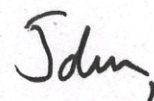


8 December 2011

Mr John Pierce  
Chairman  
Australian Energy Market Commission  
PO Box A2449  
SOUTH SYDNEY NSW 1235

Dear Mr Pierce



**Rule change proposal: Economic Regulation of Network Service Providers**

ActewAGL Distribution welcomes the opportunity to comment on the rule change proposals by the Australian Energy Regulator (AER) and Energy Users Rule Change Committee (EURCC) in response to the AEMC's October 2011 consultation paper.

ActewAGL Distribution is a public-private partnership ultimately controlled by the ACT Government owned ACTEW Corporation and Singapore Power International. ActewAGL Distribution owns the electricity distribution network in the ACT and gas distribution networks in ACT and the adjoining areas of NSW, and in Shoalhaven. The ActewAGL joint venture also has interests in water and wastewater services in the ACT, and in energy retailing in the ACT and south-eastern NSW.

ActewAGL Distribution participated in the development of and strongly supports the comprehensive submission by the Energy Networks Association in response to the consultation paper.

We welcome the decision of the AEMC to provide for an additional round of consultation on this issue of vital importance to network service providers (NSPs) and we look forward to continuing engagement with the AEMC on the vast range of issues raised by the rule change proposals. At this early stage I would like to raise two fundamental issues of particular concern to ActewAGL.

- The first major issue is the AER's proposal to give itself significantly greater discretion to determine regulatory allowances and to do so in a way where it can ignore actual circumstances related to the business. This represents a fundamental and unwarranted shift away from the incentive regulation model that was carefully developed, through extensive consultation, and incorporated in the current rules. High level benchmarking, while a useful tool for assessing whether proposals meet general cost expectations, should not replace proper assessment of proposals based on local knowledge and circumstances.

- The second relates to the timing of the proposed changes, and the issues of procedural fairness this raises, particularly for the ACT and NSW NSPs. The ACT and NSW NSPs are currently preparing for the 2014-19 determination process, against a backdrop of unreasonable uncertainty about the Rules that will apply, having not yet had a determination under the current chapter 6 of the Rules (as transitional Rules applied for the 2009-14 determination).

These two issues are discussed in more detail below.

### **1. AER's increased discretion over required levels of forecast expenditure and the role of benchmarking**

The current test of reasonableness of expenditure under the NER leverages the NSPs' detailed knowledge of their networks. NSP proposals for capital and operating expenditure are based on detailed planning for the needs of the network to enable their delivery of safe and reliable services. Regulatory scrutiny of expenditure proposals then concentrates on verifying that sufficient credence has been given to available efficient options, taking into account factors such as lifecycle costs of operating and capital expenditure solutions. Outside of this detailed scrutiny, NSPs are provided with strong incentives to manage costs, while attaining appropriate service levels.

It is firmly established that a system based on business planning with appropriate checks and incentives is the best way to regulate an electricity network. The AER itself recognises this in its explanation of the role of its incentive mechanisms, stating:

It is generally accepted that firms have superior knowledge and are better placed than a regulator to effectively judge whether a particular project or organisation structure represent efficient production. In the presence of this information asymmetry, it is preferable for the regulator to leave a substantial amount of discretion to the firm, while providing a system of broad financial incentives to induce the firm to use that discretion to pursue desirable outcomes.<sup>1</sup>

The AER's proposed approach is inconsistent with its own stated approach to incentive regulation. The inferior alternative is a situation where the regulator must assume full knowledge, where local knowledge is overlooked and network managers lose effective control of (and therefore responsibility for) the performance of their networks. Under these circumstances they are required to manage based on the rationing of available maintenance funds.

As a replacement for direct knowledge of specific network circumstances, context and needs, the AER proposes greater use of tools such as benchmarking to determine efficient expenditure. Under the proposed rule changes, benchmarking would be afforded a higher status than the NSP's proposal: the latter along with unique network circumstances being omitted from the list of factors to which the AER would have regard in determining efficient expenditure levels.

---

<sup>1</sup> AER 2008, *Electricity distribution network service providers, Final Decision, Efficiency benefit sharing scheme*, June, p. 3



The AER can and has used benchmarking to varying degrees in recent determinations as a tool to assess the efficiency of NSPs' expenditure proposals. While acknowledging the shortcomings of the technique, particularly the availability of readily comparable data and inherent difficulty in making comparisons between NSPs operating in vastly differing situations, the AER nevertheless allowed benchmarking to form a significant part of considerations in the 2009-14 ACT/NSW determinations.

In ActewAGL's view, properly conducted benchmarking is a useful tool but high level and potentially simplistic benchmarking should not be given status over other checks of performance. Such benchmarks definitely should not routinely be equated with efficiency. Every network is likely to have its own underlying cost drivers. In ActewAGL's case, an example is the planning requirement for electricity poles in residential areas to be at the rear of properties. This requirement raises a plethora of unique issues for access, inspection, replacement and vegetation management.

To be robust and informative, benchmarking must also move beyond measuring the uncontrollable factors of the physical and institutional environment and historical circumstances that comprise the largest part of cost differences, and lower order drivers such as differences in accounting treatments, into the differences in work practices and operating techniques that comprise directly controllable differences in costs.

Although it seeks increased discretion over the determination of efficient expenditure, the AER also seeks increased prescription in other areas. In the area of capital incentives, the AER seeks to prescribe that 40 per cent of the value of any capital expenditure above that approved in the previous determination would not be rolled into the regulatory asset base. Apart from the arbitrary nature of this solution to what the AER sees as an issue with incentives, the proposed measure would itself create an incentive to routinely overstate capex forecasts to reduce the possibility of such over-expenditure, as well as failing to address existing incentives to postpone over expenditure until as late as possible in the regulatory period to minimise the impact of the penalty. The scheme also provides no discretion to allow capex over expenditure as the result of unforeseen circumstances to be rolled into the asset base. It needs also to be noted that the AER's proposed remedy of allowing contingent projects and reopeners is unlikely to be of practical use to smaller NSPs such as ActewAGL unless cost thresholds are set impractically low from an administrative perspective.

## **2. Timing of the proposed rule changes**

The next regulatory control period for the ActewAGL electricity distribution network begins, along with that for the NSW network businesses, on 1 July 2014. As noted by the AEMC, the AER has indicated a desire to have its proposed rule changes in place in time for its determinations for the ACT and NSW networks.

The ACT and NSW network service providers (NSPs) were the first to have proposals assessed and determined under the National Energy Law and National Electricity Rules (NER) (transitional Rules). The truncated time available to address process matters made necessary transitional rules that continued to apply a number of measures from the existing

jurisdictional regimes. Transitional rules notwithstanding, the brevity of time available to complete submissions, in the absence of complete knowledge of the final process resulted in considerable uncertainty. The AER's Regulatory Information Notice was not finalised until the end of April 2008: just over two months before the submission.

Should the substantial rule changes proposed by the AER and EURCC be approved totally or even substantially, ActewAGL would once again find itself facing a new and unfamiliar regime at October 2012 when it would be well into the process of preparing its May 2013 submission and having never had an opportunity for a review under the full provisions of the NER as implemented in 2007.

Although the AER's rule change proposals incorporate transitional provisions for ACT and NSW determinations, these merely address practical issues of implementation rather than the procedural fairness issues that arise particularly for a relatively small NSP having to operate on a number of fronts given the uncertain framework while preparing the proposal. However, even if the proposed rule changes are rejected in their entirety, considerable resources will be diverted into understanding and preparing for their consequences. Meanwhile, the process towards the 2014 determination continues, with the AER indicating its intention to produce 3 to 4 issues papers, the first due in November 2011, in advance of the formal consultation on the framework and approach for the determination from July 2012.

ActewAGL questions why the AER is proposing such substantive changes to take effect so late as to overlap with the ACT/NSW review process and indeed whether it will always have its review process affected in this way given the lead position of ACT/NSW NSPs in the regulatory cycle. We appreciate that consideration of the AER's sweeping proposals cannot be rushed. However, even the proposed completion date of October 2012 is too late to allow fair and effective preparation for the ACT determination. Therefore, we propose that the current rules should continue to apply for the 2014-19 ACT determination.

ActewAGL looks forward to continuing engagement with the AEMC on these and other issues vital to the provision of safe and reliable electricity network services. Enquiries on this submission should be directed to Mr David Graham, Director Regulatory Affairs and Pricing, on (02) 6248 3605.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Michael Costello', with a long horizontal flourish extending to the right.

Michael Costello  
Chief Executive Officer