

22 August 2012

Mr Warwick Anderson
General Manager
Network Regulation
Australian Energy Regulator
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Dear Warwick,

RE: NSW Framework and approach paper – control mechanisms

SP AusNet welcomes the opportunity to comment on the AER thinking with regards to control mechanisms. In particular, several misconceptions about the weighted average price cap (WAPC) need to be dispelled.

Weighted Average Price Cap

The Framework and Approach Paper states that under a WAPC revenue varies with the volume of sales while costs are more closely related to customer numbers and peak demand. This statement omits key aspects of the complex pricing that can occur under the WAPC. In particular, prices can vary according to volume, customer numbers, peak demand or any combination of these metrics. Further, given the continued increase in the penetration of smart meters across Australia (particularly in Victoria), volume can be further disaggregated between:

- Peak Energy – energy that drives the augmentation of the network (energy at risk);
- Shoulder Energy – energy that could, under certain circumstances, underpin the future augmentation of the network; and
- Off-peak energy – energy that in no way drives a business' future capital costs.

This highlights that the relationship between a WAPC and actual costs can be kept very close if the National Electricity Rules are enforced.

Volume outperformance versus tariff rebalancing

The Framework and Approach Paper appears to confuse two different effects with respect to revenue outperformance or under performance that may arise from a WAPC. Large revenue out performance or under performance may result from differences in outturn energy consumption volumes relative to the energy consumption forecasts embedded in a Determination. These variances will, in almost all most cases, dwarf revenue variations that derive from annual tariff rebalancing.

This is important as problems that arise from the first effect appear to be being used to justify removing one of the key incentive properties of a WAPC which is to encourage a DNSP to make their tariffs more cost reflective over time (through the rebalancing).

However, the revenue problem associated with the first effect arises from inaccurate forecasting (regardless whether the inaccuracy arises from the regulator, the DNSP or largely external factors), that is, it is not inherent in the WAPC. Obviously the solution to this problem is to increase the accuracy of the AER's forecasting in future decisions, not take the retrograde step of moving to a revenue cap.

Furthermore, under a revenue cap, bad forecasting of cost drivers will result in an identical gap opening up between revenues and costs within a regulatory period, which will have to be "corrected" at the commencement of the next regulatory control period by rolling in the higher actual capital expenditure. The only way a business can mitigate this under a Revenue Cap is for a business to use extreme (non cost reflective) prices to ration demand, hence, the Revenue Cap has the additional cost of incredibly poor incentives to price efficiently.

It should be noted, that while the AER has highlighted some instances where their Final Determination has under estimated a DNSP's energy consumption forecast (resulting in alleged windfall gains) it has remained silent on the numerous examples where it has overestimated a DNSP's energy consumption. For example, the AER has consistently overestimated SP AusNet's energy consumption over the two most recent regulatory periods.

Revenue cap versus price cap

The Framework and Approach Paper overstates the benefit of revenue caps. As highlighted above, unless forecasting is improved, any move to a revenue cap can still result in exactly the same gap between revenues and costs that can occur under a price cap. As highlighted previously, the difference is that under the revenue cap, because the business only gets rewarded for cost reductions, and faces no financial penalty (in NPV terms) for reductions in volumes, there is an incentive to deliberately price inefficiently.

For example, DNSPs would be incentivised to levy prices above cost reflective levels to those customers that are contributing to future costs being incurred, and who are deemed to have the most highly elastic demand (these tend to be business customers). This is done so that demand can be rapidly decreased to reduce costs, whilst any revenue reduction stemming from reduced sales to those customers is compensated for in future years under the revenue cap.

Efficient Pricing

The Framework and Approach Paper also states that the theoretical incentives for efficient pricing under a WAPC have not eventuated. Firstly, if this is true, the AER should assess the extent to which it is due to

- a design flaw in the WAPC itself that can in turn be easily overcome;
- a design flaw in the broader regulatory framework that can be easily overcome; or
- a flaw in the AER's administration of the Annual Tariff Proposals submitted by the businesses under the Rules.

Identifying an issue but not what is causing that issue to occur is not a sound basis for making significant changes to the broader regulatory framework.

An example of a regulatory design flaw that may weaken incentives faced by businesses to set cost reflective tariffs across the entire regulatory period, relates to the extent to which businesses can share in the economic benefits from reducing peak demand in any particular year when those benefits accrue across multiple regulatory periods. If, as the AER has stated, costs are more closely related to peak demand and therefore are generally capital in nature, then the existing flaws in the capital expenditure carryover mechanism (i.e., there are reducing incentives the further into the regulatory period a business is) means that virtually none of the economic benefits from setting cost reflective tariffs *now* to reduce future capital costs are able to be captured by the business. In fact, the business will actually suffer from reduced revenues in the near term, as well as facing lower capital expenditure forecasts during the next regulatory period, if it seeks to set cost reflective tariffs that would reduce demand.

The weak capex incentive regime has been raised as a significant flaw in the current 'Economic Regulation of Networks' Rule change proposal process by both the AER and industry. The above example, demonstrates that leaving one area of the regulatory regime with significant flaws can cause problems in other areas. These problems then attract second best solutions (such as revenue caps) rather than the actual cause of the problem being tackled.

Secondly, despite these aforementioned issues, the Framework and Approach Paper's broader statement is contradicted by the evidence. In particular, in SP AusNet's distribution area, the cross subsidy of small residential and commercial customers by medium and large customers that was embedded in the early Victorian regime has been gradually unwound through the tariff rebalancing mechanism available under the WAPC mechanism.

Furthermore, SP AusNet has:

- successfully introduced new large commercial cost reflective critical peak demand tariff;
- sought to introduce cost reflective time of use residential and small commercial tariffs. These new tariffs were placed under moratorium by the Victorian Government.

SP AusNet has done this because it believes in the broader benefits that accrue from setting cost reflective tariffs. It would not have any incentive for this behaviour under a revenue cap, in fact, as stated previously, it is likely to have an incentive to set tariffs that are significantly above cost reflective levels.

In addition, Clause 6.18.5 (a) and (b) of the Rules require that DNSPs to demonstrate that their prices are cost reflective before tariffs are approved by the AER. To now claim that DNSPs have not been doing so calls in to question regulatory oversight of annual tariff setting.

Conclusion

The majority of the concerns of policy makers and customers would be best addressed through enhanced incentives for DNSPs to introduce efficient cost reflective pricing

throughout the entire regulatory control period, rather than see the weakening of those incentives through revenue cap regulation. Adopting a carryover mechanism that is directly related to the DNSP's key cost driver, namely peak demand capital expenditure would be the key starting point.

Therefore, SP AusNet considers that a compulsory move to a revenue cap would be retrograde step for energy regulation in Australia. In particular, it is difficult to envisage how such a move would enhance the long run interests of consumers as required by the National Electricity Objective.

Should you have any questions in relation to this matter, please contact Tom Hallam on 9695-6617, also we would be happy to provide further information if required.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'A.P.', with a long horizontal flourish extending to the right.

Alistair Parker
Director Regulation and Network Strategy