

# *Energy Consumers Coalition of South Australia*

**Australian Energy Regulator**

**SA Electricity Distribution Revenue Reset**

**The AER Draft Decision on ETSA Utilities Application**

**A response**

by

**Energy Consumers Coalition of South Australia**

**February 2010**

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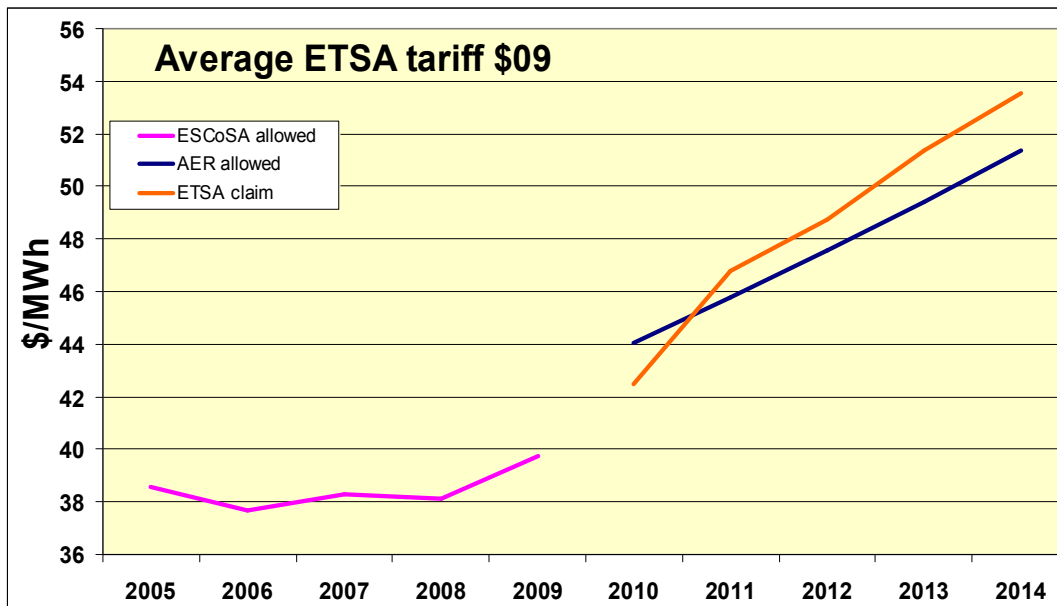
The content and conclusions reached are the work of the ECCSA and its consultants.

<b>CONTENTS</b>	<b>Page</b>
<b>Executive summary</b>	<b>3</b>
<b>1. Introduction</b>	<b>6</b>
<b>2. Total Ex-Ante Capital Allowance</b>	<b>12</b>
<b>3. Forecast Operating Expenditure</b>	<b>25</b>
<b>4. Service Performance Targets</b>	<b>38</b>
<b>5. Cost of Capital and Allowed Revenue</b>	<b>43</b>
<b>6. Demand and Consumption Forecasts</b>	<b>50</b>
<b>7. Pricing Methodology</b>	<b>52</b>

## Executive Summary

The Energy Consumers Coalition of South Australia (ECCSA) welcomes the opportunity to provide its review of the ETSA Utilities application for its revenue reset.

The impact of the AER draft decision will dramatically increase the cost of power supplies to consumers in SA. The following chart shows clearly this dramatic increase in the average tariff (total allowed revenue in relation to expected consumption). As can be seen, the previous ESCoSA decision resulted in an average real tariff of about \$38-40/MWh, with the AER draft decision raising the average tariff by more than 30% in real terms over the next five years.



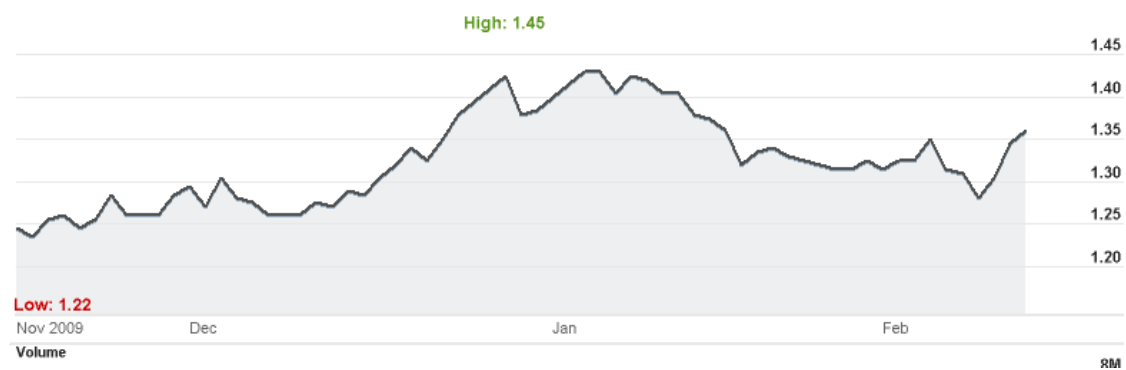
The ECCSA considers the AER draft decision to be very disappointing for consumers. Notwithstanding the modest reductions required by the AER in capex and opex claims offset by an increase in WACC (mainly due to the increase in the risk free rate), it clearly demonstrates that ETSA has been able to pass scrutiny. The modest opex and capex reductions are not consistent with the self benchmarking carried out by ETSA in previous regulatory periods.

The draft decision by the AER is very curious, and is clearly confounding to (and pleasing) independent analysts, such as Credit Suisse on Page 4, in its 1 December 2009 Company Update "Draft ETSA decision positive for SKI<sup>1</sup>":

<sup>1</sup> SKI is the ASX code for Spark Infrastructure, half owner with CKI of ETSA, Powercor and Citipower

- **Nominal revenue allowance of \$3.55bn only 5% below ETSA proposal:** The AER has allowed nominal revenue of \$3.55bn for the regulatory period, only \$173mn (5%) below the ETSA proposal. The AER revenue allowance has exceeded CS expectations by \$293mn (9%) given the higher WACC parameters than forecast. In our view this is a good result for ETSA particularly given the 30% reduction in allowed capex.
  - **Opex allowance reduced by \$131mn (11%):** Key reductions to opex allowance by the AER are (1) \$19.5mn reduction to maintenance and repair and emergency response; (2) \$38mn reduction to reflect revised real input cost escalators; (3) \$33.2mn for reduction to self insurance opex.
  - **Higher WACC offsets lower capex:** The 'return on capital' allowance of \$1.63bn is within 4% of the ETSA proposal. This reflects the 30% reduction in capex partially offset by a 50bps higher WACC allowance than ETSA requested.

The impact of such positive views is clearly shown in the movement of the Spark share price, prior to and just after the AER draft decision was released on 30 November 2009



The nominal revenue allowance of \$3.55 billion is only 5% below ETSA's proposal, or \$173 million. This fact is partly driven by the WACC being higher than ETSA's claim primarily caused by an increase in the risk free rate.

However, closer examination of the allowances for opex and capex, shows that the AER has been less rigorous in its review compared with that previously undertaken by the jurisdictional regulator and this will lead to consumers being required to pay excessively high, and in the view of ECCSA, unnecessary and unjustifiable increases for the distribution service. At the same time, there is no discernable benefit (e.g. improved service performance) that consumers will receive for paying this increased cost.

**Clearly, the AER's draft decision is another disappointing review for consumers. Notwithstanding the biased and unbalanced AEMC/MCE rules which have over-incentivised network investments, the AER's review shows the extent to which consumers can no longer rely on the NEM institutions to ensure that the NEM actually operates in the long term interests of consumers. Rather, it appears that the owners of the**

**distribution assets are being granted excessive returns for providing no better service.**

In its 2005 decision, ESCoSA delivered to SA consumers an outcome which provided a reasonable balance between the cost of the distribution service and the quality of the network service provided, and therefore it met the needs of SA electricity consumers.

The outcome of the AER review, just five years later, has delivered no better service, but at a cost which has increased by an average of 20% over the next five years, and is so structured that in the following period, SA consumers can expect to see even more cost increases.

The ECCSA is particularly concerned with the following:

- The Draft AER decision on capex for growth means that the cost per new customer to be connected is about \$26,000, or alternatively, the cost to service each extra MW of demand will be \$2.3m of increased peak demand. In comparison, in the current period the relevant figures are about \$8,600 and \$0.85m
- The limited and incomplete analysis by EMS in assessing the deliverability of the proposed ETSA capex program
- The failure by the AER in assessing whether allowed increases in the costs of materials and labour will mean that the proposed opex and capex programs are so expensive that they become inefficient
- The draft AER decision on cost escalation to develop ETSA's capex program (10%) equates to some \$264m or equivalent to the actual capex (in \$09) spent by ETSA in 2005/06 and 2007/07, i.e. the AER is forecasting two years of the current capex program will be replicated just by increased costs in the next period. There needs to be a reality check on such cost escalators and their application.
- The failure by the AER not to use the self benchmarking that ETSA has provided from its previous performance which has resulted in an excessive step change in the first year of the next regulatory period.
- The failure of the AER in assessing related business transactions and to confirm they are made at arms-length.
- The curious decision to accept that opex should be allowed to increase at a faster rate than customer numbers, faster than consumption increases and faster than increases in maximum demand increase.
- The curious decision to allow ETSA to receive a bonus by doing nothing more in its service performance achieved in the current period. More challenging performance targets must be set.
- The failure by the AER to require ETSA to comply with the requirements of the Rules in regard to tariff setting.

## **1. Introduction**

### **1.1 The ECCSA**

The Energy Consumers Coalition of SA (ECCSA) is a forum representing large energy consumers in South Australia. The ECCSA is an affiliate of the Major Energy Users Inc (MEU), which comprises some 20 major energy using companies in NSW, Victoria, SA, WA, NT, Tasmania and Queensland.

The ECCSA provided its views on the application from the SA electricity distribution business (ETSA Utilities) late last year and presented some of its views of the AER draft decision before Christmas at the AER public forum. The ECCSA welcomes the opportunity to provide its detailed comments on the AER draft decision.

The companies represented by the ECCSA (and their suppliers) have identified that they have an interest in the **cost, reliability, quality and long term sustainability** of the electricity supply needed for their businesses, suppliers and employees. In particular, they see that the energy networks services are an essential element in the electricity supply chain and therefore are very keen to provide their input to the AER review and reset of allowed revenues for these businesses.

### **1.2 An overview of the AER draft decision**

As was observed by the ECCSA in its response to the ETSA application, ETSA had taken to heart the fact that the new Rules encourage investment in networks and as a result it obviously considered a major capex program should be sought. The AER draft decision has effectively condoned this ambit claim by ETSA.

In addition to allowing much of the requested massive capital claims (especially that element for growth projects), the AER has even failed to use ETSA's own historic benchmarking of opex needs, and allowed the business to implement a significant step increase in operating expenses.

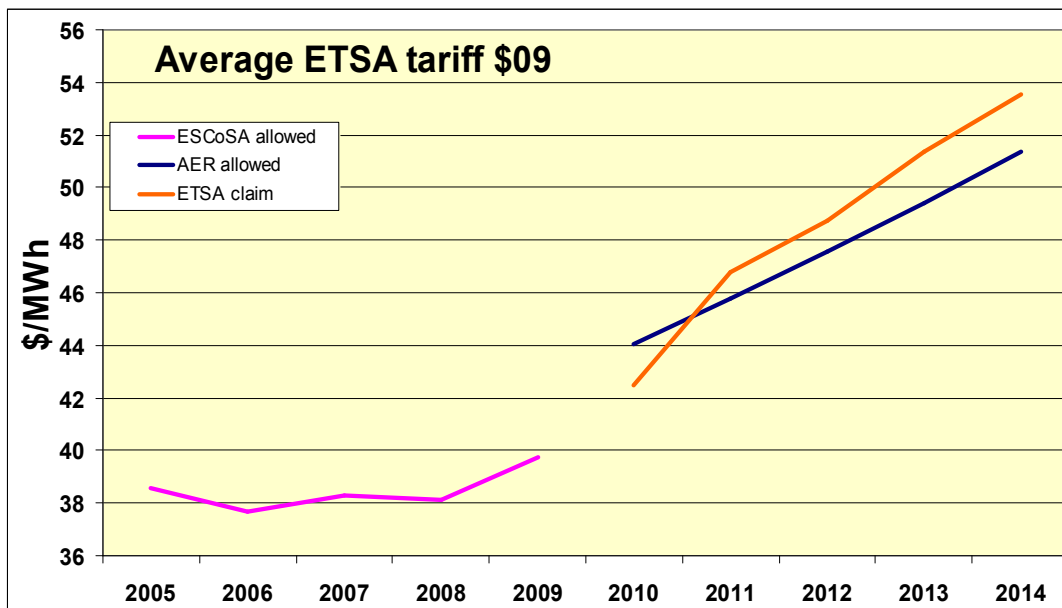
The increases in capex and opex have been supposedly justified on the basis of significant growth in electricity demand, yet the projected movements in growth in South Australia over the next few years will be much less than in the current period. The ECCSA recommended that the AER should seek independent assessments of future growth and has identified that ETSA had overstated expected demand growth and understated expected consumption – trends that ECCSA had seen previously in earlier applications by ETSA and other DBs. The independent review effectively concurred with ETSA's view on peak demand and customer numbers but significantly revised the forecast consumption. Of the

three sets of figures considered consumption forecasts have the greatest impact on what consumers pay per unit of electricity used.

In addition to the expected demand growth, ETSA pointed to the need to replace ageing assets. The AER draft decision has assumed that this is a key element within the reset yet analysis of the application and the AER draft decision demonstrates that despite growth being lower in the next period than in the current one, growth capex has ballooned, and replacement capex is still a relatively small proportion of the total capex proposed.

The ECCSA sees that replacement capex programs should have the impact of reducing opex, but the asset replacement program proposed by ETSA has not resulted in the AER reducing opex to any discernable extent, as the AER (curiously) proposes a large step increase in opex overall.

As a result, the outworkings of the AER draft decision will leave a massive impost on SA electricity consumers. The AER draft decision provides its own view as to the expected increases in the “real” cost of electricity for the small consumer in its table 16.6 which is shown graphically as follows:-



The AER draft decision provides a greater step change in tariffs although it provides a smaller annual increase thereafter. Effectively, the AER draft decision requires the average consumer to see a 28% “real” increase in tariffs between now (a 45% increase in nominal terms), and by the end of the next regulatory period just for distribution tariffs alone. SA electricity consumers should prepare for further very substantial price increases when the increased energy costs stemming from rising generation costs and government climate change policies commence.

### 1.3 Consumers ability to pay

That the AER blithely accepts these increases as an outworking of its “bottom up” approach highlights the disconnect between what is reasonable for consumers to pay and what ETSA would like to receive.

The arguments given for these massive increases are:-

- There is significant growth expected in demand
- The investment allowed historically under government direction, and later under ESCoSA assessments, was inadequate
- There is a need for replacement due to ageing assets
- Increased costs have recently occurred due to competition for, and scarcity of, labour and materials

The ECCSA points out that the blithe acceptance of price increases by the AER has little foundation. The main driver for price increases is an increase in demand and consumption. Yet the increases forecast for these variables are less than in the current period. This highlights a disconnect between what is considered to be a reasonable cost and what the AER accepts.

The issue of government constraining previous capital also requires comment. It has been consistently alleged by network businesses that government processes prevented adequate investment in electricity networks whilst networks were under direct government control and later allowances by jurisdictional regulators prevented adequate investment in ageing assets.

It must be recognized that governments (whether state or local) had the need to balance delivery of the service with the funds available. The dramatic increase in electrification occurred in the period of post World War I. Thus for 75 years governments had the responsibility to balance the competing needs of security of supply with the ability of consumers to pay. For some 10 years, ESCoSA (and its antecedent SAIR) has had this responsibility and the AER only just recently has been given this responsibility.

If government and jurisdictional regulatory approaches were so wrong in the past (in that they did not provide the funding ETSA sees is necessary and is now so critical of previous government limitations), how is it that the quality and security of supply was so well provided in the past. It raises the very question that the network business finds it difficult to maintain historic performance standards which were achieved, under what they consider, was inadequate funding.



Effectively, what the network business experienced under government control was the very limitations general industry sees from its Boards of Directors – that funding for capital works must be constrained to a level that the market allows, rather than to what the practitioners would like to have. Nothing focuses the mind when there is a requirement to address the critical few issues.

That ETSA is effectively critical of the constraints government and EScSA applied to its capital expenditure aspirations, provides a poignant reminder to the AER that it also has to be careful with consumers' money. It is blatantly unacceptable for the AER to allow a DB effectively unfettered capital and operational allowances which consumers must pay, but where they may have limited ability to do so (particularly low income consumers and industries exposed to competition). For the distribution element of electricity bills to be allowed to rise by 45% over the next five years is clearly unacceptable and totally at odds with the current and expected economic climate, especially when it is remembered that the AER has allowed ElectraNet a similar increase in its costs, and the AER itself has noted that generator market power in SA has significantly caused massive increases in electricity supply costs.

The AER needs to take into consideration the ability of consumers to pay for what ETSA is stating are necessary costs, especially for a service which is essential to all SA consumers and, as electricity usage is essentially price inelastic, where there is limited ability to modify demand. The very price increases have the potential to cause large consumers to reduce production or even relocate. Should this occur, there would be a significant loss of demand. This would result in significant spare capacity in the network, but as the Rules do not punish a DB for building or having surplus capacity, the costs will be carried by a fewer number of consumers, potentially causing more consumers to refrain from using the network.

Thus the AER must have regard for the ability to pay as an essential element of its assessment. Allowing largely unfettered price rises which result in a reduction of usage (which ETSA implied in its application) has minimal impact on ETSA, but a significant impact on the consumers continuing to use the service.

In its response to the ETSA application, the ECCSA pointed out that electricity prices must be efficient in economic terms – this is the whole concept behind the electricity market reforms. To achieve this expenditure, it must also be assessed as prudent. Prudence must include consideration given to ensure that the price increases do not result in a reduction in usage of the assets. If the out-turn of the AER decision is that some consumers cease using the network, those fewer consumers remaining will have to pay more for the same service.

This aspect has not been assessed at all by the AER.

## **1.4 Two specific aspects of the AER draft decision**

The draft decision highlights two aspects that the ECCSA would strongly support – those on capital contributions and easement valuation.

### **1.4.1 Capital contributions**

ETSA Utilities argued that ESCOSA had removed \$13.5 million of customer capital contributions from its asset base as at 1 July 1999 without authority. ECCSA notes that the AER has queried ESCOSA and has been advised that it had replicated the calculation of the initial asset base as determined by the Treasurer, which had included the adjustment for capital contributions.

**ECCSA supports the AER's draft decision in rejecting ETSA's proposal that the customer capital contributions deducted from its initial asset base by ESCOSA be reinstated into its RAB as at 1 July 1999.**

### **1.4.2 Easements valuation**

As stated in ECCSA's August 2009 submission on ETSA Utilities' application, there are concerns that the Regulatory Asset Base could be inflated by regulatory gaming and that the effects arising would persist into the future, at the expense of consumers.

Easements valuation is one of those items that network businesses seek to upsize in an effort to increase the RAB. In this case, ETSA Utilities have sought an addition to its opening RAB of \$116.2 million representing a fresh valuation of its easements.

In its application to ESCoSA at the last revenue reset (in 2004), this issue was raised by ETSA. ESCoSA addressed this issue at that time, and refused to include easements in ETSA's RAB.

The AER is correct in referring to clause 56.2.1(c)(1) and clause 56.2.1(c)(2) of the National Electricity rules. The former clause states that the opening RAB for the purpose of the current distribution pricing determination is \$2,466 million, which is derived from the most recent price determination for ETSA made by ESCoSA. The latter clause permits an adjustment to the opening RAB only if there is a difference between forecast and actual capex or if another legislation were to override the provisions of the NER.

The ECCSA shares the views raised in submissions by SACOSS and COTA respectively that easements were not intended to be revalued post ETSA's purchase of the network, and that any evaluation of

easements post purchase is equivalent to compensating ETSA Utilities for money that it had not spent. The pricing review is not about removing business risks from ETSA, nor is it to reward spurious claims.

**Accordingly, ECCSA supports the AER's draft decision to reject the ETSA proposal to revalue its easements and for the new valuation to be included in the opening RAB**

### 1.5 Summary

It appears that in its draft decision, the AER has not had regard for:

- The recent down turn in the economy, and persists in allowing for costs that ETSA might incur if the SA economy grows strongly
- It has not addressed the fact that all businesses must improve productivity just to maintain current standing
- The increases in costs claimed that are unlikely to occur
- The greater difficulty consumers are likely to have in paying the increased charges
- The likelihood that governments and regulators in the past did apply a realistic approach to constraining the claims for increased costs from the DBs, and that even with these constraints, the service provided was adequate for the needs

Unless the AER takes these aspects into account, it will have failed in its duty to provide certainty that the regulatory bargain has been maintained at an appropriate level.

## **2. Total Ex-Ante Capital Allowance**

ECCSA reiterates its concerns expressed in its August 2009 submission with the biased and unbalanced Chapter 6 Rules determination, based on the AEMC development of the Chapter 6A Rules for transmission which overtly over-incentivise network investments. The results from the AER's distribution pricing reviews (New South Wales, Queensland and South Australia) have seen an explosion in institutionally-driven approved capex allowances.

Notwithstanding the AER's draft decision in reducing proposed capex by ETSA Utilities from \$2,315.3 million to \$1,628.2 million, it is still a very significant sum. On ECCSA's calculations (see August 2009 submission) capex should be some \$1.0-\$1.2 billion for the period.

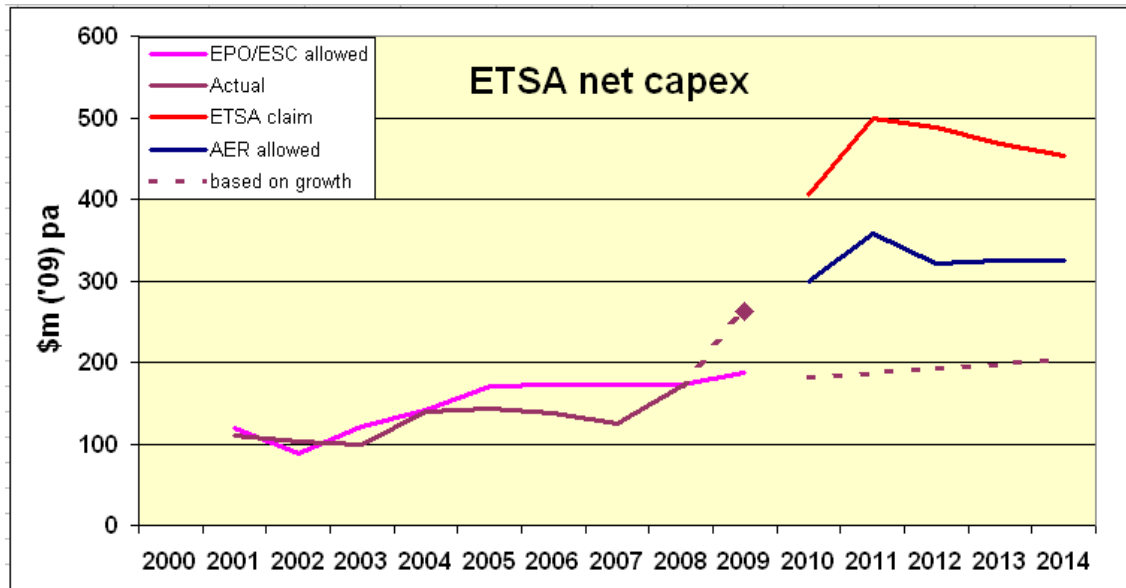
ECCSA notes that the AER has responded to its concerns that 20% of ETSA's capex claims represent asset replacement, reflecting the age of its assets. ETSA had made similar claims in the ESCOSA review in 2004, yet still underspent its allowance for capex.

**Whilst ECCSA supports the AER's draft decision in approaching ETSA's asset replacement claims on a "conditions approach" rather than age-based, it still has an underlying concern that ETSA will underspend the regulatory allowance, especially in the early years of the period. Overspending capex in the last two years exposes ETSA to minimal risk, as it is allowed to roll in any overspend into the RAB for the following period and still get a handsome return on the investment.**

### **2.1 An overview of the AER draft decision on capex**

The AER has trimmed the ETSA claim for capex by an average of some \$140m pa yet the size of the ETSA capex claim was so great that even this "trimming" still leaves a doubling of the capex ESCoSA deemed sufficient for ETSA to maintain its service standards.

The size of the AER proposed capex program relative to the ESCoSA allowances can be seen in the following chart.



Source: AER DD, ESCoSA FD, ETSA application

ETSA has sought to provide justification for the significant increase in capex proposals as being due to:

- Growth, especially peak demand growth
- Reliability obligations, as part of licence conditions
- Asset renewal, as a result of ageing asset profiles
- Input cost escalators.

The ECCSA agrees that these are reasonable aspects to consider as part of a capital program. By and large, the AER engineering consultant (PB Australia) has recommended some reductions to the allowed capex but has basically concurred with ETSA stated need to have a large increase in capex and has agreed to a doubling of the current period capex program; the AER draft decision effectively supports this view.

The approach to assessing the capex by the consultant and then by the AER concentrates on the assumption that the DB requests are valid, and then attempts to assess whether there are aspects where the capex requested might be considered to be excessive. This approach is referred to as a “bottom-up” approach. Experienced senior business practitioners are all too aware that a bottom-up approach to capex (and opex) claims by subordinates can be difficult to refute and as a result the maximum allowances are commonly set on a top down approach which looks at the business limits on cash available for capital investment. The approach by executives is that there is a limit on the available capex and this requires decisions on setting priorities for capex.

What is absent from the ETSA application and also from the AER draft decision is the absence of constraints as to whether the market can absorb

the costs that will result from such a program proposed or allowed and the need to prioritize projects within the business. As noted in section 1.3 above, in previous times governments would balance the desires of the electricity industry it owned with its assessment of whether there was an ability to pay for the desires. Typically, if ETSA is to be believed, consistently the government (when it owned the assets) would scale back desired investment based to a level where it considered it had the ability to raise the cash needed for such programs and the ability of the consumers to pay for the work.

In its assessment, PBA has only assessed whether the capex can be justified (which it confirms it can be, on both a needs basis and a cost basis), and has not assessed whether there is an ability to raise the cash needed for the works, and if consumers can pay, let alone force the business to prioritize projects. From PBA's viewpoint, this might be considered to be reasonable, but the AER must apply its overview as to whether the capex program needs to be scaled back to match ETSA's market (consumer) expectations.

The ECCSA does not doubt that a case can be made for the capex allowed. The main question the ECCSA has, is whether the amount requested is economically efficient (ie whether it is needed now or could be deferred) and whether the market has the capacity to pay for the investment.

Economic efficiency in relation to investment and as interpreted by the AER and its consultants has concentrated on whether the capex requested can be justified and if the costs involved are reasonable. This is just one side of an assessment as, in fact, investment economic efficiency requires more than this. Overall, an economic efficient approach in a wider business sense requires an assessment as to whether the intention to invest can be matched with a high expectation of receiving a return which provides a better outcome than investing elsewhere or even not investing.

In the context of a regulated monopoly, the expected return for an investment is set by the regulator and, where the monopoly service is essentially inelastic with respect to price, the regulator has to identify whether the benefits received by the consumers are reflected in the costs it will cause to be imposed on the consumers. This balancing in relation to electricity distribution needs the investment to return to consumers improved or maintained service standards at a price which consumers can pay.

The AER draft decision makes little attempt to address this second element of economic efficiency in relation to delivery of improved service, whether this improved service is required and whether the consumer can afford to pay for this improvement in service. It has merely assessed whether the request by ETSA is justifiable, and then deducted amounts it considers to be inefficient from the ETSA claim.

**This is a very disappointing aspect of the AER review as it ignores the regulatory bargain which consumers require the NEM system of efficient economic regulation to deliver.**

**In its draft decision the AER has required a number of aspects of reduction to the ETSA forecast capex needs. The area that seems least well addressed from an overview aspect is the way the AER and its consultant have addressed the capex claimed by ETSA for growth. The capex for growth in the current period was greater than forecast for the next period, so intuitively we should see a lesser amount of capex needed, but to the contrary, the AER and PBA<sup>2</sup> consider that more capex is needed for less growth. Where is the reality check?**

The AER approach is entirely single focused and does not address the ability of the user's ability to pay.

## **2.2 Specific observations of the draft decision**

The ECCSA makes the following observations of the AER draft decision

### **2.2.1 Capex for growth**

After examination, the AER proposes to reduce the allowance for gross growth capex by 10%, to ~\$900m.

The AER has also assessed the growth numbers of new customers to increase by 35,068, and for the peak demand to increase by 393 MW over the next period.

This means that the AER accepts that the cost per new customer to be connected is ~\$26,000 per customer, or alternatively, the cost to service each extra MW of demand will be \$2.3m per MW in increased peak demand.

In comparison, in the current period, the increase in customer numbers was ~49,000<sup>3</sup> and the increase in peak demand was 498 MW<sup>4</sup>. The actual/forecast capex used by ETSA in the current period is \$839m in \$'09 which using the same ratio as in the current application, ETSA would have spent about half on growth projects, or ~\$420m in \$'09.

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<sup>2</sup> The ECCSA notes that PB Power (part of the PBA group) provided advice to ETSA, yet PBA was expected to critique the PB Power advice on an independent basis.

<sup>3</sup> MMA report to AER

<sup>4</sup> A peak demand of 2833 was recorded in February 2001 setting the maximum peak prior to the start of the current period, and the highest peak within the period was 3331 recorded in January 2009, giving a change in actual peak demand of 498 MW

Thus on a comparative basis in the current period ETSA spent capex per new customer connection of ~\$8,600 per new connection or alternatively \$0.85m per added MW in increased peak demand.

Showing this in tabular form

	<b>Historic cost \$'09</b>	<b>Forecast cost \$'09</b>	<b>% increase</b>
Cost/customer for new connection	\$8,600	\$26,000	300%
Cost per MW in increased peak demand	\$0.85m	\$2.3m	270%

It is accepted that such broad approaches might lack some exactness, the trends are surprisingly consistent showing that the new costs proposed by AER allow ETSA a threefold increase in the cost of providing for new growth.

In its submission on the ETSA application, ECCSA highlighted that the capex for growth appeared inconsistent with past performance. It would appear that the AER and its consultant have failed to carryout even a modicum of analytical work to assess whether on a comparative basis, the ETSA claim for growth capex, is grossly overstated.

The work by PBA and the AER concentrates on the projects ETSA sees as needed to provide for the new growth, but at a high level, ETSA past performance and forecast performance appear grossly at odds.

The AER should carryout more analytic work (along the lines carried out by ECCSA) to establish if the costs proposed by ETSA to match the increases in peak demand and new customer growth warrant so much capex, or whether all consumers are being levied with unnecessary capital investment.

When the adjustments the AER has made to other elements of the capex program (especially the asset replacement and reliability elements) an approach similar to that made by ECCSA for growth shows that the allowances the AER proposes for these elements, are much more in keeping with the actual expenditure incurred in the current period.

The ECCSA considers that the AER must carryout much more analysis of the proposed growth capex, to ensure that the final allowance reflects the actual forecast conditions.



### **2.2.2 Outcomes from the capex**

There is an essential element missing from the AER draft decision.

If the AER proposes that ETSA be permitted any capex for the next period, it is essential that there be some expected outcomes which provide a long term benefit to consumers, as required by the NEO.

The only outcome that the AER has determined will come from the capex, are unstated expectations that the network will transfer electricity to consumers and that service standards will match the target service standards within the STPIS. There is no explicit outcome stated.

Yet consumers are expected to pay for some \$2.3 billion in net capex. Good corporate governance requires that for an investment there must be a clearly stated outcome. Against this outcome(s) there must be measured assessments as to whether the outcome(s) have been achieved.

As far as ECCSA can see there is only one outcome that has clearly stated, and that is the service targets will be met, and if they are not there will be a penalty/bonus arrangement to reflect variations from the targets.

The AER must clearly state what it sees are the outcomes from the investment of the \$2.3 billion it requires consumers to fund, so that consumers can see what they are getting for the money the AER says they must pay.

### **2.2.3 Ability to deliver the capex program**

The AER commissioned EMS to assess the deliverability of the ETSA capex program.

The EMS report is quite limited in its approach concentrating primarily on ETSA staffing needs and the historic approach ETSA has used to resource its needs. There are a number of projects that ETSA admits will require it to outsource, on a contract basis, its labour to achieve the work implied in the capex program.

In this regard the ETSA capex program cannot be looked at in isolation. ETSA opex needs provide competition for the capex program, as does the ElectraNet opex and capex programs.

EMS does look at the SA statewide workforce, but fails to look much wider. In particular the AER has proposed a massive increase in

Queensland DBs capex programs to add to the Powerlink program approved a couple of years ago. Likewise the AER has just received applications for the Victorian DBs all seeking massive increases in capex.

These other capex programs just in the electricity industry will put heavy pressure on labour and material resources raising the spectre of significant shortages or significant price rises.

Overall, EMS has not addressed likely outcomes of other AER decisions, nor of the pressure on the SA workforce from other states, to provide ETSA with the needed supervisors and labour to implement the proposed capex program.

The AER has addressed the need for implementing the capex (and opex) programs by allowing for increases in the costs of material and labour. But at the same time, it has not addressed whether the cost increases make those opex and capex programs so expensive that they become inefficient.

ECCSA considers that the AER needs to address the potential for costs exceeding the efficient upper bound. At the same time the AER should also consider whether more of the proposed ETSA capex program should be delayed to a time when cost pressures are less.

As the ECCSA assessment in section 2.2.1 shows, there is considerable potential for further trimming the ETSA capex program in relation to growth projects. By doing so the AER could provide ETSA with a capex allowance that is more reflective of the achievable historic capex program and reduce the cost pressures likely from ETSA trying to implement a more ambitious capex program.

If the AER persists with allowing such a large step increase in capex, on the assumption that the capex program is deliverable, then it should address to following underlying concern.

Historically, consumers have seen allowed capex programs to be manipulated in a way that earns a DB a commercial benefit not contemplated by the regulator – back ending the capex program (ie underspending in early years and overspending in later years) provides such a commercial benefit. If the DBs do not spend all of the capex allowance then they still retain the commercial benefit of underspending. A review of ETSA's capex programs shows that this is what ETSA has done previously

The ECCSA has pointed out that it considers ETSA will find it difficult to achieve spending the allowed capital prudently and efficiently due to

competition for resources, including the essential funds required from debt and equity needs.

With these concerns the AER must develop a method of ensuring that it's approved capex is efficient and that it does not include for allowances (on which a return is included in the allowed revenue) which might not be achieved. The ECCSA suggests that the AER impose on ETSA some controls to ensure that the failure to achieve the capex programs does not result in unearned income for ETSA. Some suggested approaches to avoid this occurring are:-

- Move some of the capex to contingent projects such that ETSA must demonstrate to the AER that the need for the capex is real before the capex is included in the revenue stream.
- Carryout an annual assessment of actual capex and allowing only the actual capex to be included in the following year revenue. This will have the added benefit of preventing back ending of capex programs
- Build in a claw back mechanism to recover the unearned revenue from capex underspends
- Carry out an annual assessment of all capex to ensure that the capex is still efficient. This will assist in preventing capex programs which were initiated on the basis they are efficient at the estimated costs but when actual costs show there will be an over run they can be terminated before inefficient capex is incurred.
- There is a relationship between opex and capex in that opex includes for the capital raisings necessary. If the capex program is less than allowed, the costs of debt and equity raisings should be discounted for the amount of capital (debt and equity) not raised.

#### **2.2.4 Escalation of costs**

Since the AER commenced operations under the AEMC revised chapter 6A rules and the MCE revised the chapter 6 following the same pattern, there has been an explosion of capex and opex increases being sought (and allowed) for increased capex and opex allowances to accommodate increases in capex (and opex) based on a view that the rate of increases in material and labor costs used by electricity transport businesses is higher than general inflation.

Regulation is expected to replicate the pressures of competition on a monopoly, yet regulation as applied by the AER is taking a view that any "real" increase in costs (ie where costs exceed the general inflation) is justification for an increased allowance to a regulated business.

Of its gross capex, ETSA had included an increase in costs of 15% to allow for inflation and cost escalation to the rates ETSA used to develop its capex program. The AER has reduced this 15% on cost to 10%, still allowing ETSA some \$264m additional funds for its capex program. **To put this into context, \$264m is the same as the actual capex (in \$09) used by ETSA in the two years of 2005/06 and 2006/07!**

This means that the AER is forecasting two years of the current capex program will be replicated by increased costs in the next period. This is a cost that consumers find unacceptable.

Every regulatory review by the AER has allowed for a “real” cost increase in capex and opex because of this factor.

Although the ECCSA accepts that input cost escalators must be assessed by the AER, it counsels extreme care in regard to them. ECCSA sees that assessing input cost escalators is the “new game” in the regulatory process. The risk to consumers is twofold – that overall national productivity is neglected to be included in the assessment, and that the forecast are likely to be conservative. These aspects are addressed in more detail below.

The ECCSA makes the following observations on the AER draft decision with respect to cost escalators.

#### **2.2.4.1 Wages cost growth**

In section 3.2.2 ECCSA provides its views on whether the wage escalators used by the AER are appropriate.

The ECCSA considers that the approach taken by the AER is too conservative and requires consumers to pay for costs that in previous years (when wages were growing faster than now) ETSA was readily able to manage within its allowances.

Whilst it is acknowledged that wages have consistently increased faster than CPI, this per se does not mean that capex needs to be increased to accommodate the increases. Across all industries, higher wages are offset by increased productivity, and so the long held assumption that the net cost of employing labour matches the general level of inflation. To allow ETSA an increased allowance in its capex budget for increased wages without the offsetting impact of increased productivity is poor regulatory practice, as it exposes consumers to unnecessary costs which they are required to pay a return on and a return of, for the next 40 years or so.

Contrary to the approaches taken by jurisdictional regulators, the AER has not imposed a productivity adjustment (ie a declared reduction in wage costs due to productivity improvements) as part of the draft decision. In fact the AER has allowed an increase in wages replicating the full expectation of wage growth without the leavening impact of productivity improvement.

If the costs for providing the network service are to rise to the extent implied in the AER draft decision, then consumers have a right to expect that the increased costs will include a productivity gain replicating the average across all industries.

The ECCSA considers that the AER must include for a productivity gain and recommends that the state wide increase in wages be the surrogate to establish the productivity benchmark for ETSA.

#### **2.2.4.2 Materials price growth**

The AER has permitted the capex program to be significantly escalated due to expected material price rises above the CPI. Competitive pressure is intended to provide incentive to increase productivity and creative approaches to maintaining costs. For the AER to allow electricity network businesses an automatic right to increase allowances where costs are following a long term average runs counter to the concept of regulation being a surrogate for competition.

In its draft decision, the AER has examined each of the elements for material cost growth expected for the next five years (see appendix G3).

In principle, the ECCSA does not support such an approach as used by the AER, as it implies that the AER will forever be subject to having to forecast the movement in materials costs, rather than allowing for step changes when and if they occur. The tendency will be for the AER to take a conservative view on expected changes and therefore the businesses will be rewarded at the expense of consumers. There is no ability for the AER in future to correct its mistakes in forecasting in future reviews, yet consumers will be paying a return on the errors for next 40 years or more. This is unacceptable.

For example, in the ETSA draft decision the AER forecast the future movement of the \$A/\$US exchange rates. In the ETSA draft decision appendix G, the AER provides the following table of forecast exchange rates

**Table G.8: AER conclusion on exchange rate forecasts for ETSA Utilities (USD/AUD)**

	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14	2014–15
Exchange rates	0.744	0.800	0.656	0.603	0.585	0.581	0.580

Source: AER analysis; Econtech, ANSIO, 20 August 2009 p. 110

This seems to indicate a very conservative forecast, when the entire period of floating exchange rates is reviewed. The following chart shows the historic exchange rates and the forecasts of the AER



Source: RBA, AER DD

For the expectation of the exchange rate for 09/10, the AER has forecast a value of \$A0.80. The average exchange rate up to early February (ie of more than seven months of data) shows that the actual current average exchange rate for 09/10 is \$A0.877. This shows that the current AER estimate is significantly conservative for 09/10 and should be revised. To have an average of 0.80 for this year would require the exchange rate to immediately plummet to 0.69 for the rest of this year. This is not an expectation of the market as a whole and is an unrealistic forecast.

The forecasts of the balance of the new regulatory period (shown as dotted) shows that the AER estimates for the exchange rate are the lowest for the entire period of floating exchange rates except for a relatively short period from 2001 to 2002 where the exchange rate was lower than the AER forecasts for the next 5 years. Effectively, the AER forecast implies the \$A will have a more sustained period

of low exchange rates than has ever been experienced since the \$A was floated. Again, we would question this forecast.

The overall trend of \$A to \$US is that there has been a slow reduction of perhaps \$A0.04 pa over the entire period of floating exchange rates.

This conservatism in the exchange rates is significant as it flows to the price expectations for all of the price movements of the other materials the AER has estimated, as the prices of these materials are all quoted in \$US.

The fact that the AER has used a conservative approach to the exchange rate raises the concern that all other material forecast prices are equally conservative.

The ECCSA considers that the best regulatory approach for setting capex (and opex) is to follow the historical approach used by the business itself as the basis for setting future allowances, making adjustments only for defined step changes in the conditions which the business must work under.

The performance of ETSA over the past regulatory periods where there have not been allowances for increased material costs, shows that the DBs have consistently been able to absorb increases and decreases in materials prices within their capex allowances adjusted by CPI. The ECCSA observes that other businesses must manage these price movements within a market that has price movements measured by the CPI.

Therefore the ECCSA considers the AER approach to allowing larger than CPI adjustments for material based on estimates, only further increases the risks consumers face under this regulatory process developed by the AER.

### **2.3 An observation**

The AER has not addressed what appears to be a major inconsistency in the build up of the ETSA capex program. In its submission ETSA makes regular reference to the need to replace ageing assets. As part of its program of assessing elderly assets, it has increased its opex program to include better monitoring of the condition of the assets. As a result the capex requirement for assets replacement has been reduced by ETSA from a "replace due to age" approach and then the asset replacement capex has been further reduced by the AER. To achieve this goal, ETSA and then the AER have sensibly used both a "bottom up" approach to needs and then addressed the need from a more global "top down" perspective. The

outcome has been a more rational outcome for consumers overall. The ECCSA supports such approaches as they reflect what occurs in competitive industry.

On the other hand, despite growth being less than in the current period, ETSA has claimed a massive increase in capex for growth projects, and the AER has made a very modest downward adjustment to the growth capex allowance. Other than examining the growth capex from a "bottom up" approach, the AER and its consultant have not addressed the growth capex claim from a global perspective (ie on a "top down" basis), and therefore has missed that the costs ETSA has claimed appear to be significantly high. A similar observation applies to the non-network capex assessment by the AER.

The ECCSA is concerned that the AER has not been consistent in examining all elements of the capex program from both the "bottom up" approach used by ETSA and on the global "top down" approach it used for the replacement capex.

## 2.4 Capex overall

ETSA has made a claim for a massive increase in its capex for the next period, increasing its current actual capex by some 2-3 times. It has based this need for such a large amount of capex on four main aspects:-

1. Growth
2. Replacement
3. Increased security, reliability and safety
4. Non-network and other

The AER has addressed the aspects of capex for replacement and increased reliability, safety and security, by proposing appropriate reductions to capex requested by ETSA for these categories.

The aspects where the AER has failed to propose a more sensible capex program is in the aspect of growth. As the ECCSA points out, the costs per unit of growth (customer numbers and peak demand) have increased by a factor of three times between the historic ETSA performance and what the AER proposes to accept. This massive unit increase is totally unsustainable.

The AER draft decision includes for ETSA to receive as cost escalation and inflation (ie funds for no identifiable outcome) the same amount as the capex ETSA spent in real terms in the first two full years of the current period. The enormity of this escalation impact in an environment where inflation is expected to be 2.5% pa immediately raises questions as to its validity.



### **3. Forecast Operating Expenditure**

#### **3.1 An overview of the AER draft decision**

ECCSA notes that the AER's draft decision has applied a reduction of \$131 million to ETSA's forecast opex, or around 11%. This is, in ECCSA's view, an inadequate reduction in ETSA's proposals, which have been extensively padded, as detailed in ECCSA's August 2009 submission.

ETSA sought an increase in opex of nearly 50% above its assumed efficient benchmark year of 08/09. In reaching its draft decision the AER has accepted:

- The ETSA arguments that 08/09 year provides efficient opex
- That the base year should be adjusted upwards by some 9% for step changes, an "usually low" opex in the base year and regulatory, legal and tax changes
- Opex should increase by 4% due to the capex program
- Opex should increase by 10% because of an increase in "scale" of the ETSA activities
- Opex should increase by 12.5% real due to increases in input costs, or 15% in nominal terms
- Opex should not reduce due to efficiency gains
- Capex does not provide opex reductions

This means the AER proposes to approve an increase from the 08/09 actual opex by some 35% real, and not to require ETSA to achieve any efficiency gains.

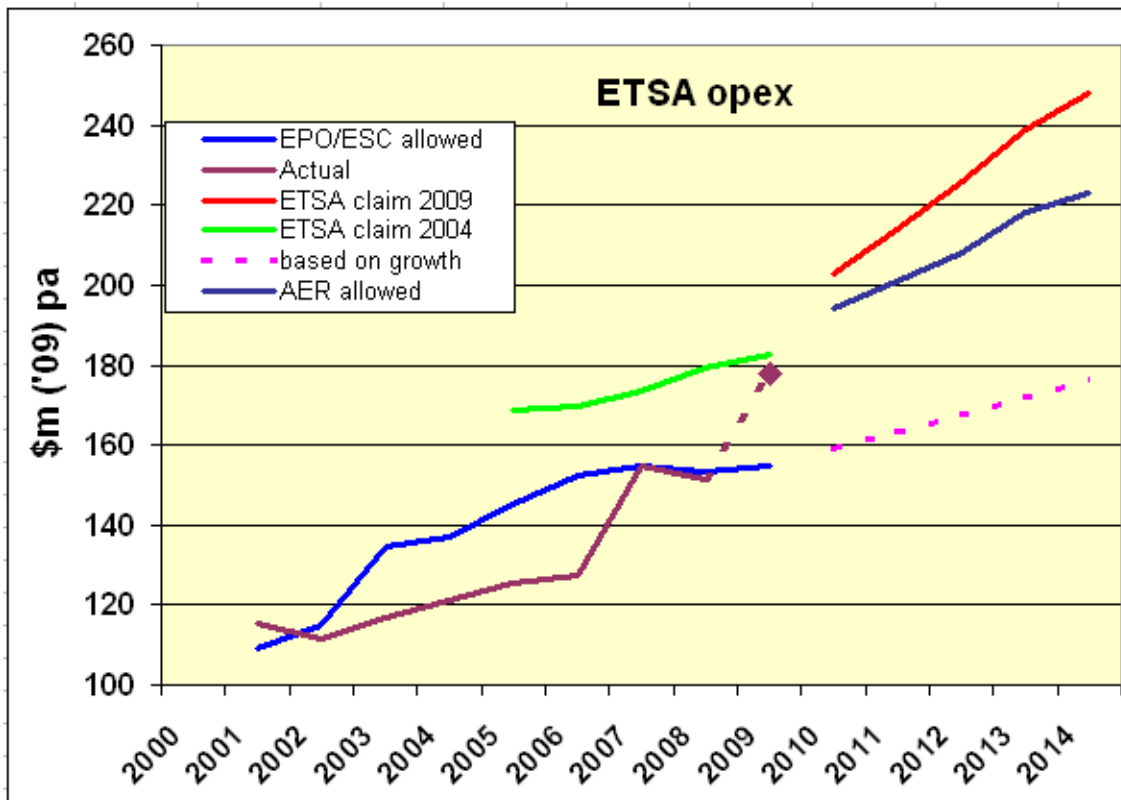
ESCoSA allowed ETSA an average of \$152m pa for opex in the current period, and ESCoSA allowed ETSA some \$153m for opex in the year of 08/09 used as the base year. Against the ESCoSA allowance ETSA used \$40m less than the ESCoSA allowance for the first four years of the current regulatory period, and it should be noted that the opex for the final year is still to be determined.

**On an overview basis, the AER decision effectively ignores the fact that ETSA was able to manage its opex so well that it had a surplus of some \$40m of opex that it did not use its opex allowance in the first four years of the current period.**

**What is more concerning is that the AER sees that the ESCoSA allowance was obviously incorrect for the fourth year by allowing an effective increase in the ESCoSA allowance (the "adjustment on the base year").**

The AER proposes an opex allowance of \$209m (average) for the new period, whereas the ESCoSA allowance for the “base year” was \$153m. This means that the AER has increased the ESCoSA allowance by 37% in real terms.

These concerns are pictorially shown in the following chart



Sources: ESCoSA decisions 2004, ETSA application, AER DD

The AER did not address the fact that ETSA claimed some \$33m pa for the first four years of the current period more than it actually spent – an overclaim of some 25%. Obviously, the AER has been convinced that ETSA has only overclaimed by 12.5% this time, based on its own historic performance.

Based on growth in demand/consumption, the AER proposes that ETSA is entitled to an extra \$40m pa above the projected opex needed based on forecast growth. To put this into context, consumers will pay an additional \$0.45/MWh to give ETSA what consumers view is an unreasonably high level of opex.

Overall, the AER has followed its previous practice of over-rewarding the DBs compared to the process used by the jurisdictional regulators.

### 3.2 Aspects where the AER has erred

**3.2.1 The benchmark year for setting opex.** As noted in the previous section, the ECCSA considers the AER has erred in its approach to setting the base line opex, and the allowances made to adjust the notional baseline opex.

In particular, the AER notes that its view (page 198) that the 08/09 actual opex is efficient is supported by the fact that for 08/09 ETSA overspent its opex by 5%, and that therefore ETSA did not unreasonably increase its opex for 08/09 year. This assessment ignores the fact that ETSA had already “banked” some \$40m in opex savings in previous years, and could afford to return its opex to that allowed by ESCoSA.

In regard to benchmarking, other consumer groups have raised with the AER the need to use benchmarks to set opex allowances. The ECCSA has sympathy for this view as industry wide benchmarking is the only tool which provides a regulator with the tools to assess the principle behind incentive regulation – that of competition by comparison. Unless a monopoly is compared to another as a core requirement to assess the reasonableness of a monopoly’s claim, a regulator has little ability to impose the strictures of competition on the monopoly.

This principle of industry wide benchmarking is the driver behind the Total Factor Productivity approach being championed by ESCV and the Victorian government.

However, the ECCSA recognizes that under the Chapter 6 Rules, the AER is constrained from using industry wide benchmarking as the primary tool for setting opex, as the Rules list a number of approaches that the AER must use. These include:

1. Information provided by the NSP in an application
2. Information from submissions made in response to an application
3. AER analysis
4. Benchmark data incurred by an efficient NSP
5. Actual opex incurred during any preceding period
6. Relative prices of opex and capex inputs
7. Substitution between opex and capex
8. Opex and capex labour should reflect an EBSS
9. Ensuring opex claims from a provider reflect arm’s length terms
10. Whether non network options have been considered.

Of these, in relation to setting the opex allowance, aspects 1, 2, 3, 4, 5, and 8 have the greatest impact on setting efficient opex, and these are addressed in more detail below.

### **3.2.1.1 DB provided information**

Information from DBs in their applications would be such that they would seek to maximize their profitability by over claiming on opex needs. A DB has an incentive to overstate its needs and this reality needs to be recognized. The historical performance by ETSA shows that it has consistently overstated its opex needs in the past, and this must cast doubt on the veracity of the claims being made now.

### **3.2.1.2 Submissions**

Submissions to the AER are effectively of two types – those from other NSPs which would be expected to support increases in opex allowances so they benefit from future AER reviews of their activities, and those of consumers who pay for the services and have a view of the relative cost for the service and the quality of the service provided.

The ECCSA considers that due to the clear commercial interest other NSPs have in relation to supporting increases in opex allowances, the AER should give very qualified regard to such observations.

It would be expected that those paying for the service would recognize the need to balance between quality of service and the cost for the service. Historically, consumers have tended to use past performance (past costs and past quality of service) as the best guide to balancing these competing aspects and developing a view on opex.

If the historic quality of service is at a level acceptable to consumers then the actual costs of providing a service to that level must gain significant primacy in regard to what constitutes an acceptable level of opex.

### **3.2.1.3 AER analysis**

The AER relies on technical support to assess the reasonableness of an opex claim. This support is usually provided by engineering consultants who are also directly employed, at different times, by NSPs. Consumers employ such consultants for similar activities very occasionally, if at all.

The ECCSA is not attempting to impugn the integrity of any engineering consultant but the reality must be stated. As a result consumers are concerned that the technical advice provided to the AER for its analysis might not be as rigorous as it could be.

For example, the AER used PB Associates for its detailed engineering analysis of the ETSA application, yet ETSA also used PB Associates for providing support for its application (ETSA attachments E10 and E16). Another example is that the AER used MMA to report on customer numbers yet ETSA also used MMA for support (attachments F9 and F10).

It is always wise to avoid any perception, real or otherwise, of the potential for conflict in advice provided to the AER by consultants used also by ETSA. This type of issue has arisen before, but surprisingly the AER obviously is not concerned. This is another disappointing aspect of the AER review.

#### **3.2.1.4 Benchmark analysis**

Benchmarking is a core element of the implicit requirement of regulation – that of competition by comparison. The Rules require benchmarking (ie competition by comparison) to be against an efficient NSP. A major issue this then produces, is at what point is an NSP considered to be efficient and therefore able to be used as a benchmark.

In Australia there is only a small reservoir of independent but similar businesses that the AER can benchmark against. In the case of DNSPs, there are only 12 separate DNSPs in the NEM, and two outside it. Of the 12, nearly half are in the second smallest region in the NEM (implying there is in fact a smaller reservoir of independent DBs than the numbers indicate).

Each of the DBs alleges that it is different to all the others, and comparisons are difficult to make. For example, to compare Citipower in Victoria (with only a CBD and a dense urban population) to Ergon Energy which is a vast DB with some low urban population and a sparsely populated rural population, is inappropriate. In fact, there are almost no DNSPs in the NEM which have similar characteristics and therefore allow for reasonable comparison.

Notwithstanding this, the Total Factor Productivity (TFP) approach used to some extent in the Northern Territory and proposed as an alternative in the NEM, attempts to use a wide range of elements where some degree comparison might be possible.

The ECCSA considers that benchmark analysis has a role to play in setting opex allowances, but it has some drawbacks – such as the lack of a large number of similar businesses, and the approach taken by DBs that they provide only those benchmarks where their business appears to perform well.

The most important drawback is that of setting what benchmarks will be used – number of customers, line length, energy consumption and maximum demand – and the weighting given to each. The most recently used benchmark is “size” which is a combination of all the above benchmark elements, with others added, such as geographic area of the business, density of customers and power used, etc. As with the other benchmarks, the key aspect is the weighting applied to each element, and establishing this weighting creates major issues, especially when comparing such different businesses as ETSA and other DBs.

#### **3.2.1.5 Past performance (point 5) an impact of an EBSS (point 8)**

The most powerful form of benchmarking is assessing past actual performance and using the inputs and outputs generated by a monopoly itself, especially when it has been incentivised by an EBSS of some form (a separate requirement, and included in point 8 of those assessments the Rules require AER to consider).

In regard to ETSA it has been subject to an EBSS of some form for the past regulatory period and therefore the outcomes of this are reflected in the actual opex incurred by it.

The ESCoSA deliberately decided to implement its form of EBSS so that it was able to use self benchmarking as its primary tool for assessing opex. It used self benchmarking for the 2004 review and there was every expectation that self benchmarking would be used for setting future opex allowances.

The efficacy of the EBSS implemented by the ESCoSA has resulted in significant opex savings to SA. The AER assessment of opex used during the current period, again highlights that ETSA does not require the levels of opex granted to it in previous periods where an EBSS applied.

#### **3.2.1.6 Assessment of the Rules requirements**

The ECCSA considers that self benchmarking coupled with the application of the EBSS for the last period, should allow the AER to use self benchmarking as its primary tool for setting opex and to have complied with the requirements of the Rules.

**That the AER has not used the self benchmarking that ETSA has provided from its previous performance, has also allowed significant changes to it, and that it has not rigorously applied the principles of step changes, indicates that the AER has erred in setting the opex for ETSA by not complying with the Rules.**

As a direct result, the AER proposes that ETSA be granted a significantly higher opex than its past performance warrants

### **3.2.1.7 Arms length provision of service**

ETSA is part owned by Spark Infrastructure and CKI. Citipower and Powercor in Victoria are also owned by these companies. In all three cases, there are services provided to ETSA by its related businesses, Citipower and Powercor, as well as by its owners and businesses related to them.

The Rules require that all opex and capex be costed as at arms length. The AER has not investigated fully whether ETSA costs include elements being provided by related parties other than the FRC IT platform costs.

### **3.2.2 Wages Growth**

The AER has allowed the full expected increase in real EGW wages to be included as an escalation allowance. The AER has erred in not allowing both the expected real wages growth and the expected efficiency in labour productivity. Overall, labour productivity is the difference between the cost of nominal wages and inflation.

Labour costs continually increase at a faster rate than general inflation. How the nation pays for this increased real cost is by improving productivity so that the actual cost to produce a unit of output remains constant. That is the additional wages paid are offset by the increased output of labour.

**On this basis the ECCSA considers that ETSA should be subjected to the same cost pressures as all other employers of labour. To maintain a static position in the market, labour costs must also remain static. If wages increase then productivity must increase to compensate.**

From a national perspective the real increase in sectoral labour costs is the difference between the average wage and the sectoral wage. Therefore the ECCSA contends that ETSA labour costs should only be increased if the EGW wages are higher than the average wages.

To a significant extent the review by Access Economics report prepared for the AER<sup>5</sup> quantifies the ECCSA contention.

Access Economics opines that EGW wages are likely to rise at a rate less than the SA state average (table 9.5) over the next regulatory period. Accepting the state labour average change reflects the productivity gain for

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<sup>5</sup> Report by Access Economics Pty Limited for the Australian Energy Regulator "Forecast growth in labour costs" 16 September 2009

the state, then on the basis of these estimates, Access Economics is forecasting EGW wages to be less than the state productivity improvement for the early years of the next period and to slightly overshoot them in the later years. On average over the regulatory period, EGW wages are expected to be 0.1% lower than the state average.

**Table 9.5: SA wage forecasts**

Financial year changes in SA nominal Labour Price aggregates										
Annual % change	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
SA	3.9	3.6	4.3	4.1	3.7	3.8	3.9	4.1	4.2	4.1
Utilities	4.6	4.2	3.8	3.8	3.8	3.9	4.0	4.1	4.1	4.1
Mining	5.7	4.1	3.8	4.0	4.1	4.4	4.4	4.5	4.2	3.9
Construction	3.5	3.5	4.5	4.5	4.2	4.7	4.9	4.3	4.0	4.4
Manufacturing	4.0	3.8	5.0	4.6	4.3	4.2	4.3	4.5	4.4	4.1

Financial year changes in SA real Labour Price aggregates										
Annual % change	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
SA	0.7	1.7	1.2	1.0	1.2	1.7	1.9	1.6	1.5	1.6
Utilities	1.4	2.3	0.6	0.7	1.3	1.8	2.0	1.6	1.4	1.6
Mining	2.4	2.2	0.7	1.0	1.5	2.3	2.5	1.9	1.5	1.5
Construction	0.3	1.6	1.3	1.4	1.7	2.6	2.9	1.7	1.3	2.0
Manufacturing	0.8	1.9	1.8	1.5	1.8	2.1	2.3	2.0	1.7	1.7

Financial year changes in SA nominal productivity adjusted Labour Price aggregates										
Annual % change	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
SA	4.3	2.4	3.0	3.3	2.5	1.6	1.9	2.1	2.4	2.2
Utilities	5.7	2.7	2.4	2.4	2.2	1.7	2.4	3.1	2.7	2.2
Mining	7.8	0.7	2.0	2.5	2.2	2.0	2.5	2.8	2.5	2.4
Construction	3.6	2.5	3.0	3.3	2.7	2.4	2.8	3.8	3.2	2.7
Manufacturing	4.1	2.7	3.8	3.1	2.6	2.2	2.5	2.9	2.8	2.6

Financial year changes in SA real productivity adjusted Labour Price aggregates										
Annual % change	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
SA	1.1	0.5	-0.1	0.3	0.0	-0.4	-0.1	-0.4	-0.2	-0.1
Utilities	2.4	0.8	-0.7	-0.6	-0.3	-0.4	0.5	0.5	0.1	-0.2
Mining	4.4	-1.1	-1.1	-0.6	-0.3	0.0	0.5	0.3	-0.1	0.0
Construction	0.4	0.7	-0.1	0.2	0.2	0.3	0.8	1.2	0.6	0.3
Manufacturing	0.8	0.8	0.6	0.1	0.1	0.1	0.6	0.4	0.1	0.2

In contrast the expectation is that construction labour will show an increase in average wages compared to the benchmark of the state average wage or base state productivity.

**Of the \$40m pa ECCSA considers the AER has over-allowed ETSA in its future opex, more than one third is a result of input cost escalation. There is no doubt that the AER needs to review its approach to automatically increasing the opex (and capex) allowances due to wages increases because it has created regulatory uncertainty and required consumers to pay higher costs than needed because:**

- 1. Wages have consistently exceeded CPI and therefore there is an expectation that opex allowances will always increase faster than inflation**



2. **This approach by the AER to indexing opex to wages growth rather than inflation has not been used widely by jurisdictional regulators**
3. **Those jurisdictional regulators that have allowed opex to be indexed to wages growth have also included a compensating deduction in opex to reflect the increase in productivity.**

**By excluding an opex reduction for productivity, consumers are not being granted the benefits of productivity improvements that are seen across the nation, and are essential for the nation to be able to afford wages that grow faster than inflation.**

**There is clear evidence that there is no need at all to increase the allowance for capex and opex to reflect EGW wages growth as there is no demonstrable forecast that there is an overall increase in the average long term EGW wages, although there is an indication that SA construction wages will increase faster than the average SA wages growth.**

### **3.2.3 Scale escalation**

Price cap regulation implies that the regulated business will receive increased revenue as a result of increased sales. Implicitly this means that based on the previous regulatory decision, there is support for a view that any increase in revenue from the last year's actual revenue achieved by the DB to the next year should be related to the actual growth in the market and not some new value developed by the applicant.

Allowing a change in the revenue due to "scale escalation" implies that the growth in consumption and demand do not define an increase in scale. If "scale escalation" is a higher amount than consumption, there is a disconnect between one regulatory period and the next, and that scale is measured by other means. But within a regulatory period a change in scale is tied only to a mix of consumption and demand under a price cap approach, as changes in volume are reflected in the revenue achieved. Usually this means that consumption and demand will increase, as the DB is incentivised to increase sales under a price cap.

ETSA claims there are four drivers of their "scale escalation":

- **Growth in the size of the network** (ie the more spent as capex, an additional allowance is required). This principle is predicated on whether the allowances for capex used to develop the capex allowances are inclusive of overhead or not. Within a regulatory period, the growth in consumption and demand provide for the premiums needed, so there is doubt as to

whether there should be a further doubling up at a regulatory review this is determined on a cost basis relating to net expenditure as a proportion of undepreciated RAB)

- **Growth in the volume of capital and maintenance work** (ie higher capex and opex allowances warrant a further increase in the categories). As the growth in volume of capex is already included in the growth in size of the network, this seems to be a further doubling. As with growth in size, the assumption is being made that the rates used in developing the capex and opex allowances exclude the overhead needed to manage the increases. However during the regulatory period, the only adjustment in the direct costs and the related overhead were recovered purely on growth of demand and consumption. As the rates used for work within a regulatory period are all encompassing, there is no need to provide an increased allowance at a regulatory reset
- **Growth in customer numbers.** There will be increased overhead (at least on a marginal basis) needed to accommodate increased billing and supervision of new connections. The question that remains unanswered is whether the increase in customer numbers is a subset of consumption and demand changes reimbursed within a regulatory period by the changes in consumption and demand which provide revenue changes.
- **Growth in the size of the workforce** (ie as workforce size is increased to manage an increase in opex and capex, an additional allowance is required). This is an argument that unless the direct costs allowed for opex and capex include for overhead, then there will be additional costs to provide for overhead costs.

Under the price cap control mechanism within a regulatory decision, scale is only measured by consumption and demand and therefore the rates used to develop capex and opex to provide for the changes in consumption and demand, whether arising from increases by existing customers or by the addition of new customers.

Implicitly the price cap approach **within a regulatory period** must allow for changes in overhead within the base rates used to address the various elements of opex and capex needs used in the period. This therefore means that changes in the four scale escalators nominated by ETSA are all addressed as part of the rates used to extrapolate the capex and opex for the next regulatory period.

**In addition to its basic view that there is no basis for scale escalation to be applied, ECCSA is concerned that the AER has effectively agreed (although in ECCSA's view incorrectly) with**

**ETSA that the scale escalators should be used to increase capex and opex. Because of this ECCSA has identified some concerns with aspects of the four scale escalators used:**

### **3.2.3.1 Network growth**

ETSA bases the growth escalator on the cost to replace and upgrade existing assets less the value of assets sold in relation to the undepreciated (or replacement) value of assets using the formula: network growth equals

$$\frac{(\text{Network extensions} + \text{Upgrades} - \text{Retirements})}{\text{Undepreciated RAB}}$$

**The main aspect of this formula is that asset disposals have to be costed in replacement terms as well, in order for all elements to be consistent. ECCSA has a concern that retirements have been costed at actual sale value or the depreciated value of the asset – to be consistent, they must be costed at replacement value.**

### **3.2.3.2 Growth in capex and maintenance**

ETSA observes that the bulk of its capex is carried out by contract, (such as building or expanding substations and line stringing) and a significant proportion of its opex is carried out by contract (such as vegetation clearing).

**ECCSA points out that the overhead and attendance associated with a contract remains essentially the same regardless of the value of the contract.**

**Therefore the bulk of the capex and opex does not suffer from increased overhead or attendance as implied by the scale factor calculation.**

### **3.2.3.3 Growth in customer numbers**

**Increases in customer growth result in new demand and consumption. ETSA increases its revenue under the price cap approach for increased demand and consumption. Implicitly, the price cap approach therefore reimburses ETSA for increases in customer numbers.**

### 3.2.3.4 Workforce growth

**There are increased costs associated with an increase numbers of employees, but not contractors. The cost for contractors already includes for supervision and attendance and the cost to ETSA of employing workers for contracted projects remains constant regardless of the size of a contract.**

### 3.3 The ETSA opex claim

Throughout the ETSA claim and in the PB report assessing the ETSA claim, there is frequent use of the terms “additional labour, resources” to “carryout more frequent” activities (inspections, attendance) than in the past.

This raises two important aspects for consumers.

1. That if ETSA performance in the past was inadequate then why has performance been as high as it has been? The assumption that ECCSA makes in this regard is that ETSA has been able to convince PB through its “bottom up” approach that including such additional labour and resources is a good idea, but PB has not recognized that the opex used to achieve that past acceptable performance, was adequate for the purpose and therefore is efficient
2. That the AER should verify that through the next regulatory period that ETSA has actually provided the additional inspections and attendance that it says it is going to carryout. ECCSA recognizes that the AER is not able to claw back opex unspent, but analysis like this will provide AER with a better understanding of the veracity of ETSA claims to justify increased opex when the next regulatory review is carried out.

The ECCSA considers that, with such a significant increase in capex projects, ETSA should be required to provide much larger efficiency savings in:

- Capex/opex trade-offs (i.e. larger opex savings)
- Productivity savings
- Savings from maintenance programs no longer required on replaced assets.

Yet because of its less rigorous approach than the jurisdictional regulators, what is being seen, is a large step increase in opex as well as the large capex claims and opex increasing massively because the AER considers that such causes of reduced opex have almost no value.

### 3.4 Summary of the ECCSA view of the AER draft decision on opex

The AER has provided arguments essentially supporting the ETSA claim for opex, although the AER proposes to remove some of the more blatant and excessive elements of the ETSA claim.

The AER had an opportunity to use its powers to more rigorously address the basis of the opex using historic performance in the same manner as ESCV and ESCoSA have done in the past. However, the AER has decided not to do so and as a result consumers are seeing higher costs so that ETSA has less pressure on it to act as a business subject to competition must do.

In particular, the AER has failed its responsibilities to consumers by:

- Not taking a stronger view on step changes and their costing
- Not requiring ETSA to overtly include for savings from productivity improvement such as would be achieved by benchmarking EWG and construction wages against the state average wage instead of inflation
- Not avoiding any perceptions of conflicts of interest – real or otherwise – in the choice of consultants (although ECCSA has no view on this issue).

Overall the AER has accepted that in principle opex should be allowed to increase at a rate faster than customer numbers, faster than consumption increases and faster than increases in maximum demand increases.

This defies an underlying principle in a competitive environment that, to remain in business, the cost of a service must fall in real terms over time. Further, to remain in business, the cost per unit must fall as the number of units provided increases.

## 4. Service Performance Targets

### 4.1 Overview

The AER proposes that the service performance (STPIS) targets should be as follows (table 12.4 AER DD):

**Table 12.4: AER performance targets for ETSA Utilities for the next regulatory control period**

Parameter	Unit	Targets				
		2010-11	2011-12	2012-13	2013-14	2014-15
<b>SAIDI</b>						
CBD	minutes	27.1	27.1	27.1	27.1	27.1
Urban	minutes	104.4	104.4	104.4	104.4	104.4
Short rural	minutes	184.0	184.0	184.0	184.0	184.0
Long rural	minutes	270.2	270.2	270.2	270.2	270.2
<b>SAIFI</b>						
CBD	per 0.01 interruptions	0.263	0.263	0.263	0.263	0.263
Urban	per 0.01 interruptions	1.292	1.292	1.292	1.292	1.292
Short rural	per 0.01 interruptions	1.736	1.736	1.736	1.736	1.736
Long rural	per 0.01 interruptions	2.111	2.111	2.111	2.111	2.111
<b>Customer service</b>						
Telephone answering	percentage	88.7	88.7	88.7	88.7	88.7

The AER proposes that the revenue at risk is +/-3% as part of the STPIS, despite ETSA suggesting that +/-5% of revenue could be subject to the STPIS.

The ECCSA can understand why ETSA suggested a higher proportion of revenue be at risk, as the targets suggested by ETSA were significantly less under the average achieved over the current period.

The AER proposal does **nothing** for consumers nor the regulatory bargain as its proposed targets are the average achieved by ETSA over the past four years as shown in the following table (table 12.3 AER DD).

**Table 12.3: ETSA Utilities' average of historical service performance for reliability**

	2004-05*	2005-06	2006-07	2007-08	2008-09	Average
<b>SAIDI</b>						
CBD	-	27.5	24.2	23.6	33.0	27.1
Urban	-	128.4	106.0	92.4	90.7	104.4
Short rural	-	170.1	214.7	159.7	191.4	184.0
Long rural	-	260.1	309.5	265.3	245.8	270.2
<b>SAIFI</b>						
CBD	-	0.250	0.315	0.236	0.251	0.263
Urban	-	1.530	1.362	1.173	1.102	1.292
Short rural	-	1.912	1.794	1.457	1.782	1.736
Long rural	-	2.046	2.353	2.063	1.981	2.111

Notes: (a) Data not available as ETSA Utilities only implemented OMS and started recording with this system from 1 July 2005.

What the AER is proposing is that ETSA need only achieve the average performance over the past four years in order to meet the regulatory bargain. In this regard, the AER proposes to massively increase ETSA capex by 75% and opex by 25%, being the main cause of the average tariff to rise by an average of 20%.

Thus for this increase in tariff of 20% consumers get no more than they get under the current regulatory bargain. This makes the AER proposal extremely difficult to understand – why do consumers have to pay more under an AER decision for the performance they got under the lower priced ESCoSA decision. This is totally illogical.

#### 4.2 Willingness to pay for improved service

ESCoSA carried out a review during the last regulatory period to identify if there was a willingness of SA consumers to pay more for better service than currently received<sup>6</sup>. The outcome of that research, specific to SA electricity consumers, was that SA consumers do not want to pay more for improved service. It should be noted that the price they were paying for that service was embedded in the ESCoSA 2005 decision on ETSA.

In particular, the research identified that:

<sup>6</sup> McGregor Tan Research for ESCoSA “Consumer Preference for Electricity Service Standards”, November 2007

- Any interest in an improved service was only there if the cost was very modest,
- The higher the cost for the improvement, the less interest in improved service
- There was general acceptance of the current level of service (reliability).

This research appears in direct contrast to the studies used by the AER (Charles River Associates and KPMG) supporting their view that there is an interest amongst SA consumers that they will pay more for an improved service. The ECCSA considers that the CRA and KPMG reports need to be assessed in light of the McGregor Tan work for ESCoSA which is very SA specific. ECCSA members concur with the McGregor Tan findings.

ECCSA considers the AER draft decision in relation to this point is in error and its assessment needs to be corrected.

Where the AER assessment is flawed, is that those consumers receiving poor service expect to get the same level of service all other consumers get for the same cost. For example, consumers on an unreliable feeder do want better service, but they do not consider they should pay more than others who get a better service for the same cost.

**Overall the AER needs to reassess its view that there is a general acceptance that consumers will pay more for better service – the fundamental issue is what better service they get and how much they are required to pay to get it; this aspect was addressed in the McGregor Tan study.**

#### **4.3 Should ETSA get a bonus because it is better than average?**

The implication of the STPIS and the targets set, is that should ETSA achieve a better outcome than the average of its performance over the past four years, it will receive a bonus payment. Prima facie this appears to be reasonable.

**However, the question needs to be asked, how much extra did consumers pay for the service they received for the same period?**

For an average tariff ranging between \$38-40/MWh, consumers received the same service levels as the AER is proposing as the targets for the next period. That is, consumers are going to get nothing more than they have been receiving in terms of service, but the cost is much more.

As a matter of principle, if there is a requirement for consumers to pay more, then there is a balancing expectation that consumers will get more for the premium they are to pay.

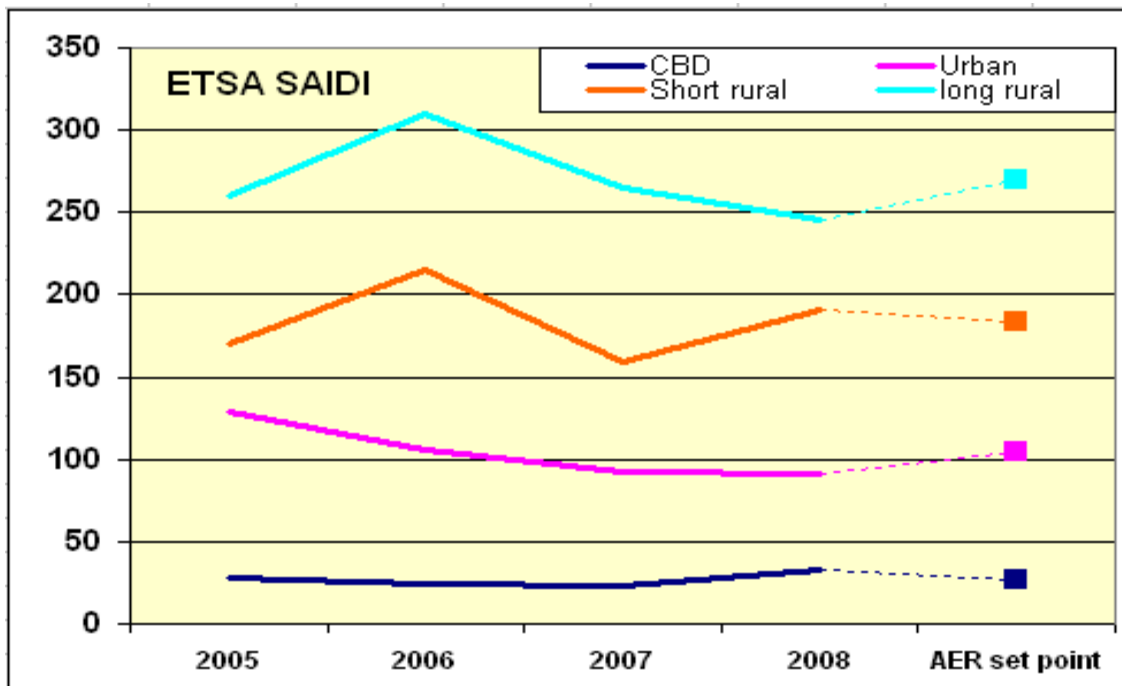


However, the AER is proposing that consumers will pay more for the same service levels they used to pay less for (as in the current period) but if ETSA actually does provide a better level of service than was provided in the past, then consumers will pay ETSA a bonus under the STPIS – consumers will pay twice.

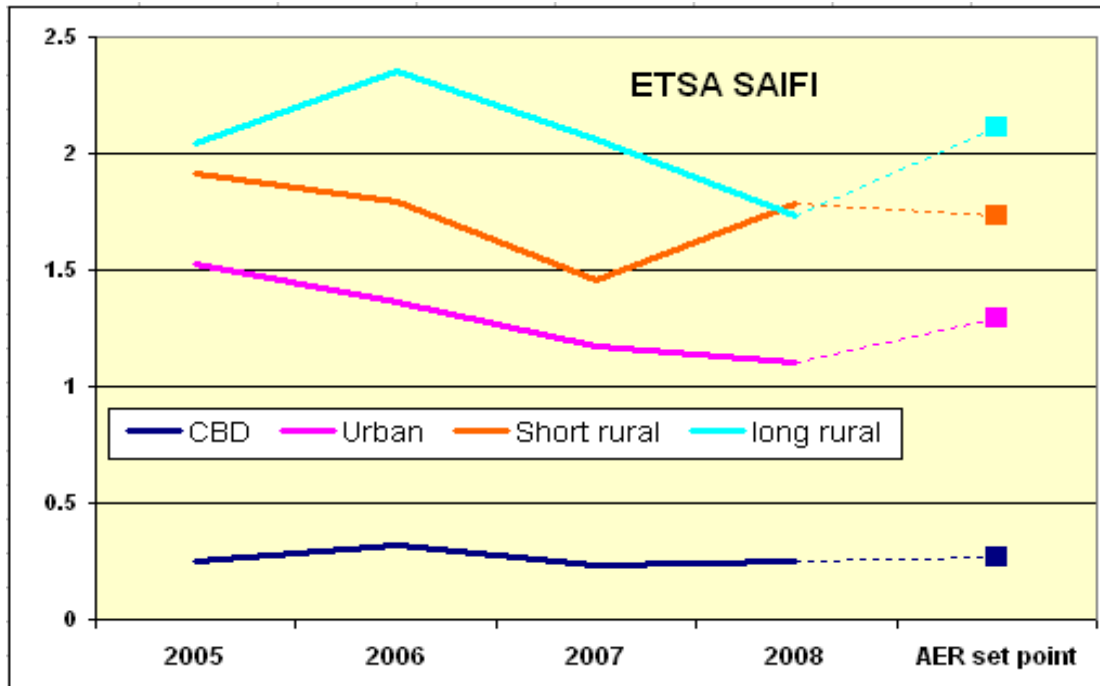
The AER has not addressed this basic element of equity.

The ECCSA considers that if a bonus is to be paid then ETSA has to earn it. To recognize this the service targets for the payment of a bonus need to be made challenging, and not just because a marginal improvement above average has been achieved.

**Analysis of the basis of the AER proposal shows that ETSA is most likely to receive a bonus by doing nothing more than it has in the current period. The following two charts show SAIDI and SAIFI achieved and the AER proposed set points. In seven measures ETSA would receive a bonus if the AER set points are used and ETSA achieved the performance it did in the last two years. This is because the averages show high values for the first and second years, and after then ETSA performance improved.**



Source: AER DD



Source: AER DD

The AER proposal by using arithmetic averages over the past four years but as noted above, this provides ETSA with the immediate potential for a bonus payment.

**ECCSA considers that the AER proposal is insufficiently challenging and the performance targets need to be set so that ETSA has to continue to achieve against its recent performance rather than the average of the last four years.**

**Based on this analysis, ECCSA recommends that more challenging performance targets be used in the STPIS, especially considering that ETSA has been granted significant increases in opex and capex which should improve the overall performance of themselves.**

## **5. Cost of capital and allowed revenue**

### **5.1 WACC**

Notwithstanding the AER's statement:

“For this draft decision, the AER has determined a nominal vanilla WACC of 10.02 per cent for ETSA Utilities, which is slightly higher than that proposed by ETSA Utilities. This difference is due to an increase in the nominal risk-free rate since ETSA Utilities submitted its regulatory proposal. The impact of the increase in the nominal risk-free (rate) was partly offset by maintaining a MRP of 6.5 per cent” (AER, p.xxiv)

it is worth noting the assessment from an independent source (Credit Suisse<sup>7</sup>) on the AER WACC draft decision:

- **Nominal Vanilla WACC of 10.02% a good result:** The AER in its draft has allowed a WACC of 10.02% versus ETSA's proposed 9.52% and CS assumption of 9.31%. While the market based components (risk free rate and debt margin) are still subject to market movements between now and the final decision, we believe the draft WACC is a good result for ETSA (particularly the debt margin). Key points to note:
  - **AER has denied an increase in MRP as expected:** ETSA as part of its submission requested an increase in the market risk premium (MRP) to 8.0%, 150bps above the 6.5% set in the AER draft WACC decision in April 2009. The AER has concluded there is no persuasive evidence to warrant a change in MRP.
  - **Debt margin of 427bps well above CS expectations:** The AER has decided to use CBASpectrum BBB+ fair value curve to benchmark 10year BBB+ corporate bond yields giving rise to a 427bps debt margin. ETSA locked in 5, 7 and 10 year debt at an average margin of ~295bps in July-09. On that basis ETSA will be making a ~130bps benefit than the regulated allowance reflecting its higher credit rating (A-) and also shorter duration debt (5,7 & 10 year) against the regulated allowance (BBB+, 10 year). We had assumed a debt allowance of 300bps. Given the final decision is still 5 months out, this debt margin will change with market movements.
  - **ETSA request for 0.50 Gamma denied:** ETSA requested a reduction in the gamma to 0.50 from the 0.65 established in the AER final WACC decision. This has been refused.

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<sup>7</sup> Credit Suisse, Company Update 1 December 2009, “Draft ETSA decision positive for SKI”, Page 3. SKI is the ASX code for Spark Infrastructure, part owner with CKI of ETSA, Powercor and Citipower

As the Credit Suisse release notes, ETSA sought an increase in the market risk premium and a reduction in gamma, the allocator for tax imputation in the CAPM.

The ECCSA supports the AER decisions not to increase MRP and reduce gamma. The ECCSA reasons for supporting these outcomes are fully detailed in its response to the ETSA application.

The ECCSA also notes that the reason for AER including a WACC higher than that sought by ETSA in its application is due primarily to the risk free rate being some 115 basis points higher than when ETSA made its application.

The AER has also reduced the debt risk premium of 457 basis points sought by ETSA to its assessment of 429 basis points. It should be noted that this allowance is well beyond that identified by Credit Suisse as applying to ETSA now, of 295 basis points achieved in July 2009 for its existing debt facility. As CS states in its release referenced above:

“...ETSA will be making a~130bps benefit than the regulated allowance reflecting its higher credit rating (A-) and also shorter duration debt (5, 7 &10 year) against the regulated allowance (BBB+, 10 year). We had assumed a debt allowance of 300bps”.

In its submissions to the AER WACC review, MEU (an ECCSA affiliate) pointed out that a higher credit rating was needed than the BBB+ the AER had identified. Further, the MEU also identified that a sensible debt approach for a business is to hold a range of debt maturities. What CS states in regard to ETSA replicates exactly what MEU was advising in its responses to the AER but which the AER determined for its SoRI were incorrect.

The CS assessment goes further in that it believes the nominal WACC was expected to be 9.31% compared to the ETSA application WACC of 9.52%. On its assessment the AER determined WACC of 10.02% far exceeds the CS expectations. Again this supports the MEU contentions that the AER SoRI WACC parameters are conservative and when combined have returned about 80bps conservatism as assessed by CS as being a reasonable outcome. The ECCSA would agree with CS that the AER has been overly generous with its WACC assessment for ETSA.

Whilst the ECCSA recognizes that the WACC parameters in the SoRI should be maintained for regulatory certainty, it does counsel the AER to assess its outworkings of the debt premium. It is clear that ETSA has secured debt at a premium far less (some 130bps) than the AER has calculated. Because of this the AER needs to reassess how it calculated the

debt premium so that its assessments can achieve similar outcomes to actuality, rather than be hidebound by a mechanistic approach.

In its draft decision the AER sees that it needs to take a holistic approach to developing its value for the WACC. The MEU has been consistent that a holistic approach is essential to ensure the WACC developed for electricity DBs is appropriate for the economic conditions. By taking a holistic approach the AER can address the clear inconsistency identified by CS in its report on ETSA.

It would appear that a holistic view of real world expectations indicates the AER draft decision delivers an outcome too high compared to the actuality of the market!

The ECCSA supports the AER in the consistency of its approach in retaining the WACC parameters as developed less than 12 months ago, and detailed in its SoRI. However, the DRP used by the AER is not an actual figure included in the SoRI and therefore based on the CS analysis the AER should re-assess the DRP it has used, as this appears to be way too high

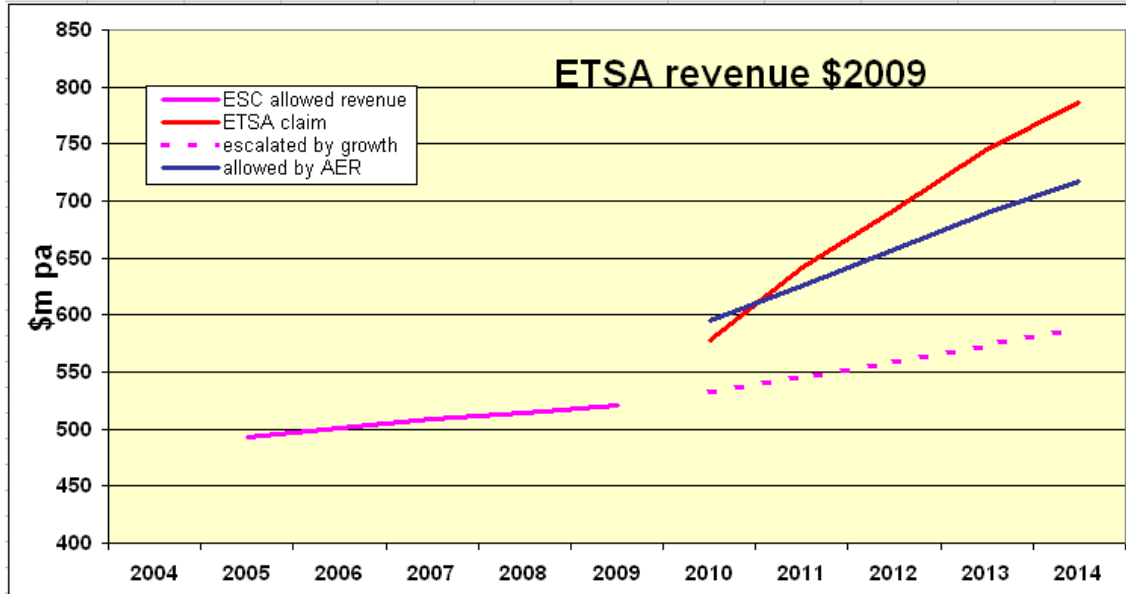
## 5.2 Revenue allowed and the impact on consumers

Clearly, the AER's draft decision is yet another disappointing review for consumers. Notwithstanding the biased and unbalanced rules which have over-incentivised network investments, the AER's review shows the extent to which consumers can no longer rely on the NEM institutions to ensure that the NEM is in the long term interests of consumers.

The nominal revenue allowance of \$3.55 billion is only 5% below ETSA's proposal, or \$173 million. Again, the assessment by an independent source (Credit Suisse Company Update 1 December 2009 Page 4, "Draft ETSA decision positive for SKI") is worth highlighting:

- **Nominal revenue allowance of \$3.55bn only 5% below ETSA proposal:** The AER has allowed nominal revenue of \$3.55bn for the regulatory period, only \$173mn (5%) below the ETSA proposal. The AER revenue allowance has exceeded CS expectations by \$293mn (9%) given the higher WACC parameters than forecast. In our view this is a good result for ETSA particularly given the 30% reduction in allowed capex.
  - **Opex allowance reduced by \$131mn (11%):** Key reductions to opex allowance by the AER are (1) \$19.5mn reduction to maintenance and repair and emergency response; (2) \$38mn reduction to reflect revised real input cost escalators; (3) \$33.2mn for reduction to self insurance opex.
  - **Higher WACC offsets lower capex:** The 'return on capital' allowance of \$1.63bn is within 4% of the ETSA proposal. This reflects the 30% reduction in capex partially offset by a 50bps higher WACC allowance than ETSA requested.

Revenue as proposed by the AER draft decision is to increase at only a little less than that claimed by ETSA, and this is shown of the following chart.

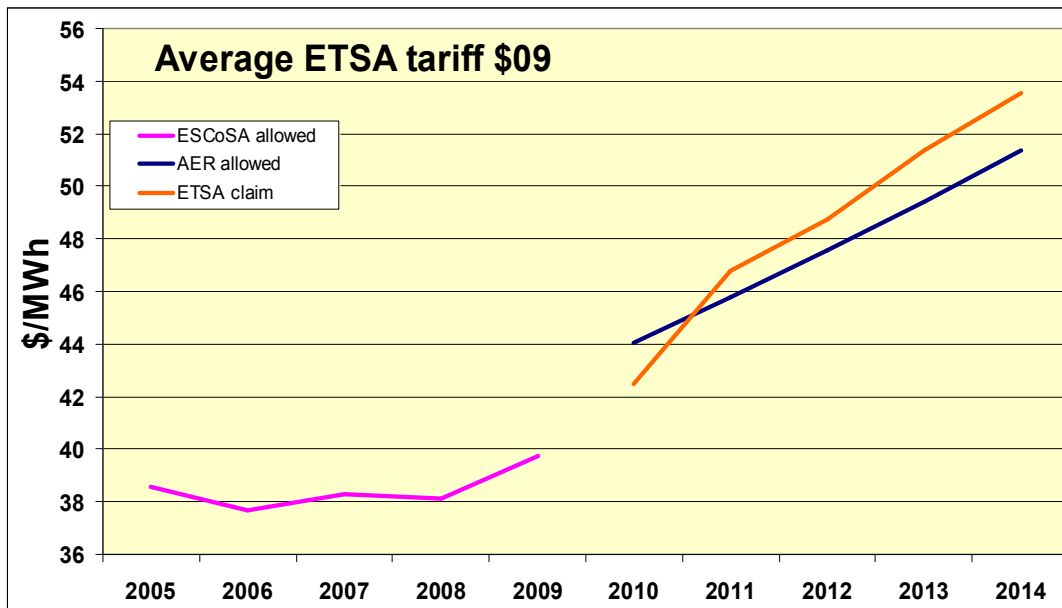


Source: ETSA claim, AER DD, ESCoSA FD

The AER proposes that ETSA should receive some \$100m pa more than the ESCoSA revenue granted in 2005 and extrapolated by the expected increase in peak demand. At the same time consumers get no more for this additional revenue than they received for much less under the ESCoSA decision.

Not content with a large step increase in revenue the AER has decided that revenue should increase annually much faster than the annual forecast increases in peak demand.

The impact of this massively increased revenue is that tariffs will increase as well, and the following chart shows.



Source: ESCoSA FD, ETSA application, AER DD

**In 2009/10, the average tariff is ~\$40/MWh. By the end of the next regulatory period, the average tariff will be, based on the AER draft decision some 30% higher in real terms. At the same time, service performance is not forecast to increase at all, indicating that the regulatory bargain has been permanently tilted in favour of the regulated service provider.**

**What is important to note is that at \$40/MWh average tariff, ETSA was able, not only to provide a service which met consumer expectations, but to spend on average less on opex and capex than the jurisdictional regulator had allowed. Thus ETSA not only received the regulated return provided for, but also made additional revenue by underspending the amounts allowed.**

**At a very basic level, the AER draft decision is incomprehensible in terms of the regulatory bargain.**

In its submission relating to the ETSA application, ECCSA provided data which indicated that the lowest income quintile of consumers in SA were already facing difficulty in paying for the electricity service based on the ESCoSA decision. The AER draft decision just exacerbates this problem.

ECCSA members have already advised that they are facing extreme difficulty in accommodating power prices in SA, and they have noted many of their suppliers are facing similar stresses. A 30% hike in distribution charges will create more difficulty for all industrial power users.

Electricity supply is an essential service and in a first world country for a regulator to allow the provider of an essential service to price its product at a level where it either causes financial hardship to a large element of the service users or to ultimately cause users to cease using the service due to the cost being too high, is clearly not in the purview of a regulator.

The ECCSA has the view that the AER must balance the ability to pay for the service against the aspirations of a monopoly to maximise the cost of the service it provides. Unfortunately the AER has perpetuated the experiences of electricity consumers where AER decisions are causing massive increases in costs but not delivering any improved service.

### 5.3 Pass through events

In its draft decision the AER proposes that ETSA be subject to the following pass through events

- (1) 'regulatory change event'
- (2) 'service standard event'
- (3) 'tax change event'
- (4) 'terrorism event'
- (5) 'smart meter event'
- (6) 'CPRS event'
- (7) 'feed-in tariff event'
- (8) 'native title event'
- (9) 'general pass through event'

Whist the first four events are included in the NER, the AER proposes to add an additional five new events, four of which have some relevance as they are likely to occur and will impact on the ETSA operations. The ECCSA has some sympathy for adding these, it is concerned that the AER sees fit to extend the requirements of the NER in such a way.

**But most concerning to ECCSA is that the AER has now included a new "general pass through event" which would reimburse ETSA at consumer expense, for an uncontrollable and unexpected event which cannot be prevented or mitigated by prudent risk management.**



**ECCSA has a significant concern about including such a “catch-all” pass through clause, even one which is qualified by materiality as proposed by the AER.**

It is recognized that the NER is general in its definition of pass through events, the AER guidelines do provide for some refining of the generality. Equally jurisdictional regulators have been quite specific in what they consider constitutes a reasonable pass through event.

The ECCSA sees that pass through events should be made specific in a reset decision and not allow additional events to be added during the regulatory period. When the next rest review is undertaken the NSP has the option to include the unforeseen event as a step change and so receive reimbursement in the future.

As ECCSA commented in its submission on the ETSA application, it:

“... considers that ETSA should be required to absorb the costs of all pass through events until the current capex and opex allowances are exceeded, and then for new pass through events to be considered on their merits, with the potential that the AER might allow the costs to be added to the allowed revenue. This approach has the benefit of imposing constraints on ETSA for seeking pass through events to be allowed into their revenue rather than encouraging ETSA to seek for every avenue to increase revenue under this provision, and avoids the imposition of a materiality test or bright line approach until the available capex and opex is used.”

The proposed approach by the AER makes ECCSA view its submission as a more acceptable solution to the issue of pass through events, and is much more reflective of what occurs in a competitive world where what are considered to be pass through events have to be absorbed at no cost.

## **6. Demand and consumption forecasts**

In its August 2009 submission, ECCSA pointed to the differences between ESIPC peak demand and consumption forecasts and those submitted by ETSA Utilities.

ECCSA said then that:

“The implications of the mismatch between ETSA and ESIPC forecasts is that based on the ETSA forecasts

- The higher increase in peak demand implies a greater need for capex to manage the additional demand.
- The lower forecast for consumption implies a higher tariff rate to recover the increased revenue over a smaller volume, an approach which incentivises ETSA to understate its expected consumption” (ECCSA, p.64).

ECCSA observed that the AER had commissioned independent reviews of demand and consumption forecasts from AEMO the inheritor of ESIPC which was the government owned independent assessor of energy demand in SA. From mid 2009, ESIPC has been incorporated into AEMO and AEMO now has the same role that ESIPC had in the past.

As well as providing AER with its views on SA demand and consumption forecasts, AEMO has the NEM wide responsibility to develop and publish the annual review of the electricity market – the Electricity Statement of Opportunities, ESoO. The fact that AEMO does develop the ESoO gives it a better understanding of the trends in the electricity markets in each region.

The ECCSA recommended AER obtain an independent forecast of the consumption and peak demand, and AEMO is well positioned to provide this.

As an outcome of this independent review the AER notes that:

“The AER considers the energy sales forecasts proposed by ETSA Utilities do not provide a realistic expectation of the demand forecast required to achieve the capex and opex objectives in clauses 6.5.7(a)(1); 6.5.7(c)(3); 6.5.6(a)(1) and 6.5.6(c)(3) of the NER”. (AER p.98).

The ECCSA concurs with the AER draft decision.

From ECCSA's viewpoint the most critical element of concern it had with regard to the ETSA forecasts was that of the expected consumption. Of the

three elements forecasted (consumption, peak demand and customer numbers) consumption is the element ECCSA and its affiliates have consistently seen as being the most contentious, as it underpins the development of most of the tariffs. Under forecasting consumption, provides ETSA with the greatest ability to maximize its revenue because the price cap regulation applying to ETSA incentivises the DB to seek to increase consumption, and under-forecasting consumption gives a DB an immediate benefit.

ETSA forecast that it expected to see a reduction in consumption in the next period, despite stating it expected to see an increase in peak demand and an increase in customer numbers. To some extent to forecast an increase in customer numbers but see a reduction in consumption would seem counter intuitive. And so the AEMO review demonstrates that such an occurrence is unlikely to occur.

In fact, AEMO forecasts that SA consumption will increase at the rate of 2.3% pa. This is in stark contrast to ETSA forecast reduction in consumption of 0.7% - a reversal of some 3%. ECCSA considers that the AEMO forecast for consumption is correct as it is more in keeping with the recent SA trends.

The AEMO forecasts of customer numbers increasing at 1% pa, and demand to increase at the rate of 3% pa replicates ETSA forecasts

This indicates there will be a further lessening of the SA load factor, a feature forecast by ESCoSA at its last review.

**Overall, ECSAA accepts the AER's draft decision in respect of demand and consumption forecasts, but notes particularly the caveat with regard to the peak demand and customer numbers forecasts driving ETSA capex and opex proposals.**

## **7. Pricing Methodology**

In its response to the ETSA application, ECCSA commented on the need for ETSA tariffs to be as cost reflective as possible – a requirement of the Rules.

ECCSA pointed out that inappropriate tariffs lead to potentially “tariff gaming”, which has the ability to increase revenue without the DB having to spend and so earn the increased revenue.

The AER response (see appendix B) is that ETSA is to retain its current tariff structure and retain those customers already using these tariffs, on those tariffs. New customers are to be allocated by ETSA into a tariff ETSA considers to be most appropriate, and ETSA may reassign existing customers to new tariffs, although the customer has the right to appeal such assignment.

This approach by the AER does not address the requirements of the Rules. Clause 6.18.5(b) of the Rules requires ETSA to demonstrate

*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; and
- (2) must be determined having regard to:
  - (i) transaction costs associated with the tariff or each *charging parameter*; and
  - (ii) whether customers of the relevant *tariff class* are able or likely to respond to price signals.

Appendix B does not require ETSA to comply with this clause of the Rules.

Consumers see that setting tariffs to reflect LRMC for each class of customer is the only way that they are assured the tariff structure as a whole is demonstrably cost reflective.

**When ECCSA requested ESCoSA at the last review to ensure the tariffs were cost reflective, ECCSA was advised this was outside its abilities as the NEC did not require cost reflectivity. It is, therefore, insufficient for the AER to rely on the ESCoSA review of tariffs as ESCoSA was unable to require ETSA to do more than to set tariffs that were within the stand alone and marginal cost boundaries. Clause 6.18.5(b) requires tariffs to be more than within these very wide bounds.**

**The AER has failed in its draft decision to require ETSA to comply with the requirements of the Rules in regard to tariff setting.**

The Rules do require that within a regulatory period, there are side constraints on tariff movements. However, such side constraints do not apply at a reset and therefore the AER has to require ETSA to ensure the tariffs it wants to use are cost reflective and to adjust these where they are not so.

In particular, ECCSA recommends that the AER requires ETSA to develop tariffs that ensure those applying where there is a consistent short term peak in demand (especially those providing power for refrigerative air conditioning) do catch the costs for providing for these short term peaks in demand.