Major Energy Users Inc.

Australian Energy Regulator

Interim Distribution Guidelines for ACT/NSW DNSPs

Comments on the Preliminary Guidelines

by

The Major Energy Users Inc

On behalf of

Energy market Reform Forum

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The content and conclusions reached are entirely the work of the Major Energy Users Inc, EMRF and its consultants.

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Executive Summary

In general the MEU considers that the AER has addressed well the setting of guidelines for the transitional Rules applying to the review of ACT and NSW distribution businesses. The MEU has some residual concerns which it develops within each section of its response to the proposed approach to guidelines.

These concerns are:-

PTRM
The move from a pre tax to a post tax model will most likely provide the DBs with a long term benefit due to the change in approach to depreciation. The MEU accepts this but adjures the AER to note that this is yet another bias made in favour of the regulated business, and that this should be taken into account when making its final decision.

Roll forward
The MEU is concerned that there is an opportunity for EnergyAustralia to benefit from the continual movement of assets between distribution and transmission. As a result the MEU is concerned that there may have been double counting in the past.

Efficiency benefit sharing
Allowing the DB an untrammeled ability to have additional exclusions provides a benefit to the DB by an asymmetric ability to exclude elements where the DB might be exposed, but retain elements where it might gain an unearned benefit

The MEU is concerned that inclusion of capex in the EBSS will provide an incentive to manipulate capex, and agrees with the AER that capex should be excluded from the EBSS.

The MEU totally disagrees that the AER should nominate a particular year for the starting point for opex, as by doing so it incentivises the DB to minimise opex in other years and to maximise opex in the nominated year. The MEU considers that the average of opex for the previous five years (ie including the final year of the previous period) should be used as the basis for the new period starting opex.

The MEU does not concur with the AER that its approach will result in a continuous incentive. In fact the MEU considers that the AER approach will result in opex peaking in the nominated year.

Care needs to be taken in that there is a relationship between capex and opex. As opex is the only element exposed to the EBSS, the AER should assess the impact of a large capex program on subsequent opex needs.

Service performance STPIS

The MEU totally disagrees with the AER that it is too early to implement a financially driven STPIS. The MEU considers that there is adequate information already available to set benchmarks and incentives and that an approach based on that staged development for a STPIS used by ORG/ESC could be implemented now by the AER.

The MEU considers that a STPIS could be developed now based on:-

- GSLs for customer service (eg such as established by ESCoV
- Network performance using average network performance levels that are already measured.

The AER could implement a STPIS cap (eg 1% of revenue) if it considers that there is too high a risk for the DBs.

Control mechanism

The MEU agrees that the AER is constrained in setting the control mechanisms, but observes that the constraints will have much less impact if the AER closely addresses the tariffs set by DBs to ensure that they closely relate to the long run marginal cost for the provision of services covered by each tariff.

1. Introduction

1.1 The needs of EMRF members

The Energy Markets Reform Forum (EMRF) is an organisation which brings together the major users of energy in NSW. It is directly affiliated with Major Energy Users (MEU) which is an energy focused consumer organisation. Through this relationship the EMRF is also affiliated with Energy Consumers Coalition of South Australia and the Energy Users Coalition of Victoria and the Pulp and Paper industry (A3P) and the Cement Industry Federation (CIF). Each affiliated organisation represents the larger energy consumers in each region. The MEU also has provided support to the Major Employers Group in Tasmania and to the Northern Territory Major Energy Users in the NT. Between them, members and affiliates of MEU represent over 50 major energy using companies in NSW, Victoria, SA, Tasmania, Queensland and NT.

Because its NSW members are impacted by decisions about electricity matters in NSW, the MEU, on behalf of EMRF, welcomes the opportunity to provide comments to the AER on its preliminary activities in preparation of the first AER review of an electricity distribution business.

Analysis of the electricity usage by the members and affiliates of MEU shows that between them they consume over 10% of the electricity generated in the NEM, and the EMRF members are a significant proportion of this total. Many of the members are located in regional parts of NSW, some distance from the major centre. They are highly dependent on the transmission network to deliver the electricity essential to their operations, as well as using the local distribution assets to deliver from the transmission nodes. Being regionally located, the members have an obligation to represent the views of their local suppliers and of the regionally based workforce on which the companies are dependent. With this in mind, the members require their views to not only represent the views of large energy users but also those of smaller power consumers located near to their regional operations.

The companies represented by the EMRF (and their suppliers) have identified that they have an interest in the **cost** of the energy network services as this comprises a large cost element in their electricity and gas bills.

The businesses all operate in the open competitive market for their products. In order for them to ensure that they will be profitable into the future they must have a high degree of certainty of their future costs. They are not keen on prices that fluctuate excessively as this creates uncertainty. The excessive volatility in the NEM has been of great concern, and as a result most businesses "lay off" the risks inherent in the NEM to electricity retailers, but at a cost. This demonstrates that **stability** and **certainty** are much preferred over volatility. Businesses need to have stability in their input costs, as this is needed to ensure forecast costs for the products made are within the expected price range for sale.

Although electricity is an essential source of energy required by each member company in order to maintain operations, a failure in the supply of electricity or gas effectively will cause every business affected to cease production, and members' experiences are no different. Thus the **reliable supply** of electricity and gas is an essential element of each member's business operations.

With the introduction of highly sensitive and sophisticated equipment required to maintain operations at the highest level of productivity, the **quality** of energy supplies has become increasingly important with the focus on the performance of the distribution businesses because of the central role they play in terms of the control over the quality of electricity and gas delivered. Variation of electricity voltage (especially voltage sags, momentary interruptions, and transients) and gas pressure by even small amounts now has the ability to shut down critical elements of many production processes. Thus member companies have become increasingly more exposed to the quality of electricity and gas services supplied.

Each of the businesses represented by the MEU has invested considerable capital in establishing their operations and in order that they can recover the capital costs invested, long-term **sustainability** of energy supplies is required. If sustainable supplies of energy are not available into the future these investments will have reduced value.

Accordingly, MEU is keen to address the issues that impact on the **cost, reliability, quality** and the long term **sustainability** of their electricity (and gas) supplies.

1.2 The EMRF views of the Preliminary Position topics

The Preliminary Position Paper brings together five basic aspects of the Distribution Price Review, viz:-

- Post tax revenue model
- Roll forward model
- Efficiency benefit sharing scheme
- Service target performance incentive scheme
- Guideline on control mechanisms for direct control services

The following five sections of this submission address these individually.

However, as a general observation, the MEU would point out that notwithstanding there are now differences between the approaches used by ICRC and IPART, the AER should use this opportunity to commence its transition to a uniform approach to its reviews of all distribution businesses.

2. Post tax revenue model

Under the transition Rules for ACT/NSW distribution reviews, the AER is required to use the post tax revenue model. This approach immediately introduces some aspects which need to be addressed; this is further complicated by the different approaches used previously by the ICRC (for the ACT DB) and IPART (for the NSW DBs).

As an initial comment, the MEU observes that the outworkings of the AER calculations of transiting from a pre tax to post tax model show that there will be a net benefit to the DBs because the AER does not intend to make adjustments to the RAB to discount the double benefit a DB will probably accrue as a result of the change in treatment of depreciation.

The MEU accepts the logic of the proposed AER approach, because to do so could be construed to be in the "…long term interests of consumers …" as the AER decision is less likely to result in a detriment to the DB which may result in a loss or reduction of service. But despite this acceptance in principle, the MEU recommends that the AER takes into consideration this benefit provides when assessing the permitted revenue for a DB.

In addition to the implicit benefit inherent in the transition of pre tax model to post tax model, the AER identifies that there are other issues that need to be addressed.

2.1 Capital contributions

A capital contribution from a customer is required by a DB where there is a shortfall between the expected revenue accruing from the increased demand provided by the new customer and the cost of providing the additional assets required to deliver the increase in demand.

Effectively this is a "once off" payment made by the customer, and as such the value of the assets it provides should not be added to the RAB, as to do so would result in an increase in regulatory revenue; the DB should not be allowed to get a return on the assets or return of the assets provided as a result of a contribution made by another party.

However as the AER notes, the DB will receive the cash from a customer and this must be added to its revenue for tax purposes, and as this same payment made from the customer reduces the customer's revenue, then a capital contribution effectively transfers the tax liability for the value of the capital

contribution from the customer to the DB. The DB pays this tax liability and then recovers this through depreciating the capital amount.

Providing this process for management of tax liability is fully ring fenced from regulatory accounts, the MEU agrees with the AER that this process is appropriate.

2.2 X-factors

The MEU concurs with the AER approach.

2.3 Cashflow timing

The MEU concurs with the AER approach as a matter of expediency, but notes that the DB has an incentive to time its capex to maximise its cash benefit as a result of the AER approach.

2.4 Depreciation

The MEU concurs with the AER approach.

2.5 Capex recognition

The MEU concurs with the AER approach, but notes that any requirement for capital for work in progress should be eliminated by this approach.

2.6 Pre tax to post tax

The MEU concurs with the AER approach, but notes that this provides a windfall to the DBs. That the DB has been granted this windfall benefit, must be recognised when making an overall assessment of regulatory bias towards a DB at the time of any regulatory review

3. The roll forward 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.

3.1 ACT

The MEU notes that transition Rules effectively require the AER to use the ICRC process, and therefore there is limited scope for the AER to address any concerns that it might otherwise have had. Use by the AER of the ICRC model is therefore seen by MEU as appropriate.

3.2 NSW

The MEU agrees with the AER on the approach to the roll forward, but notes that the AER should err on the side to integrating more detail into the model than attempting to simplify the model.

3.3 EnergyAustralia

The MEU is concerned that the continued movement of assets between the distribution and transmission elements comprising EA reviews has been to the detriment of consumers. The MEU sees that having both distribution and transmission reviews carried out by the AER is likely to reduce any chance of double counting.

On this basis the MEU supports the AER proposed approach.

4. Efficiency benefit sharing scheme

The MEU notes that neither ACT nor NSW DBs have been subject to an EBSS prior to this review by the AER. The MEU supports the implementation by the AER of an EBSS as it is an essential element in encouraging a DB to minimise its capex and opex.

The basic principle of an EBSS is that that if a regulated business does identify cost savings then providing it gets a share of these savings it will pass the long term benefit onto consumers. The reality is that if any business can:-

- identify savings and find a way of retaining these savings in full, without sharing them with the customers by way of lower prices, then it will
- garner the benefit from unearned savings, but get exemption from any losses, it will

Based on this assessment the MEU agrees that the AER should exclude from the EBSS

1. the consequences changes in capitalization policy
2. differences in forecast and actual demand growth
3. impact of pass through events.

The MEU notes that the AER proposes to allow the DB to exclude other categories from the EBSS. The MEU does not agree that it should be the province of only the DB being able to exclude other categories. As a principle a DB would seek to exclude categories where it sees the likely benefits will be exceeded by the likely detriments, but to retain those categories where the reverse applies. This then creates an opportunity for the DB to retain categories where it may benefit from movements which are uncontrolled by the DB, and eliminate categories where there are detriments where the movements might be controlled by the DB.

This effectively creates potential bias in favour of the DB. As a result the MEU considers that the AER should have the ability to impose additional exclusions or reject an additional category, in order to counter any potential bias from which an application from a DB might result.

The MEU supports the AER approach in collection of additional information in order to assess whether the approach remains symmetrical and is not being used by the DB to unfairly improve its commercial position.

4.1 Incentive to manage capex and losses

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 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 requires, 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 transition distribution Rules.

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

On this basis the MEU concurs with the AER that the EBSS should not include capex and losses at this stage. The MEU is prepared to work with the AER to extend the EBSS to cover capex and losses at some future time.

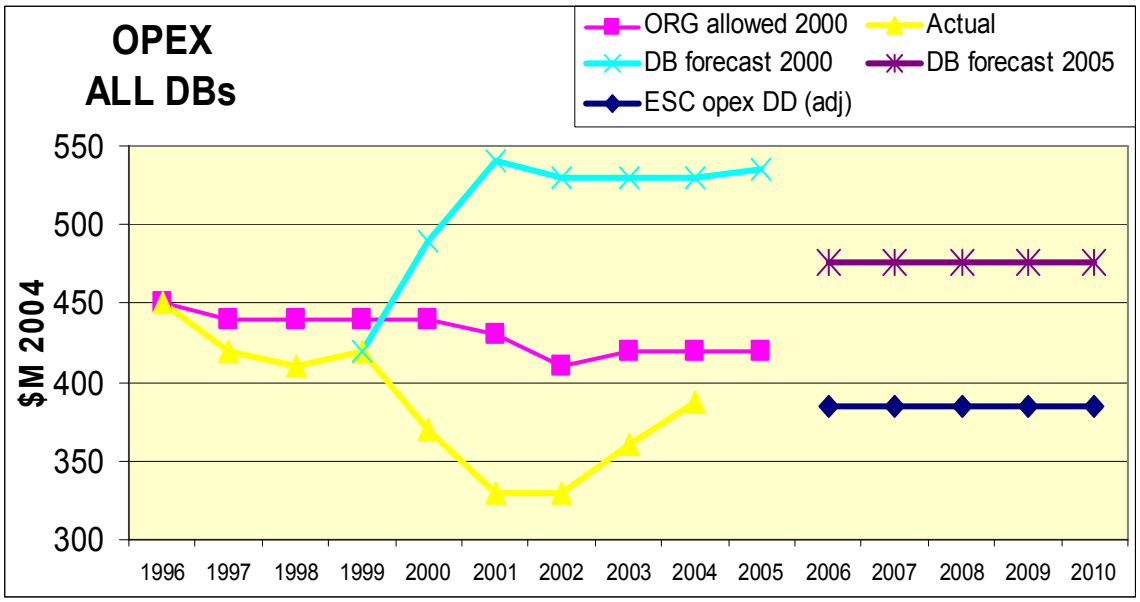
4.2 The starting point for future opex

The AER notes that it intends to use the fourth year out-turn opex (adjusted for scale and scope) as the basis to setting the new period opex. The MEU totally disagrees with this approach, and strongly recommends the use of the average of actual opex for the previous five years (including the actual for the last (fifth) year of the previous period).

This view is the result of the MEU (its associates and consultants) being deeply involved in every regulatory review since deregulation in the electricity and gas markets. Consistently the MEU has seen the regulated business increase its actual opex in the fourth (last actual) year of a revenue review. That this has occurred is not unexpected.

By the regulator giving prior advice that it intends to use a single year actual as the basis for setting future opex, is a direct incentive for the regulated business to maximise its opex in this year. This maximises the allowed opex forecast for the next regulatory period, and therefore sets a higher EBSS reward for the future.

The following graph (for electricity DBs in Victoria) is typical of observed actual opex changes incurred by regulated businesses in almost every regulatory review since energy deregulation commenced.



Source: ORG, ESCoV documents for 2005 electricity distribution review

The initial savings made in the early years of AA1 (1996-2000) were stated by the DB in 2000 to be unsustainable (note the upturn of the opex in 1999 which was the base year for opex in AA2). The telling figure is the forecast opex for year 2000 at $480m, yet the actual for 2000 was $370m. Using 1999 actual opex as the basis the ESCoV set the opex for AA2, which the DBs easily outperformed, garnering large EBSS payments. The DBs had been advised prior to the review that year 4 opex would be used as the basis for the next period opex. As a result the opex for 2004 shows a distinct upturn from the opex in previous years

The MEU considers that the average of the previous five years actual opex, including the last year of the previous period, should be used for the setting of future opex. This approach has three benefits:-

1. It encourages the concept of continual improvement rather than targeting specific opex outcomes for particular years in the period
2. It removes the incentive to increase opex in the year nominated (ie it reduces regulatory gaming),
3. It recognises that it is opex reductions over the longer that are the goal of the EBSS

The AER comments that the benefit of nominating a specific year as the basis for the next regulatory period as (page 25)

> "Using fourth year actuals combined with the application of negative carryovers will provide the most consistent and continuous incentive for DNSPs to reveal their efficient or true costs."

The AER just makes this assertion, without any evidence, either from actual experience or from first principles. In fact the evidence would not support this hypothesis, and an argument based on continuous improvement being the basis of the assumption would result in an averaging approach is more likely to result in long term sustainable reductions in opex than from using a single year.

In fact using a single year actual data is statistically less robust than using actual performance from a number of years. This would seem to be the meaning behind transition Rules 6.5.6(e)(4) and (5) which state that the AER must have regard to:-

> (4) benchmark operating expenditure that would be incurred by an efficient *Distribution Network Service Provider* over the *regulatory control period*;
> (5) the actual and expected operating expenditure of the *Distribution Network Service Provider* during any preceding *regulatory control* ***periods*;**
> (emphasis added highlighting the plurality of the word preiords)

The MEU interprets these clauses to imply that the opex incurred over a longer time – even multiple regulatory periods – than one (pre-nominated) year is to be used to assess the claimed opex.

On this basis the MEU does not consider the AER has demonstrated that its approach will provide a better long term outcome than using an averaging approach as proposed by MEU. Further the AER approach is more likely to result in regulatory gaming than the MEU proposal.

With these in mind the MEU considers that the AER is incorrect in using a pre-nominated single year as the basis for forecasting future opex.

4.3 Other issues raised by AER

Fifth year adjustments
The AER proposes to make adjustments for fifth year gains/losses which will be included in the first year of the new regulatory period when actuals are known. The MEU supports this approach.

Negative carryovers
The MEU also supports the AER approach to negative carryovers, although it recognises the danger implicit in such an approach. If the DB is penalized then it

will have less opex available and may be tempted to reduce the quality of service, or not carryout work which may put supply to consumers at risk.

Term of EBSS
The MEU supports the AER approach to tying the EBSS to the five year regulatory period.

Continuous incentive
The AER asserts, without any evidence that their approach will result in continuous incentive. As noted in section 4.2 the MEU does not necessarily agree with this assertion as applied to continuous *improvement* as presented, but does agree that an EBSS is more likely to achieve efficient operating practices by a DB than the absence of such an approach.

Opex and capex interrelation
The MEU notes that the AER has observed there is an interaction between opex and capex, and that this will be integrated into the EBSS. The MEU supports this but adds that increasing capex must result in less opex for the same coverage of supply. This means that a larger than necessary capex program could well result in lower opex.

As it stands the AER proposes to allow this opex reduction to be included in the EBSS. As it is consumers that ultimately pay for the additional capex provided (through return on and return of capital) then allowing the DB the benefit of both a higher capex program and having the benefit of lower opex could be seen as a "double dip". Recognising this is a benefit to the DB, the AER is expected to provide close monitoring to ensure that the process is properly managed.

Non-network incentives
The MEU does not agree that the EBSS provides incentive for non-network solutions. A non-network solution is usually treated as a pass through cost and therefore it has (in theory) no profit available to it. The AER allows the DB to retain the return on the capex that was included for the purpose that the non-network solution provides, but only until the end of the regulatory period. The long term rewards to the DB are much greater if the network is augmented, ands so the DB is incentivised to network solutions as a result of the building block approach to setting the regulatory revenue.

5. Service target incentive scheme (STPIS)

The electricity network is purely a tool for delivering power – it is a form of transport. Other than providing this connection between generator and consumer, it adds little as far as value to the electricity supply system. Yet in performing its function, it can have a massive impact on consumers and generators.

As such the MEU supports the AER in developing a STPIS. When considering a service performance incentive scheme there are three elements that must be considered:

- What are the key elements of service performance that will add value to those offering the incentive for better performance. As consumers are the beneficiaries of the improved service and will pay the incentive, there must be a focus on what consumers seek from the DNSPs as an improved service.
- Should the incentive be one way (ie a bonus only) or two way (a penalty if the targets are not met, combined with a bonus if they are exceeded).
- The amount of DNSP revenue at risk.

When developing a service performance assessment program the first issue that must be determined, is what a reasonable service standard is for the basic revenue granted. From this point, increased revenue should be available to a DB only if it provides a service *better than* the basic service expected for the base payment.

The second issue is that if service performance is *averaged* then this implies that some customers may be receiving better service than others for the same payment. Therefore whilst average performance is important, it is also essential to assess service performance for the worst service provided, so that efforts can be devoted to bringing the worse service performance to the average.

The third issue is to identify what are the services that should be rewarded for improved performance. These fall generally into two categories

- The first is related to the direct supply – reliability (how often is supply lost and for how long each time) and quality (how often does the supply voltage change and by how much). Different consumer classes have different needs (eg for one customer a transient dip in voltage might trip off sensitive control equipment causing an outage yet for another the only observed outcome is light flicker)

- The second category is related to customer service – the time to respond to queries, being on time for meetings, the time needed to provide connection services, etc.

A competent STPIS must be able to address all of the wide variety of service interfaces involved and as most consumers are connected to the DNSP (rather than to TNSPs) the STPIS for a DNSP must be more encompassing and cover more issues than a STPIS needed for a TNSP.

The AER posits four alternatives for a STPIS bearing in mind that neither ACT nor NSW DBs are currently exposed to a STPIS. These options are

1. Incentive scheme, linked to regulated revenues.
2. Incentive scheme linked to regulated revenues, but with no financial impact (paper trial).
3. Public comparative performance reporting.
4. Information collection only, with a view to applying of a scheme in the future.

Effectively the ACT DB is basically subject to options 3 and 4 currently, with NSW DBs currently exposed to options 2, 3 and 4. It should be noted that the Victorian and SA DBs are exposed financially to attainment of service standards.

The AER proposes that due to the tight timeframes associated with publishing a STPIS for the ACT and NSW DBs that it will only expose these businesses to a paper trial using the less time-constrained time frame available for development of the “General” review of STPIS for DNSPs, and that a financially driven STPIS for ACT and NSW DBs will be implemented in 2014.

The MEU points out that NSW consumers have had no performance standards required to date, and yet Victorian consumers have had a STPIS in place for many years. It should be remembered that NSW and Victoria deregulated at the same time. Under the AER approach, Victorian consumers will have had a STPIS in place and operating for some 15 years before NSW consumers get the benefits of a STPIS.

It appears to the MEU that the AER has decided that it is too hard to develop a STPIS even in basic form.

The MEU considers that a STPIS for ACT and NSW can be developed and implemented now, even if it is in a basic form. The MEU suggests that for a basic STPIS the AER could readily implement performance standards now, using the approach used in Victoria, which has used a staged approach in developing the STPIS.

The MEU recommends that the AER use the Victorian ESC set of service standards as a base and modify them to reflect the lesser degree of information on performance that is available for the ACT and NSW DBs. The ESCoV developed a two tier approach to service performance – one based on physical performance and customer performance.

Customer service standards

The MEU sees that the direct implementation of the customer performance standards is directly applicable and could be implemented immediately. The following GSL service performance is incorporated into the SP Ausnet decision[1]

In addition to these there is a service standard for answering calls of 75% within 30 seconds.

Table D.65: GSL payments scheme, thresholds and payments, other customer service measures, 2006-10 regulatory period, SP AusNet

		Threshold	Payment
Connection time	Final Decision	10 business days	$50 per day (max. $250)
	Distributor proposed	15 business days for GSL payments, 20 business days for Electricity Distribution Code	$50 per day (max. $250)
	2001-05 reg. period	20 business days	$50 per day (max. $250)
Appointment window (customer present)	Final Decision	2 hrs	$20
	Distributor proposed	Specific appointment time	$20
	2001-05 reg. period	—	$20
Appointment window (customer absent)	Final Decision	1 day	$20
	Distributor proposed	—	—
	2001-05 reg. period	—	—
Repair of public lighting	Final Decision	2 business days	$10
	Distributor proposed	2 business days	$10
	2001-05 reg. period	2 business days	$10

The MEU considers that service standards such as these guaranteed service levels (GSLs) are readily translated into ACT and NSW, and should be.

[1] ESCoV, Electricity Distribution Price Review 2006-10, Final Decision, Part D: Summary of Final Decision by Distributor, SP Ausnet

Network service performance

The MEU notes that average performance as measured by network wide SAIDI, CAIDI, SAIFI and MAIFI (both planned and unplanned) have been measures used by DBs for many years (even before deregulation) so that setting individual network averages against each of these measures is quite feasible. The MEU does accept that unless these are measured currently for rural and suburban areas or on a feeder basis, (as has been required of the Victorian DBs) then to move beyond overall network averages for STPIS at this time, is not feasible.

The ESCoV (and its predecessor ORG) initially used overall network averages for these standards until there was adequate historical data available to move to more detailed performance covering rural and urban with identification of individual feeder performance. This was a staged approach to STPIS development, implementing greater detail over time.

The decision of ORG/ESC to implement a staged development of the STPIS at the commencement of regulation was based on the assumption that, unless there was a financial incentive, a DB would not even attempt to improve the quality of service. Having the financial incentive drove the Victorian DBs to improve their service, and as a result the ORG/ESC was able to adjust the set points over time for the STPIS to reflect improved service.

The MEU considers that the ORG/ESC approach was sound, and it directly resulted on improved service for consumers. Using a paper trial approach as suggested by the AER will not improve standards at all, and the MEU sees that DBs will have an active incentive to have worse performance so that when the financial incentive is implemented, the DB will have a low set point against which to perform and so maximise its financial benefit by “picking the low hanging fruit”.

The MEU considers there is no reason not to implement a STPIS immediately using average network performance data now available. Not to implement such a program now condemns ACT/NSW consumers to another five years of less than optimal service performance.

Overall the MEU considers that the AER is letting an opportunity pass by not immediately implementing a financially driven incentive scheme. There is no doubt that a GSL approach can be implemented now, and a network service performance can be implemented using current levels of SAIDI, CAIDI, SAIFI and MAIFI, averaged over the network. Even if these data points are set a little conservatively now, they will encourage an immediate change in approach by the DBs so that when the 2014 review is commenced, there are “hard” numbers available to be used.

At the same time, the MEU recommends that the AER commence collection of data on rural and urban feeders so that a more detailed scheme can be implemented in 2014.

Conclusion

The MEU considers that that the AER can readily implement a STPIS immediately based on:-

- GSLs for customer service (eg such as established by ESCoV)
- Network performance using average network performance levels that are already measured and available.
- If the AER is concerned that using such an approach might result in un-measurable risks, it might limit the exposure of the DB to 1% of revenue on the same basis that it decided this level of risk for TNSPs

Failure to implement a financially driven STPIS but use a paper trail approach has the potential to result in worsening of performance by DBs and cause increased costs for consumers.

6. Control mechanism for direct control services

The MEU notes the constraints on the AER with regard to attempts to ensure that the tariffs used by the DBs over time reflect the revenue considered by the AER to be appropriate for the DBs for providing direct control services.

The MEU considers that the AER approach to the proposed control mechanisms is the best that can be implemented under the constraints. In particular the MEU agrees that the TUoS cost element in the tariffs should be adjusted annually to reflect actual TUoS costs.

The main cause for concern raised by the SCO during the debates in setting the transition Rules was to avoid price shocks *within* a regulatory period. It is accepted that at each review, there may be price movements which are greater than the side constraints applying within a period.

The MEU has made significant study of the reasons why there might be a need to have intra-period price side constraints. By far the most significant cause for a larger than required movement in a tariff, results from the tariff being set initially at a value which is not cost reflective. The less cost reflective the tariff is, the greater the need to subsequently exceed the average price movement.

It was with this concern in mind that the MEU strongly encouraged for the distribution Rules to include 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 reason for the MEU to focus on this issue resulted from observations made over a decade that DBs actively seek to increase revenue as a result of tariff manipulation. Tariff manipulation within the averaging which the control mechanisms use, can be a very profitable source of unearned revenue for a network service provider. The closer the tariff is to recovering the long run marginal cost, the less the need to move tariffs within the "basket" and the lower the reward from tariff manipulation.

Noting the constraints the AER has regarding the control mechanisms available to it, the MEU recommends that the AER make a much closer examination of proposed tariffs to ensure that they are as close to LRMC as possible. In this way

the AER can ensure the control mechanism will provide adequate adjustment of tariffs so that the DB recovers the expected revenue, but no more.