CITIPOWER

12 March, 2010

Mr Chris Pattas
General Manager
Network Regulation South
Australian Energy Regulator
GPO Box 520
MELBOURNE Victoria 3001

email: Chris.Pattas@aer.gov.au
David.Chan@aer.gov.au
aerinquiry@aer.gov.au

Dear Mr Pattas

Benchmark Upstream Augmentation Charge Rates for CitiPower's Network Draft Decision

I refer to the AER draft decision *Benchmark Upstream Augmentation Charge Rates for CitiPower's Network* of the 19 February 2010 (**Draft Decision**) and thank you for the invitation to make this submission in response to that Draft Decision.

As you would be aware, in the Draft Decision, the AER finds that CitiPowers approach does not adequately account for the connection life of new customers when calculating the upstream augmentation component of incremental cost. As a result, the AER proposes a modified approach[1] to set a reference price for new customers to pay for future upstream augmentation involving a fair and reasonable cost allocation between new and existing customers to fund future costs.

The AER recognises in its Draft Decision that the bring forward cost of augmentation is approximately the same as undertaking the augmentation immediately[2]. Accordingly

[1] A proposed model was presented by the AER in its formal decision on CitiPower's current approach to charge new customers capital contributions for upstream network augmentation and further consultation on what should be the fair and reasonable charging rates released on 17 July 2009

[2] AER Draft Decision – Benchmark Upstream Augmentation Charge Rates for CitiPower's Network, 19 February 2010, page 20

the AER recognises in its Draft Decision that "CitiPower is able to recover the full MCR from its customers which is largely in line with CitiPower's current practices."[3]

CitiPower believes that this finding, that the bring forward cost of augmentation is approximately the same as undertaking the augmentation immediately, confirms that CitiPower's approach of applying the full marginal cost of network reinforcement (MCR) in calculating the connection charge is fair and reasonable and compliant with *Electricity Guideline No. 14 - Provision of Services by Electricity Distributors* **(Guideline No.14)**. This finding is also consistent with the analysis carried out by CitiPower and submitted to the AER on 25 September 2009.

However, the AER nonetheless maintains that CitiPower's current charges are not compliant with Guideline No.14 because "CitiPower is not applying Guideline No.14 correctly in relation to the prescribed life of customers".[4]

Following consideration of the submissions made on the AER original methodology proposed in the final decision of the 17 July 2009, the AER has developed a modified methodology (**AER Modified Methodology**) for determining charges it considers would be "fair and reasonable".

The AER Modified Methodology

The AER Modified Methodology is used to determine its proposed benchmark charges (**AER Benchmark Charges**). This results in an incremental cost of 84.4% and 60.6% of the marginal cost of network reinforcement (**MCR**) for domestic customers and all other customers respectively. This calculation is based on:-

- an assumption that at the end of a new customers assumed connection term another new customer will immediately connect and use the capacity left by the first customer;
- present value calculations using a discount rate equal to the real pre tax weighted average cost of capital (WACC) of 6.4% applicable under the prevailing price determination;
- a connection life of 30 years for domestic customers;
- a connection life of 15 years for all other customers.

The resulting AER Benchmark Charges are significantly higher than the charges originally proposed in the final decision of the 17 July 2009.

[3] AER Draft Decision – Benchmark Upstream Augmentation Charge Rates for CitiPower's Network, 19 February 2010, page 20

[4] AER Draft Decision – Benchmark Upstream Augmentation Charge Rates for CitiPower's Network, 19 February 2010, page 20

HEAD OFFICE
40 Market Street, Melbourne VIC Australia Telephone: (03) 9683 4444 Facsimile: (03) 9683 4499 Postal Address: Locked Bag 14090, Melbourne VIC 8001 Australia
CitiPower General Enquiries: 1300 301 101 www.citipower.com.au ABN 76 064 651 056
Powercor General Enquiries: 13 22 06 www.powercor.com.au ABN 89 064 651 109

The AER explains the rationale for its Modified Methodology as follows:

> *Under Guideline No. 14, new domestic and business customers are assumed to have 30 and 15 years of connection life respectively. However, CitiPower calculates new customers' incremental revenue based on the prescribed connection life but it calculates the incremental cost as though new customers were connected indefinitely.*
>
> *As upstream assets can be used by any customer, the same asset could be used by future new customers once the earlier customers stop using such assets at the end of their assumed connection life. It would not be equitable for the first new customer to fund the full cost of upstream augmentation as CitiPower will charge future users for the same asset. The AER considers that the full cost of augmentation should be shared among connecting customers, such that each customer pays for only the portion of augmentation attributable to their assumed connection life.*[5]

CitiPower has considered the AER Modified Methodology and believes it has flaws and may not be consistent with the purpose of CitiPower's Licence conditions and Electricity Industry Guideline No.14.

Error in AER Modified Methodology

As discussed above, the AER Modified Methodology is premised on an assumption that at the end of a new customer's assumed connection term set out in clause 3.3.3(a)(1) another new customer will immediately connect and use the capacity left by the first-mentioned new customer.

In our view, in developing the AER Modified Methodology on the basis of this assumption, the AER misconstrues the conditions of CitiPower's Licence that require CitiPower to impose capital contribution charges for new augmentations that are 'fair and reasonable' and compliant with Guideline 14. This is because, in construing CitiPower's Licence conditions, the AER has disregarded the Essential Services Commission's (**ESC**) purpose in imposing those conditions. In particular, in construing CitiPower's Licence conditions, the AER applies clause 3 of Guideline 14, including in particular clause 3.3.3 concerning connection terms, without having regard to the purpose of those provisions of Guideline 14.

It follows from this that, to the extent that the AER Modified Methodology is based on an assumption that at the end of a new customer's assumed connection term set out in clause 3.3.3(a)(1) another new customer will immediately connect and use the capacity left by the first-mentioned new customer, it involves error.

[5] AER Draft Decision – Benchmark Upstream Augmentation Charge Rates for CitiPower's Network, 19 February 2010, page 20

HEAD OFFICE
40 Market Street, Melbourne VIC Australia Telephone: (03) 9683 4444 Facsimile: (03) 9683 4499 Postal Address: Locked Bag 14090, Melbourne VIC 8001 Australia
CitiPower General Enquiries: 1300 301 101 www.citipower.com.au ABN 76 064 651 056
Powercor General Enquiries: 13 22 06 www.powercor.com.au ABN 89 064 651 109

AER must have regard to purpose of CitiPower's Licence conditions and Guideline 14

No administrative decision-maker, acting reasonably, would disregard the purpose for which licence conditions were imposed or the purpose for which guidelines were made, in applying those conditions or guidelines. Any failure to do so would arguably constitute an error of law. In particular, any decision made on the application of licence conditions or guidelines, without regard to the purpose for which they were imposed or made respectively, would arguably be *Wednesbury* unreasonable (i.e. no administrative decision-maker, acting reasonably, would make that decision) or involve a failure to take into account relevant considerations and/or a taking into account of irrelevant considerations.

It follows that, in enforcing a distribution licence condition, the AER should construe the conditions imposed by that licence, having regard to the ESC's intent in imposing the licence condition. Similarly, in applying an ESC guideline in construing and enforcing the conditions of a distribution licence, the AER should do so having regard to the ESC's purpose in making those guidelines. More specifically, the AER should construe the conditions of CitiPower's Licence that provides for CitiPower to impose capital contribution charges for new augmentations that are 'fair and reasonable' and compliant with Guideline 14, having regard to the purpose of the ESC in imposing those Licence conditions and making Guideline 14.

Purpose of Guideline 14

The ESC's purpose in making Guideline 14 is evident from the ESC's *Issues Paper - Review of Connection and Augmentation Guidelines - Vol 2 Customer Contributions for Connections and Augmentations* (**Issues Paper**) of October 2002 and its *Review of Connection and Augmentation Guideline – Final Decision* (**ESC Final Decision**) of April 2004.

The Issues Paper discloses that the purpose of providing for assumed connection terms for domestic and other (i.e. business) customers in clause 3.3.3(a) of Guideline 14 was to prescribe the compensation that distributors would receive for the risks associated with the uncertain life of customers', particularly business customers', usage and asset stranding. In discussing the life of new connections, the ESC stated as follows:

> *In principle, the life that is assumed for the connection should reflect an unbiased estimate of the time that the new customer uses the network and pays the forecast network charges. Clearly, however, for some types of business customers, there may be some uncertainty associated with the time for which the new customer remains in operation, as well as the demand or usage associated with that connection. This is turn would create some uncertainty with whether the projected incremental revenue materialises.*
>
> *Coupled with this, customers (all other things being held constant) may have an incentive to overstate the expected life of their usage, given that this would have the effect of reducing its customer contribution. On the other hand, distributors may have an incentive to overstate the risks associated*

HEAD OFFICE
40 Market Street, Melbourne VIC Australia Telephone: (03) 9683 4444 Facsimile: (03) 9683 4499 Postal Address: Locked Bag 14090, Melbourne VIC 8001 Australia
CitiPower General Enquiries: 1300 301 101 www.citipower.com.au ABN 76 064 651 056
Powercor General Enquiries: 13 22 06 www.powercor.com.au ABN 89 064 651 109

with a new customer, given that a lower expected life may raise the customer contribution, and in turn provide a financial windfall (albeit small) to the distributor.

Uncertainty itself does not justify a higher up-front charge. However, the Commission has stated elsewhere that it is reasonable for new customers, for whom there is significant uncertainty with whether their usage flows as expected, to bear this risk.

...

Clearly, the risk associated with not recovering the costs caused by a particular customer is going to depend upon a number of factors, including the following:

- *For warehouses, office blocks, shops and similar types of electricity users, if the original new customer goes out of business or leaves, another customer with similar demand could be expected to take over the site, with little threat of the assets being stranded permanently. In contrast, highly specialised usage may well imply that it would be unlikely that there would be a replacement customer with similar demand requirements.*

- *Some of the assets that may be installed to serve a new customer may be transportable to another site if the customer leaves the premises (such as transformers). Accordingly, the sunk costs associated with these assets (and so losses incurred) would be small. In contrast, it is generally not feasible to remove conductor [sic] and transport it to another site, and so the proportion of sunk cost associated with these assets (and so the potential loss that would be incurred if the customer left the system) could be large.*

In all cases, however, the risk associated with a new customer would depend upon the product market conditions of the customer, as well as any significant production risks[6].

The ESC prescribed connection terms of 30 and 15 years for domestic and other (i.e. business) customers in clause 3.3.3(a) of Guideline 14 because it considered that these terms would appropriately compensate distributors for the risks associated with the uncertain life of customers' usage and asset stranding. The ESC stated in its Issues Paper:

As a proxy for the expected economic life associated with new connections, the Commission advised the distributors to assume a 30 year life for a residential connection for the purposes of calculating the expected future revenue stream, and a 15 year life for a business connection, unless there are

[6] Issues Paper Review of Connection and Augmentation Guidelines Volume 2 Customer Contributions for connections and Augmentations – October 2002, Page 12

HEAD OFFICE
40 Market Street, Melbourne VIC Australia Telephone: (03) 9683 4444 Facsimile: (03) 9683 4499 Postal Address: Locked Bag 14090, Melbourne VIC 8001 Australia
CitiPower General Enquiries: 1300 301 101 www.citipower.com.au ABN 76 064 651 056
Powercor General Enquiries: 13 22 06 www.powercor.com.au ABN 89 064 651 109

strong grounds for believing that a shorter (or longer) life would be appropriate for the latter category[7].

It is evident from the first extract from the Issues Paper set out above that the selection by the ESC of a shorter connection term for business customers was intended to ensure that the distributor was properly compensated for the higher risks of reduced revenue from new business customer connections.

The ESC's selection of connection terms of 30 and 15 years for domestic and other (i.e. business) customers respectively as the terms that would appropriately compensate distributors for the risks associated with uncertain life of customers' usage and asset stranding was premised on:

- their use in calculating the revenue expected from a new customer (i.e. incremental revenue) from payments for network services; and
- an assumption that no new customer will connect after an earlier new customer stops using the capacity in respect of which they are making a capital contribution, with the result that those terms are not used in the calculation of incremental cost.

This latter assumption is implicit in the extracts from the Issues Paper set out above. In addition, it is evident from the ESC Final Decision that, in prescribing connection terms of 30 and 15 years for domestic and other (i.e. business) customers, the ESC envisaged that:

- these connection terms would be used in the calculation of incremental revenue but not incremental cost; and
- it is the revenue and cost that are due to the connecting customer that are the relevant revenue and costs (and so revenues or costs from subsequent customers or connections should not be considered).

The ESC stated as follows, in the ESC Final Decision that:

The approach is developed from the principle of basing capital contributions on incremental cost - that is, customer contributions for new connections or capacity upgrades should be required only where the revenue expected from a customer over the life of the connection (under the tariff applicable to that customer) is less than the incremental cost of serving that customer, where:

- *the revenue expected from a new customer (incremental revenue) is the present value of the expected stream of payments for network services over the expected life of the customer's connection*
- *the additional costs caused by a customer (incremental cost) is the difference between (1) the expected present cost of providing network services with that customer (or the customer's upgraded*

[7] Issues Paper Review of Connection and Augmentation Guidelines Volume 2 Customer Contributions for connections and Augmentations – October 2002, Page 13

HEAD OFFICE
40 Market Street, Melbourne VIC Australia Telephone: (03) 9683 4444 Facsimile: (03) 9683 4499 Postal Address: Locked Bag 14090, Melbourne VIC 8001 Australia
CitiPower General Enquiries: 1300 301 101 www.citipower.com.au ABN 76 064 651 056
Powercor General Enquiries: 13 22 06 www.powercor.com.au ABN 89 064 651 109

capacity) and (2) the expected present cost of providing network services without that customer (or the customer's upgraded capacity)[8].

The ESC's purpose is reflected in the words of clause 3.3 of Guideline 14, which contemplate that periods for costs and revenues are not to be the same. It is clear that incremental revenue may only be considered over the prescribed 30 and 15 year connection terms but incremental costs are not restricted in the same way.

Clause 3.3.2(b) of Guideline 14 describes the incremental revenue as 'the present value of the incremental distribution tariff revenue the distributor will earn in providing services as a result of also providing the connection services offered', while:

- clause 3.3.3(a)(1) states that the connection services are to be assumed to be provided for 30 years for domestic customers and 15 years for others (unless the distributor fairly and reasonably determines some other term is appropriate for non domestic customers); and
- clause 3.3.3(a)(2) refers to the distribution tariff earned by the distributor 'over that term' (i.e. the term of 30 years or 15 years, as the case may be, prescribed by clause 3.3.3(a)(1).

Read together, clauses 3.3.2(b) and 3.3.3(a) do not allow for tariff revenue earned from the new connection beyond these terms to be considered in determining incremental revenue.

By contrast, clause 3.3 of Guideline 14 does not restrict the calculation of incremental costs in the same way as it restricts the calculation of incremental revenues. This is consistent with the ESC's intention in prescribing the connection terms of 30 and 15 years for use in the determination of incremental revenue in clause 3.3.3(a), to compensate the distributor for the risks associated with uncertain life of customers' usage and asset stranding.

AER Modified Methodology inconsistent with purpose of CitiPower's Licence conditions and Guideline 14

As discussed above, the AER Modified Methodology is premised on an assumption that at the end of a new customer's assumed connection term set out in clause 3.3.3(a)(1) of Guideline 14 another new customer will immediately connect and use the capacity left by the first-mentioned new customer. In this way, each customer's capital contribution charges for new augmentations associated with their connection are reduced below the historical average MCR cost of their connecting demand because successive customers are presumed to contribute to CitiPower's recovery of the historical average MCR cost of that connecting demand.

The AER's use of the connection terms prescribed in clause 3.3.3(a)(1) of Guideline 14 is contrary to the use of those terms envisaged by the ESC in enshrining those terms in Guideline 14 and imposing CitiPower's Licence conditions.

[8] *Review of Connection and Augmentation Guideline – Final Decision* of April 2004 at Section 4.2

HEAD OFFICE
40 Market Street, Melbourne VIC Australia Telephone: (03) 9683 4444 Facsimile: (03) 9683 4499 Postal Address: Locked Bag 14090, Melbourne VIC 8001 Australia
CitiPower General Enquiries: 1300 301 101 www.citipower.com.au ABN 76 064 651 056
Powercor General Enquiries: 13 22 06 www.powercor.com.au ABN 89 064 651 109

As discussed above, the ESC envisaged that these connection terms would be employed in determining the value of incremental revenue expected to be received from the provision of network services to new connections but not the value of incremental cost. The underlying assumption in the calculation methodology intended by the ESC was that, at the end of a new customer's connection term, no new customer would connect and use the capacity left by the first-mentioned customer. The ESC selected the connection terms of 30 and 15 years for domestic and other (i.e. business) customers (rather than say shorter connection terms, e.g. of 15 and 5 years) because it considered these terms, when employed in this manner, would deliver appropriate compensation to the distributor for the risks associated with the uncertain life of customers' usage and asset stranding. Because the AER Modified Methodology departs from the ESC's intended use of the connection terms set out in clause 3.3.3(a)(1) of Guideline 14, it will not compensate CitiPower in the manner and amount intended by the ESC.

To the contrary, the AER Modified Methodology will not compensate CitiPower for the risks associated with the uncertain life of customers' usage and asset stranding *at all*. The AER Modified Methodology assumes that at the end of a new customer's assumed connection term set out in clause 3.3.3(a)(1) of Guideline 14 another new customer will immediately connect and use the capacity left by the first-mentioned new customer. That is, the AER Modified Methodology assumes away the very issue that the ESC sought to address through clause 3.3 of Guideline 14, that of the risk of the uncertain life of customers' usage and stranded assets. The effect of the AER Modified Methodology is to shift these risks from the new customers to the distributor. This is in clear contradistinction to the ESC's intention, in establishing clause 3.3.3(a)(1), that 'it is reasonable for new customers, for whom there is significant uncertainty with whether their usage grows as expected, to bear this risk'[9].

This is despite the fact that, like the ESC, the AER recognises, in its Draft Decision, that subsequent connecting customers might not use the same assets as earlier connecting customers. In discussing the rationale for the AER Modified Methodology, the AER states that:

> *Not all* new customers' connection to the network triggers upstream augmentation. *Some* new customers use network capacity that has already been paid in part by previous customers[10]. [Emphasis added]

The difference between the AER Modified Methodology and the calculation that the ESC envisaged would be performed under clause 3.3 of Guideline 14 in determining 'fair and reasonable' capital contribution charges can be starkly illustrated by contrasting the relative charges for domestic and other (i.e. business) customers under the two approaches. The AER Proposed Benchmark Charges calculated using the AER Modified Methodology are significantly higher for domestic than other (i.e.

---

[9] Issues Paper Review of Connection and Augmentation Guidelines Volume 2 Customer Contributions for connections and Augmentations – October 2002, Page 12

[10] AER Draft Decision – Benchmark Upstream Augmentation Charge Rates for CitiPower's Network, 19 February 2010, page 21

HEAD OFFICE
40 Market Street, Melbourne VIC Australia Telephone: (03) 9683 4444 Facsimile: (03) 9683 4499 Postal Address: Locked Bag 14090, Melbourne VIC 8001 Australia
CitiPower General Enquiries: 1300 301 101 www.citipower.com.au ABN 76 064 651 056
Powercor General Enquiries: 13 22 06 www.powercor.com.au ABN 89 064 651 109

business) customers. These AER Proposed Benchmark Charges are set out in the table below.

	Domestic customers (per MVA capacity usage)	Other (i.e. business) customers (per MVA capacity usage)
Zone Substation Bus	$217,443	$156,126
HV Feeder	$230,921	$165,803
Distribution Substation	$350,793	$251,873
LV Street Circuit	$570,546	$409,657

However, the ESC intended that the calculation under clause 3.3 of Guideline 14, including in particular the application of the connection terms set out in clause 3.3.3(a)(1), would result in significantly higher charges for other (i.e. business) customers relative to those for domestic customers. This was the result that the ESC intended the specification of a connection term for other (i.e. business) customers that is half that of the connection term for domestic customers to have. Other (i.e. business) customers were intended to have significantly higher charges, as a result of their shorter connection term, in order to compensate distributors for the greater uncertainty associated with the life of business customers' usage relative to domestic customers[11].

By contrast, the AER's use of the connection terms set out in clause 3.3.3(a)(1) of guideline 14 has the result that the shorter connection term of business customers results in significantly lower charges because of the assumed greater sharing of the MCR costs of their connecting demand with future new customers associated with that shorter connection term.

One other (less significant) issue

In the Draft Decision (at 16), the AER observes that CitiPower provided it with updated figures for its historical average MCR costs for 2009, in its submission of August 2009. The AER nonetheless continues to use the 2008 MCR costs in determining the AER Proposed Benchmark Charges because 'the AER has not assessed whether the increase from the 2008 MCR rates to the 2009 rates is reasonable'.

Such an approach is inconsistent with the AER's stated objective in determining benchmark 'fair and reasonable' charges. This AER objective is "to inform relevant stakeholders, including prospective new customers, what it considers as benchmark

[11] Issues Paper Review of Connection and Augmentation Guidelines Volume 2 Customer Contributions for connections and Augmentations - October, Page 12

HEAD OFFICE
40 Market Street, Melbourne VIC Australia Telephone: (03) 9683 4444 Facsimile: (03) 9683 4499 Postal Address: Locked Bag 14090, Melbourne VIC 8001 Australia
CitiPower General Enquiries: 1300 301 101 www.citipower.com.au ABN 76 064 651 056
Powercor General Enquiries: 13 22 06 www.powercor.com.au ABN 89 064 651 109

fair and reasonable charges which are consistent with Guideline No. 14'[12]. If the AER uses the 2008 MCR rates, which are now two years out of date, in determining its benchmark charges, those charges are more likely to result in confusion for stakeholders than guidance and certainty.

CitiPower would appreciate the opportunity to discuss the way forward in relation to this matter at your earliest convenience.

If you have any queries or require further information, please do not hesitate to contact myself or Rolf Herrmann on telephone (03) 9683 4282 or email rherrmann@powercor.com.au.

Yours sincerely

Richard Gross
General Manager Regulation & Business Development

[12] AER Draft Decision – Benchmark Upstream Augmentation Charge Rates for CitiPower's Network, 19 February 2010, page 15-16

HEAD OFFICE
40 Market Street, Melbourne VIC Australia Telephone: (03) 9683 4444 Facsimile: (03) 9683 4499 Postal Address: Locked Bag 14090, Melbourne VIC 8001 Australia
CitiPower General Enquiries: 1300 301 101 www.citipower.com.au ABN 76 064 651 056
Powercor General Enquiries: 13 22 06 www.powercor.com.au ABN 89 064 651 109