16 April 2012

John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear John,

Economic Regulation of Network Service Providers Directions Paper

SP AusNet welcomes the opportunity to make this submission in response to the AEMC's Directions Paper on the following consolidated Rule Change Proposals:

- National Electricity Amendment (Economic regulation of network service providers) Rule 2011
- National Gas Amendment (Price and revenue regulation of gas services) Rule 2011
- Calculation of Return on Debt for Electricity Network Businesses Rule 2011

With regards to the broader input sought by the AEMC, SP AusNet strongly endorses the industry association submissions made by the Energy Networks Association (ENA) and Grid Australia. At this stage of the process, the company has chosen to target its response to issues where the business can supply additional evidence to help the AEMC deliberations.

In particular, SP AusNet can provide insights into the incentive effects on a private business from the current capex efficiency framework and the alternatives proposed in the AER rule change and AEMC Directions Paper.

If you have further questions regarding the information provided, please contact Tom Hallam, Manager Economic Regulation on 03 9695 6617.

Yours Sincerely,

Alistair Parker
Director Regulation and Network Strategy

1. Capital expenditure incentives

SP AusNet strongly favours the use of incentives as the primary method to achieve outcomes for customers that align with the national gas and electricity objectives. The Victorian regime's record of delivering an extended period of price decreases and reliability improvements over the last 15 years is *prima facia* evidence supporting SP AusNet's position as the regime has used incentive schemes to drive these outcomes rather than mandating particular outcomes (for example, mandating planning standards).

In particular, strong incentive schemes were developed for gas and electricity distribution for opex, capex and service standards. Once established, the jurisdictional regulator and then the AER (once assuming jurisdictional responsibility) have continually improved these schemes at each price review after engaging in an extended consultation process with interested parties. By engaging in this regular review process, regulators have been able to change the balance of incentives over time from observing networks response to these schemes. For example, in electricity distribution the power of the service standards incentive has been substantially increased over time while the power of the capex incentive scheme has been weakened. In contrast, for gas distribution which retains a simple EBSS for capex, the balance of incentives has remained largely unchanged over three review periods.

The current distribution rules allow exactly the same process, so successfully used in Victoria, to be undertaken in the national regime if the AER so chose. SP AusNet would support changes to the transmission regime to provide the AER with the same flexibility with respect to designing, consulting on and implementing a capex EBSS as the distribution regime.

SP AusNet agrees with the AEMC assessment of the proposed rule change for capital expenditure incentives. The AER's approach makes no attempt to correct many of the identified incentive problems in the current regime including the fact the incentive power declines over the regulatory period and places materially different incentive rates on different types of capex expenditure. In addition, the proposal would actually introduce new problems into the framework including making it impossible for a business to assess the strength of the incentive at the time it is making investment decisions and introducing asymmetry into the scheme while providing no evidence for the need to do so (as noted in previous industry submissions, there is scant evidence of overspending in the new regime). These issues are expanded upon below.

However, SP AusNet does not agree with the AEMC that there is evidence of a supervision problem for capital overspending that may justify some form of ex-post review. Indeed, it is questionable whether supervision is a practical alternative at all. Rather, with some notable exceptions, the problems identified above can all be addressed by changes to the existing incentive regime that can be implemented under the current rules in distribution. Therefore, a well designed EBSS should be considered the best solution and while this option remains untested, the rules should not provide for second best options.

1.1. Ex post reviews

It should be observed that regulatory regimes that were subject to ex-post reviews, for example the pre Chapter 6A transmission regime, all saw overspending by the regulated networks occurring regularly. While there will be many possible explanations for this behaviour, it raises legitimate questions about the effectiveness of ex-post reviews in addressing the 'supervision gap'. As noted above, even with the flawed capex incentive regime in place under the current regime, there is no evidence so far of overspending by either transmission or distribution networks.

1.2. Interaction with other incentive schemes

The AER solution appears to be targeted at a jurisdiction where there has been significant overspending and where mandated planning standards are used to set reliability levels rather than incentive schemes. As highlighted in our previous decision, these problems are not solved by the Rule changes under consideration.

The most effective parts of the current frameworks in Victoria are well designed and relatively strong incentive schemes for finding operating efficiencies and improving service standards (admittedly combined with the current flawed capex incentives). A crucial aspect of these three schemes is that the financial trade-offs between the schemes are explicit. This allows the business to make investment or operating decisions with confidence of the expected benefit or penalty that results. Thus, a decision to invest in reliability improvements (and carry the associated investment cost for a period as improvements are not provided for in the building block revenue) must be justified by the increase in service standard bonuses that is likely to result. Likewise, the decision to cut operating expenses in a particular area must generate an efficiency benefit that outweighs any reliability penalty or increase in investment required that might result.

The AER scheme design, however, detracts from a network's ability to make decisions with regards to these trade-offs. Specifically, it is not possible to assign a cost to a particular investment decision as it is not possible to calculate the strength of the capital incentive (that is the cost to the business of the investment) until the regulatory period is complete. Obviously, a network cannot respond to an incentive rate determined in the future so would be forced to assume the worst case scenario in its investment decisions (that is all marginal capex will be subject to the overspend penalty). This would result in many potentially beneficial investments being passed on and so the AER proposal would detract from the achievement of the NEO.

Many of the issues highlighted with the AER scheme also potentially exist with an ex post review regime. This is because the ex-post treatment of any overspends is also unknown at the time of investment and remains unknown even at the time of the price review as the final year's expenditure is not available during the review process. The example below also highlights how difficult it is to identify the cause of overspending with-in a period particularly where allowances approved are not specifically assigned to particular projects or programs. Yet the ability to identify the cause of overspending is crucial to any ex-post assessment.

Take the following outcome where the regulatory period capex allowance was $100M but $120M was spent by the network. Furthermore assume the breakdown of actual expenditure was $50M replacement, $40M augmentation and $30M reliability improvements in response to the service standard incentive scheme. The regulator is then faced with the problem of determining which category or projects drove the overspend and need to be subject to a review:

- If it was the augmentation then forecast and outturn demand will the most important factor to be assessed by the ex-post review; but
- If it is replacement then condition assessments, new condition problems and unit rates will the most important factor to be assessed by the ex-post review; finally
- If it is the service standard scheme then ex-post review is not necessary (ie let the incentive framework work).

Yet how is the 'cause' to be determined, for it is likely any specific projects will be driven by two or more of the above drivers? It is noted that these practical hurdles and the associated administrative burden, lay behind the move away from ex-post regimes initiated by the regulator and supported by the industry.

1.3. Actual and Forecast Depreciation

SP AusNet strongly endorses the industry submission conclusion that a well designed capital expenditure incentive scheme that involves the application of a EBSS to capital expenditure and forecast depreciation to the roll forward of the RAB is the best solution for achieving appropriate capex incentives. There is no reasonable justification for allowing actual depreciation as an option in the regulatory regime because:

- It introduces a large distortion to the strength of the incentive related to asset life heavily punishing expenditure on short lived assets in particular; and
- The increasing strength in the power of the capex efficiency incentive achieved by the use of forecast depreciation generally can be achieved easily by other means.

The first issue, while recognised, appears understated in the AEMC paper, considering SP AusNet is unaware of any public benefit argument having been advanced justify such a distortion.

In practice, SP AusNet has found that the incentive regime distorts the investment decision process in extreme ways.

The IT allowance provided for under the Rules is a maintain case only, therefore, any increase in IT expenditure to materially increase functionality or introduce new functionality can only be justified by savings generated to capital or operating costs or benefits from service standard improvements. However, the assessment of such expenditure starts with a massive disadvantage when being ranked against alternative investment opportunities, particularly at the start of a regulatory period.

For example, in the first year of SP AusNet's current electricity distribution regulatory control period a $10M IT project will need to generate an NPV efficiency/service standard benefit of around $8.5M before it becomes NPV positive on a stand alone basis whereas a $10M network investment need only generate a NPV saving of $3M. Therefore, all things being equal, IT projects are artificially pushed down the priority list of capex projects in the investment optimisation processes. Given many of these projects would generate net benefits for customers, the current approach detracts from the achievement of the NEO.

This is particularly perverse given that potential solutions to mitigate future network costs require substantial investments in IT systems (for example, dynamic monitoring, self-healing networks, smart meter enabled TOU tariffs and DSM to address peaky load).

1.4. Contingent Projects

The introduction of an effective EBSS for capital expenditure may require new risk control measures. One such measure advanced by the AER and the AEMC Directions paper is the expansion of the existing contingent project regime from transmission to distribution

SP AusNet considers that the current contingent projects regime, as implemented in transmission, is likely to be ineffective for the distribution sector except in very rare circumstances. The current transmission regime has focused on very large and easily separable projects, often associated with a specific large directly connected transmission customers (for example, generators or smelters). The nature of distribution capex projects which are smaller, often parts of non-location specific programs and not necessarily linked to clear identifiable in advance project specific triggers makes them less suited to this approach.

To be effective alternatives will need to be explored. For example, the AER approved allowance for a DNSP's augmentation program could be linked to the out-turn peak demand growth, particularly where a wide range of forecasts are credible. Similar approaches could be used for allowance for customer connections.

To achieve such flexibility in a contingent project regime will likely require a significant redrafting of the current Rules.

2. Regulatory Process

SP AusNet supports the industry submission on regulatory process. SP AusNet would draw particular attention to the benefits to the process from:

- the AER consulting on, and issuing guidelines clarifying how it will exercise its existing rules discretion on how it may have regard to NSP submissions.

- the AER setting clear expectations as to how they intend to exercise discretion on submissions, to create clear incentives on the NSPs to provide substantially complete initial and revised regulatory proposals.

- dialogue between the AER and NSPs to establish a common understanding of the issues at the early stages of planning.

SP AusNet has found the AER reluctant to engage meaningfully on substantive issues before the process proper begins. This appears to have been because of an inability to make significant resources available outside the review process proper and a reluctance to bind themselves outside of a Draft Decision. In particular, an unwillingness to bind themselves meaningfully can make discussions outside of the formal process largely valueless. This also often contributes to the AER suffering data overloads at the time a Proposal is lodged.

An example of this occurred during the last Victorian EDPR. The distribution business identified a major transitional issue in the form of a misclassification of services in the framework and approach paper that resulted in standard control service related to customer connections being misclassified as negotiated services well before lodgement of the Proposals were required. The distribution businesses proposed to the AER that one set of Regulatory Information Notice templates be submitted with the correct classification (again noting, there was no dispute over the error). Instead the AER required the distributors provide two separate templates (the relevant correspondence is attached). The AER decision:

- conservatively estimated this required up to a thousand extra man hours of work as financial systems had to be duplicated to produce each version of the template (noting the effects of the misclassification affected hundreds of cells in the RIN work sheets);
- Resulted in a large amount irrelevant and confusing information being submitted; and
- Wasted the AER's scarce resources as they attempted to reconcile two very different financial presentations of the same financial data (again noting one was irrelevant to process).

Therefore, formalising the requirement for early engagement would be beneficial to the process proper. It would also provide the AER opportunities to explore alternatives to the detailed review of expenditure governance processes and asset management, both, while fundamental, not directly related to the dollars proposed by the business. For example, in the UK, the economic regulator, Ofgem, encourages businesses to gain PAS 55 accreditation and from that accreditation takes assurance about the practices and procedures being used by the companies in the management of their infrastructure assets thus obviating the need for a detailed review during their price review processes.

3. Customer Engagement

SP AusNet would draw particular attention to the industry proposals that the AER:

- Should publish an Issues Paper following receipt of the NSP's initial proposal. (This recommendation is subject to an assessment of the administrative costs). The Issues Paper content should not be binding on the AER, nor constrain its subsequent decisions.
- Should introduce a process of submissions and cross-submissions on the draft decision and revised regulatory proposal. (This recommendation is also subject to an assessment of the administrative costs).

Both these steps would greatly increase customer representatives' ability to meaningfully engage in the price review process by providing, firstly, an opportunity for the AER to provide guidance on key issues highlighting important areas of a network's proposal and secondly, a formal interaction and information exchange between the network and customers through cross submissions.

4. Conclusion

The AEMC has recognised that the AER's Rule changes do not address the underlying causes of rising network costs such as aging assets and rising peak demand. It has also highlighted that some of the key drivers of rising costs cannot be addressed through a normal rule change process having been reserved to jurisdictional control.

SP AusNet strongly favours the use of incentives as the primary method to achieve outcomes for customers that align with the national gas and electricity objectives. The Victorian regime's record of using incentive schemes to deliver an extended period of price decreases and reliability improvements over the last 15 years is *prima facia* evidence supporting this position.

Finally, the industry association submission provides a detailed response to the issues and alternatives raised by the AEMC's Directions Paper. SP AusNet fully supports the consideration of the research and evidence provided by these reports by the AEMC.

Blair Burkitt
Director
Network Regulation South
Australian Energy Regulator
via e-mail

Dear Blair

Victorian Electricity Distribution Price Review - classification of connection services

The purpose of this note is to provide a response on behalf of the Victorian electricity distributors to the proposal made by the Australian Energy Regulator at our meeting with you on 28 September 2009 that, for the purposes of the 2011 to 2015 distribution determination, the provision of services facilitating new or modified connections (***connection services***) be classified as standard control services.

The distributors agree with the approach proposed by the AER, based on our understanding of the approach as set out below.

Background

In the Framework and Approach Paper published by the AER for the Victorian electricity distribution price review dated 29 May 2009, the AER proposed to classify all connection services as negotiated distribution services. The National Electricity Rules require that service classification in a distribution determination must be as set out in the Framework and Approach Paper unless the AER considers there are good reasons for departing from the classification proposed in that paper.

The AER has acknowledged that this proposed classification would not facilitate cost recovery of capital expenditure properly incurred by the Victorian electricity distributors in relation to new or modified connections in accordance with the Essential Services Commission's 2006 – 2010 Electricity Distribution Price Review. Accordingly, the AER has proposed that it would be prepared to depart from this service classification in the distribution determination, and instead classify all connection services as standard control services.

Proposed approach

The distributors understand that the intended effect of the AER's proposed approach is that capital expenditure incurred in relation to connection services, net of any capital contributions made by the customer, will be included in the regulated asset base (***RAB***). This will achieve a similar outcome to the current regulatory framework, where customers make an up front payment / capital contribution for routine or non routine new or modified connections, and the balance of the costs of providing the service are included in the RAB.

The capital contributions made by the customer will be subject to regulation under applicable regulatory instruments, which currently include the Essential Service Commission's Electricity Industry Guideline 14.

Way forward

The distributors intend to propose the approach to classification of connection services set out above in their regulatory submissions.

We note that the regulatory information notices (***RIN***) which have been served on the distributors by the AER require the distributors to provide all information based on the service classification set out in the Framework and Approach Paper, and to replicate that information if a different approach to service classification is proposed. On the basis that the distributors have agreed with the AER in relation to the classification of connection services as standard control services, we request written confirmation from the AER that, for the purposes of clause 2 of the RIN, the service classification set out in the Framework and Approach Paper in respect of connection services is to be taken to be standard control services, such that it is not necessary to provide information (including without limitation in a second set of regulatory templates) based on the classification of connection services as negotiated distribution services.

We look forward to continuing to work with you on the price review.

Yours sincerely,

Anton Murashev, Manager Asset Regulation & Strategy (JEN & AMI), Jemena

Brent Cleeve, Manager Price Review, CitiPower and Powercor

Alistair Parker, Director Regulation and Network Strategy, SP AusNet

Andrew Schille, Regulatory Manager, United Energy Distribution

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4 November 2009

Anton Murashev
Manager asset Regulation and Strategy
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Dear Mr Murashev

Classification of services and the regulatory information notice

I refer to your letter dated 23 October 2009 addressed to Mr Blair Burkitt, on behalf of the Victorian distribution network service providers (DNSPs), regrading the AER's classification of new connection services and the regulatory information notice (Notice) it issued on 13 October 2009.

In relation to classification matters, your letter refers to a meeting with AER staff on 28 September 2009. The letter states that the AER expressed a view that it would be prepared to depart from the classification of new or modified connection services, as you refer to, from that specified in the AER's *Framework and Approach Paper* dated May 2009.

It is my understanding that at that meeting AER staff did not propose that these classifications should be departed from. Instead, AER staff noted the potential issues in relation to the recovery of costs which may arise if new connection services are classified as negotiated services and acknowledged that the *National Electricity Rules* provides for a DNSP to propose an alternative classification of these services in their regulatory proposals.

It is important to recognise that unless AER staff are describing decisions made by the AER, the views expressed in such meetings are the views of AER staff and cannot in any way bind the AER. Where a DNSP in its regulatory proposal proposes a departure from the classification of services set out in the *Framework and Approach Paper* the AER will make a decision on such a proposal. No such decision has yet been made.

Finally, in relation to the Notice, I note that paragraph 2.2 of Schedule 1 requires a DNSP to provide a second set of regulatory templates if it proposes a departure from the classification set out in the *Framework and Approach Paper*. In accordance with Division 4 of Part 3 of the *National Electricity (Victoria) Law*, a DNSP must comply with that Notice as issued.

If you have any queries please contact Darren Kearney on 9290 1966.

Yours sincerely

Chris Pattas
General Manager
Network Regulation South

cc: Brent Cleeve, Manager Price Review, CitiPower and Powercor
Alistair Parker, Director Regulation and Network Strategy, SP AusNet
Andrew Schille, Regulatory Manager, United Energy Distribution