basis, if the outcomes of the opex EBSS are as stated by the AER, then the concerns of the MEU in regard to the EBSS as proposed for the NSW/ACT review have been addressed, and the MEU would support the opex EBSS. The stated preconditions are, necessarily essential.

Q. Would the application of an EBSS to capex yield sufficient benefits to consumers to offset the risk of windfall gains and losses?

Q. Could forecasts and/or actuals be adjusted ex post to reduce the risk of windfall gains and losses to acceptable levels?

Fundamentally, the MEU is of the view that there can be no incentive to better manage capex. Investment is driven by the returns that will result from the investment.

The incentives to **minimise** capex are few:

- If the business under-runs on capex, then it is permitted to retain the return on the capital not spent until the end of the regulatory period. This is an incentive to reduce the need for capex.
- A need for capital requires the business to seek more equity and debt to provide the capital for the investment.

Against this there quite are a number of incentives **to maximise** capex:

- If the WACC awarded exceeds the market expectations for the risk profile involved, then debt and equity will be readily sourced. There is little doubt that regulators do provide electricity transport businesses with a better risk/return than applies in the competitive market
- A lack of investment will cause a reduction in performance and penalties can result, whereas adequate or excessive capex can lead to performance bonuses.
- The regulated business is granted capex by the regulator, based on the requests of the business. As capex is readily sourced then there is a driver to overstate capex needs rather than understate the needs, especially if the risk/reward exceeds market expectations.
- If the capex is less than the businesses require, but the capex is needed, the business will suffer the loss of the return for only a limited time (ie until the next reset) when the capital will be rolled into the RAB and so automatically receive a return on the full investment amount for the life of the asset. Development of a typical cash flow analysis shows that the IRR of losing (say) two years of the return (out of 40-50 years) on an investment causes only a marginal reduction in the internal rate of return (IRR) for an investment. This identifies that the regulatory approach provides little disincentive to over invest.

On balance, it is quite clear that the disincentives for investing capital are more than outweighed by the incentives to invest. It is accepted that the AEMC in its review of transmission revenue and pricing had this driver as a “top of mind” issue, and this was discussed during the process to develop the transitional distribution Rules.

The incentive to reduce capex is complex and identifying drivers to manage this is challenging and requires significant debate.

With this in mind, the MEU considers that to introduce an incentive scheme for capex at this stage is premature. However, as the MEU supports the principle of providing incentives to achieve the targeted outcome, the MEU is prepared to work with the AER to assist in the development of a capex incentive scheme.

5.1 Incentives to defer capex

Q. Would the application of an EBSS to capex provide inappropriate incentives to delay capex?

The MEU has already seen that DNSPs have elected to defer capex that was planned for one period, to be carried out in a subsequent period, and to thereby garner a windfall benefit.

The MEU is of the view that a capex EBSS needs to be very carefully developed and that it should not be made part of the current guidelines at this stage.

5.2 Impact of the EBSS on incentives to undertake demand side responses and invest in distributed generation

Q. Would the application of an EBSS to only opex materially impact DNSPs incentives to undertake demand side responses and invest in distributed generation?

Under a price cap approach used for most DNSPs, a DNSP is incentivised to increase the volume of electricity transported on its

system. Any activity to reduce the amount of electricity transported is seen by a DNSP to reduce its revenue.

As a case in point, there are DNSPs that have provided consumers with a capital payment if the consumer installed refrigerative air conditioning. The DNSP expected that it would recover this payment and significantly improve its revenue by such an approach. That such an action resulted in a need for more approved capex to accommodate the increase in demand resulting from the increase in refrigerative air conditioners was seen by the DNSP as additional reward.

Under the current Rules, distributed generation will not be encouraged by DNSPs. Such generation reduces flows (and therefore revenue) to a DNSP. DNSPs argue (and successfully so) that when the distributed generation is not working (eg the solar or wind generator is not supplied with the motive power, or the fuel fired generator is down for service) they must still provide for a fully sized connection to the consumer. Even if the assets are used occasionally, they are still required and incur the same cost whether used or on standby. Until the Rules recognise that DG cannot be assessed on an individual basis but needs to be assessed as multiples of DG, then DG will not become viable.

The MEU considers that DG and other demand side responses are seen by DNSPs as competition and therefore DNSPs will not view these as options for it to consider except in very specific circumstances. If the AER wants to incentivise DNSPs to encourage DSR and DG then a new approach entirely must be developed. To achieve this will require significant assessment and until this work is completed the MEU does not see that an incentive scheme for DSR and DG should be introduced

5.3 Other issues regarding inclusion of capex

Q. Are the incentives for efficient capex in the broader regulatory framework sufficient or is there also a need for an EBSS that incorporates capex?

Q. How would the exclusion of capex from the EBSS affect the overall regulatory incentives faced by DNSPs?

Q. In considering whether or not it is appropriate to include capex in the EBSS for distribution networks, what issues should the AER consider in addition to those discussed in this issues paper?

As noted above the MEU considers that the matters associated with implementing an incentive scheme for capex has considerable detriments that need to be addressed before an appropriate incentive scheme for capex is likely to achieve its goals.

5.4 Treatment of distribution losses

Q. Is there any evidence available showing that the current level of distribution losses is significantly greater than the economically efficient level?

The MEU is concerned that introducing an incentive scheme to reduce losses within the distribution network is premature. The MEU points out that both the Ofgem and IPART schemes have significant drawbacks and therefore, without adequate investigation, it is not proven that either scheme will provide the DNSPs with either an incentive to reduce losses, or that they will receive windfall bonuses or penalties caused by exogenous impacts.

Major Energy Users Inc

MEU Comments:

AER Guidelines, models and schemes for Electricity distribution network service providers

The MEU supports the principle of incentivizing a loss mitigation program but in the absence of a program that provides for rewards to DNSPs which are clear and unequivocal outcomes of actions by DNSPs, then the MEU does not support the immediate implementation of a losses mitigation incentive program