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Our Reference: UE SU 01

Mr Chris Pattas
General Manager
Network Regulation South Branch
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3000

BY EMAIL: aerinquiry@aer.gov.au

Dear Chris

Submission to the AER's Draft Decision for ETSA Utilities 2010-2015

United Energy Distribution (UED) welcomes the opportunity to make this submission in response to the AER's Draft Decision for ETSA Utilities. In addition to the comments made in this submission UED supports the submission on behalf of the 5 Victorian businesses in relation to cost of capital.

Self insurance

The AER's Draft Decision has essentially rejected ETSA Utilities' approach to self insurance, and instead argued that the relevant risks should be addressed through the cost pass through arrangements. In the limited time available, UED has not examined the detail of ETSA Utilities' proposal with respect to self-insurance, and therefore cannot comment directly on the veracity of their proposal. However, UED is concerned that the AER appears to believe that the cost pass through provisions provide better incentives to control costs than self-insurance. For example, the AER comments that:

> "The AER considers that allowing for any underground damage and environmental liability self insurance costs reduces the incentive to the business to prevent environmental damage."

Contrary to the AER's views, self insurance provides strong incentives to minimise costs or, in this example, to prevent environmental damage. In effect, self insurance means that the network service provider is exposed directly to the costs of a risk eventuating, and therefore has strong incentives to manage the risk and respond to events efficiently.

In contrast to self-insurance, a pass through arrangement has poor incentive properties because customers, rather than the network service provider, face the costs associated with a particular event. This incentive property is known as 'moral hazard'. In the case of the pass through arrangements, the effects of moral hazard are intended to be ameliorated by the AER conducting 'after the event' reviews to check whether the expenditure has been prudent and efficient. However, such reviews raise a number of difficulties for the regulator and the network service provider. From the regulator's perspective it is often difficult to gather the appropriate information to assess the decisions made by the network service provider without applying the benefit of hindsight. From the network service provider's perspective, there is significant regulatory risk in seeking to recover costs after the event.

In terms of good regulatory practice, therefore, pass through provisions do not provide ideal incentive properties for controlling costs or minimising risks. Such provisions are necessary to cover events that are unexpected and highly material. However, the AER is incorrect in attempting to broaden the use of these provisions. Where possible, it is better to provide a self-insurance allowance as this reduces regulatory costs, minimises risks for the network service provider and minimises costs to customers.

UED also notes the AER's comment that self-insurance should only relate to costs that are 'uncontrollable', and that motor vehicle risks are not uncontrollable. UED does not accept that risks are 'uncontrollable' in an absolute sense, and therefore the standard set by the AER is unworkable. More importantly, however, the AER's approach is inappropriate because an important objective of regulation is to drive more efficient behaviours and better outcomes for customers. If self-insurance is allowed for motor vehicle risks, then (as with any operating expenditure allowance) the network service provider will have an incentive to minimise the costs arising from motor insurance events. This approach will improve outcomes for customers both in terms of better service and lower future costs.

UED also notes that the AER's suggestion that cost pass through should be used more extensively will expose network service providers to losses to the extent that costs fall below the pass through threshold. The revenue and pricing principles in the National Electricity Law requires that the regime should provider network service providers with an opportunity to recover at least their efficient costs. If the application of pass through provisions is expected to prevent network service providers from recovering their efficient costs, then a further allowance would be required to correct this outcome.

United Energy looks forward to continuing to participate in AER's reviews. In the meantime, should you or your staff have any queries regarding this submission, please contact me on (03) 8540 7818.

Yours sincerely

Andrew Schille
Regulatory Manager