8 December 2011

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235
Online lodgement via: www.aemc.gov.au

Dear Mr Pierce

AEMC CONSULTATION PAPER – NATIONAL ELECTRICITY AMENDMENT (ECONOMIC REGULATION OF NETWORK SERVICE PROVIDERS) RULE 2011

Endeavour Energy welcomes the opportunity to contribute to the debate on the National Electricity Rule (Rule) change proposals lodged by the Australian Energy Regulator (AER) and the Energy Users Rule Change Committee (EURCC) regarding National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011.

The consultation papers published by the Australian Energy Market Commission (AEMC or the Commission) have sought views on a range of threshold issues, practical considerations based on experiences to date as well as high level policy matters. Endeavour Energy supports the Energy Networks Association (ENA) submission on these matters. However, Endeavour Energy believes that its particular circumstances and experiences may provide additional insights to the Commission in its assessment of the Rule change proposals.

Broadly speaking, the threshold question of whether the increased discretion sought by the AER contributes to the National Electricity Objective to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity, has not been met. Minor refinements to improve the operation of the current regime, however would be supported to improve the process, increase transparency and reduce costs to consumers.

Network investments and incentives

The ENA has correctly identified that the Rules are currently supporting prudent and efficient investment. Moreover, since the development of the Rules, networks have improved the detail and rigour of supporting information commensurate with both the level of network need identified as well as meeting regulatory obligations and expectations.

As demonstrated in several decisions, the AER has made substantial amendments to the proposed capital and operating investment programs where the AER has determined that the proposal lodged by the network business has been deficient in providing either sufficient rigour in its submission or where the network has failed to substantively prove the need and efficiency of its proposed programs.

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Endeavour Energy considers that the Rules as currently drafted strike an appropriate balance between prescription and discretion. The existing framework allows the AER to assess expenditure proposals and make adjustments as appropriate in order to ensure prudence and efficiency. In making this assessment, the AER may have regard to a range of factors, and is not limited to what is contained in the business's proposal.

The AER's Rule change proposal seeks a significant expansion of its discretion. The AER considers that it should be able to determine allowed expenditures rather than accept or not accept (and then substitute for) the business's proposal. While the AER suggests that it would go through a similar process of reviewing the business's proposal and making an assessment, the proposed Rule change removes all requirements for the AER to have regard to the business's proposal. The AER's Rule change would leave it at large to determine what it considers to be efficient costs, having regard to any factors that it considers relevant, which may or may not include the business's proposal.

The AEMC review is occurring at a challenging time for network businesses. It is undeniable that network costs have risen significantly in recent years. Endeavour Energy recognises that there are legitimate public concerns about the economic and social impact of higher electricity prices and that network costs are a major factor in these rising prices.

Equally importantly, however, higher network costs are not of themselves any proof of failure by the regulatory regime in energy, or the regulatory bodies which currently apply them. An increase in network costs compared to historical expenditure under past regimes does not prove that the current regime is flawed.

As the AER notes, increases in expenditure allowances have been driven by various factors. Past regimes operated under different market conditions and often had different priorities. The growth in peak energy demand and the need to replace ageing assets have become more important drivers of network costs. New taxes and charges have also been introduced. The global financial crisis has raised the cost of capital. Past regimes delivered less reliable services; the introduction of the current regime coincided with a policy decision by the NSW Government to raise reliability standards. A simple comparison of historic and current expenditures fails to take into account all variables applying to network businesses.

As Figure 1 below illustrates the current capital investment needs of Endeavour Energy's network is the culmination of events over the past two decades, and highlights that the investment trend has been building since the turn of the century. It is not, as the AER has suggested, simply a construct of the Rules, which have been in effect for Endeavour Energy for the past two financial years.

Figure 1 – Endeavour Energy actual and forecast system capex

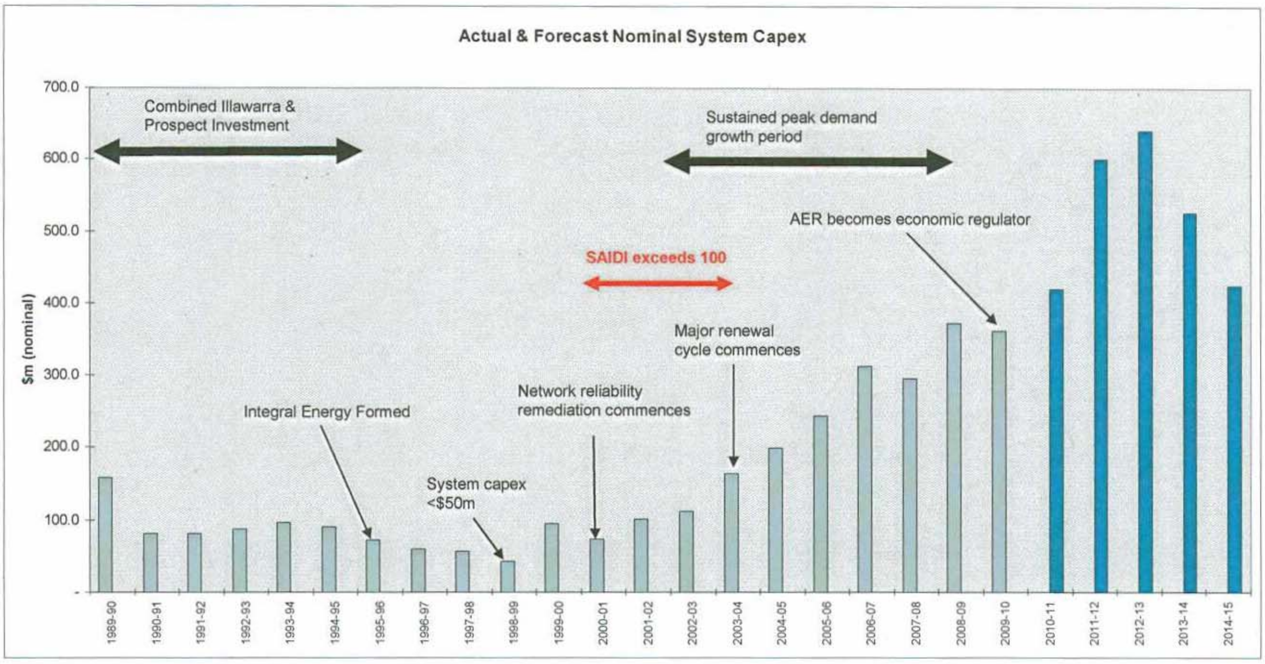
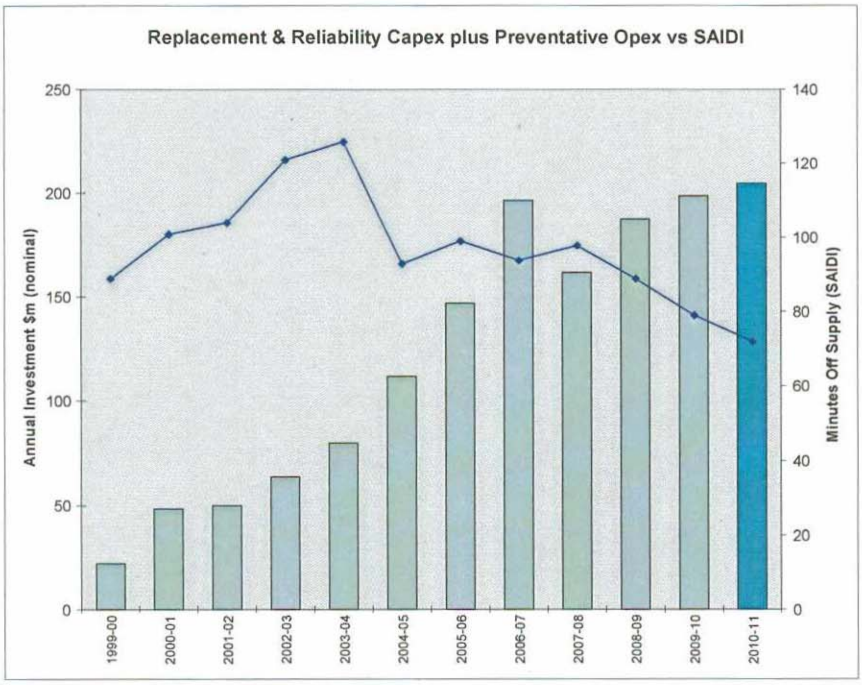


Figure 1 contains many points of interest. Firstly, it highlights that the 1990's were a period of low investment in the distribution sector with a low point achieved in 1998/99 that was below $50 million.

Secondly, the steady reductions in capital expenditure from 1993/94 resulted in customer reliability exceeding 100 minutes off supply from the 2000/01 to 2003/04 financial years inclusive. Lags in customer outcomes from under-investment in networks have been well documented, and have shown lags in the order of 4-6 years between low investment and resultant poor outcomes. This is reinforced in Figure 2[1] below.

Figure 2 – Endeavour Energy Reliability outcomes from 1999/00



[1] As at 8 December 2011, 2010/11 data has not been audited and therefore considered "forecast" in Figures 1 and 2.

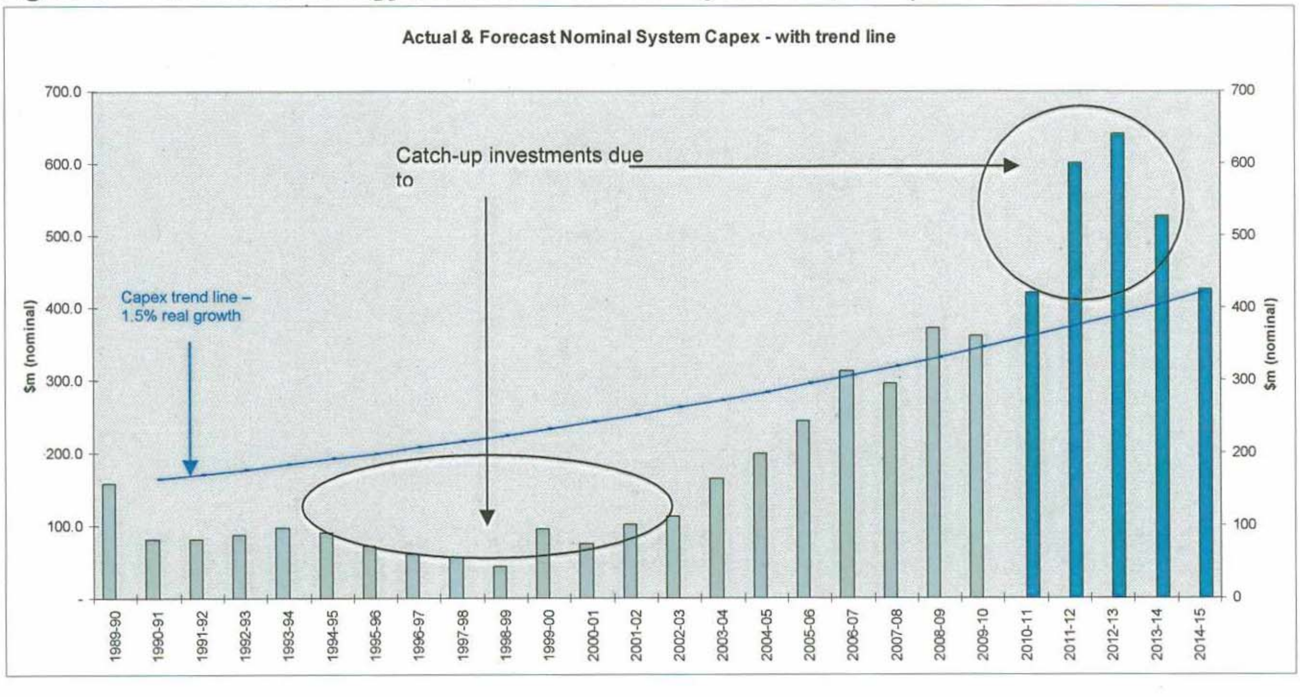
In response to the poor customer reliability outcomes, a remediation program was initiated in the 2000/01 financial year that expanded into a major renewal cycle by the 2003/04 financial year to arrest deteriorating network reliability. These remediation activities, however, were taking place at the same time as a systematic increase in peak demand across the Sydney basin driven by the significant urbanisation developments in Western Sydney that simultaneously drove substantial increases in air conditioning penetration. Based on customer survey results, air conditioner penetration across the Endeavour Energy network area had increased from 62% in 2004 to 72% in 2008, with air conditioners in 81% of dwellings in Western Sydney. The increased takeup of air conditioners has contributed significantly to the need for heightened network augmentation.

It wasn't for several years after these trends were realised that the Rules and regulation by the AER commenced to operate from the 2009/10 financial year.

By considering the longer term investment trends the linkages between past decisions and current investment programs can begin to be crystallised. Figure 3 below plots a conservative trend line of 1.5% real growth in annual capital expenditure over the past 20 years and forecasts for the next five years and compares the trend against actual expenditures[2]. It highlights that while expenditures in the next few years may be above this trend, the total value of such expenditure is still below the investment trend from the 1990's and early part of this century.

It also highlights that the current high rate of price increases could well have been avoided under a long-term systematic investment trend that included reasonable growth annual capital expenditure.

Figure 3 – Endeavour Energy actual and forecast system capex – with trend line



With respect to operating expenditure, Endeavour Energy has responded to the signals contained in the existing regulatory framework to achieve significant efficiency and productivity improvements over the past few years through focussed management initiatives. The underlying incentive properties of the "CPI minus X" framework, where cost reductions are shared between the business and its customers over time, combined with the Efficiency Benefit Sharing Scheme (EBSS) that

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[2] Assumes an average 2.5% compounding CPI over the period. As at 8 December 2011, 2010/11 data has not been audited and therefore considered "forecast" in Figure 3.

provides a consistent incentive to achieve efficiency gains over a regulatory control period, have supported Endeavour Energy's focus to improve efficiency and productivity to ease the pressure of rising electricity prices on our customers.
The regulatory framework enables businesses to recommend, and the AER to accept, productivity improvements as part of the determination process. Indeed our initial regulatory proposal for the 2009-14 AER determination expressly incorporated a number of productivity savings, including 2% reductions in labour costs across all business units each year.

To this end, the existing regulatory framework has supported the National Electricity Objective (NEO) to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity. As such, the increased discretion sought by the AER is not required to achieve the NEO and should therefore not be accepted by the Commission.

Capital expenditure incentive regime

An issue arising from the proposed Rule change that is of particular concern is the asymmetric strengthening to the capital expenditure incentive regime. Although Endeavour Energy is well aware of the generalised origin of the 60% sharing of costs/benefits, it is critical to note that this percentage is dependant upon the prevailing WACC, and that it is drawn from a symmetric incentive regime in the Efficiency Benefit Sharing Scheme that is applied to operating expenditures.

Setting aside the AER's previously long held view that incentives should be symmetric, the proposed amendment to the Rules appears to be inconsistent with the general thrust of the Rule changes where the AER has argued that the Rules should afford it greater flexibility and discretion to assess matters as they arise and in context. It appears therefore incongruous that the AER is proposing to amend the Rules to include a 40 per cent discount to any over spend that does not allow any discretion in application to the circumstances in which any "over" expenditure occurs.

Aside from the prescriptive nature of the AER's proposed capital expenditure incentive mechanism, Endeavour Energy considers that it is ill-conceived and will not achieve its stated objectives. Simply applying a flat 40 per cent discount on any overspend will not provide a consistent incentive across the regulatory period. Where a network business needs to incur over-spend during a regulatory period, it will still face incentives to defer this to the end of the period in order to minimise the extent of unrecoverable financing costs. Therefore whilst the proposed scheme may improve incentives to minimise over-spend generally, it has the potential to do so at the cost of incentives for efficient timing of capital expenditure.

The AER already has discretion under Chapter 6 of the Rules to develop an Efficiency Benefit Sharing Scheme (EBSS) with application to capital expenditure for distribution. Under clause 6.5.8 of the Rules, the AER *must* develop an EBSS applying to operating expenditure and an EBSS *may* also apply to capital expenditure. Endeavour Energy considers that instead of hard coding an incentive scheme into the Rules, it is more appropriate that the AER be given discretion to develop a scheme (such as an EBSS for capital expenditures) in accordance with the existing Rule consultation procedures.

Cost of Capital

Endeavour Energy can see that there is likely to be administrative benefit in aligning the WACC review timings for all of the network industries that it regulates. These benefits however are not contingent upon deleting two of the three existing instruments to form a single all encompassing WACC instrument.

Endeavour Energy would argue against "locking away" the WACC for 5 years without consideration of prevailing market considerations. However, Endeavour Energy would argue that a necessary precondition for such a move must be that the WACC review is subject to an effective and timely merits review process essential for the preservation of good governance and due diligence.

The errors addressed by the Australian Competition Tribunal to date serve to highlight that regulators are indeed fallible and need to be subject to independent review.

However, no amount of administrative due diligence several years in advance of regulatory determinations will address critical and unexpected market events where the framework is not sufficiently responsive to allow for the AER to adequately amend its prior views to accommodate new and material information. As experience over the past several years is demonstrating, global financial markets continue to face significant uncertainties which are resulting in persistent anomalies in the domestic financial market.

Consequently, if a single WACC framework was considered to be appropriate, Endeavour Energy submits that the current Chapter 6 arrangements for electricity distribution networks provide the better balance of certainty obtained from the 5 yearly WACC review and adaptability for the DNSPs and/or the AER to depart from the outcomes of the WACC review based on new and persuasive evidence.

Regardless of the debate surrounding the methodology for measuring the debt risk premium and overall cost of debt and as detailed in the ENA submission, there is evidence in the yields of a wide range of listed bonds of a step-change in the cost of debt financing, which also implies a tightening of supply of new equity capital.

Using standard assumptions applied in current regulatory settings, this externally driven increase in the cost of financing could be expected to increase the cost of annual financing of network businesses by around $800 million over circumstances that prevailed in debt capital markets in 2002-2007. Financial market theory would suggest that the largely unobservable cost of equity financing would have increased by at least an equivalent proportional amount, though regulatory decisions to date have provided only a temporary and partial recognition of these probable conditions.

Endeavour Energy is yet to form a view on the appropriateness and balance of the proposed changes to the setting of the debt risk premium. However, Endeavour Energy would note that the proposed amendments will result in an inconsistent conceptual framework where one element is determined on a wholly backwards looking basis rather than a current market or forward looking approach. Furthermore Endeavour Energy will need to consider the approach in light of its debt raising approaches which has seen it take a mix of shorter as well as longer term debt instruments of up to 25 years.

Competitive Neutrality

In relation to whether a separate (lower) cost of debt should apply to government-owned businesses as raised by the EURCC, Endeavour Energy does not see any merit in abandoning the principle of competitive neutrality, one of the cornerstones of the competition principles agreements.

The principles that were set out in the 1993 National Competition Policy Review (the Hilmer Report) and implemented through subsequent Government policy do not solely apply to Government-owned businesses operating in competitive markets. It should equally apply in regulated sectors where the ultimate aim of regulation is to mimic a competitive market in terms of price and service outcomes.

Embedding distortions within the regulatory regime can only lead to inefficient outcomes and the creation of potentially perverse incentives.

The forward vision for Endeavour Energy

Despite generalised concerns to the contrary, Endeavour Energy expects that customers in its network service area will experience average distribution price movements well below those of recent years and closer to the rate of inflation for the next seven years.

Based on its current investment programs, and early modelling of outcomes for the 2014-19 regulatory control period, Endeavour Energy is expecting:

- Stable capital investment programs with adaptive resourcing solutions to manage short term shifts between investment drivers as required;
- Continued focus on opportunities for efficiency improvements;
- Increased market testing and stability of the capital investment program to facilitate a period of targeted and sustainable efficiency improvements. Experience has shown that the most efficient program is one that is sustainable over time and that allows systematic improvements within a predictable program that is not subject to radical changes; and
- The achievement and maintenance of reliability at levels expected by the communities that we serve.

Although Endeavour Energy's customers have faced significant, but necessary, price increases in order to bring the network investment and reliability up to standard, there is a light at the end of the tunnel. Having increased the investment programs to levels that are more commensurate with the long-term efficient investment needs of the network, we anticipate a period of sustainability and stability in our investment programs and distribution prices to our customers.

From this history it is clear that the development of the Rules has been critical in supporting investments necessary to meet both the needs of the network to deliver the appropriate service outcomes and to achieve the sustainable long term resourcing and capital programs necessary to deliver prices in line with community expectations.

Endeavour Energy holds concerns for its customers if the current Rules, which have supported the move to the "right sizing" of investment, are amended before the benefits are realised by customers. While there are some refinements to the Rules that may be warranted, overall we consider the Rule change proposals of the AER and EURCC to be a retrograde step in the efficient and effective regulation of network businesses.

Endeavour Energy does not believe that the current framework is flawed in the manner argued by the AER. Rather, the framework is supportive of the need to achieve efficient levels of investment and that once the historic under-investment has been resolved it will become commonplace for network businesses to join Endeavour Energy in achieving price increases broadly in line with inflation.

If you would like to discuss this submission further, please contact our Manager Network Regulation, Mr. Michael Martinson on 02 9853 4375.

Yours faithfully

Vince Graham

Vince Graham
Chief Executive Officer