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Mr Chris Pattas
General Manager, Network Operations and Development
Australian Energy Regulator
GPO Box 520
Melbourne Victoria 3001
via email: sharedassets@aer.gov.au

Dear Chris,

Draft Shared Asset Guidelines

SP AusNet welcomes this opportunity to respond to the Australian Energy Regulator's (AER's) Draft Shared Asset Guidelines.

SP AusNet is broadly supportive of the AER's approach. The shared asset guidelines deal with issues that are complex, both at a theoretical level and in the detail of their application, and the Draft Guidelines set out a path that is pragmatic, seeks to simplify matters to the maximum extent possible and achieves an appropriate balance between sharing the benefits of shared asset activity with customers, while maintaining incentives for network businesses to develop services using regulated network assets.

The remainder of this letter sets out SP AusNet's position on key matters:

- The purpose of the shared asset rules, which we believe is to distribute the benefits of asset sharing;
- The pitfalls of aspects of the cost reduction method proposed in the Draft Guidelines;
- Our assessment of the cost reduction method; and
- Identification of a series matters where there is not sufficient guidance in the Draft Guidelines as to how the AER will act in its price/revenue determinations, to provide Network Service Providers (NSPs) the certainty needed to develop new unregulated services.

Shared asset rules are about sharing benefits

Before addressing the details, it is worth reflecting on the purpose of the shared asset mechanism and the context in which the shared asset rules exist. Use of regulated infrastructure to provide other services (i.e. asset sharing) generates economic value, or benefits.

CERTIFIED QUALITY MANAGEMENT SYSTEM ISO9001
CERTIFIED SAFETY MANAGEMENT SYSTEM AS/NZS 4801
CERTIFIED ENVIRONMENTAL MANAGEMENT SYSTEM ISO14001

SPI Electricity Pty Ltd ABN 91 064 651 118
A subsidiary of SP Australia Networks (Distribution) Pty Ltd
Level 31, 2 Southbank Boulevard Southbank Victoria 3006 Australia Locked Bag 14051 Melbourne City Mail Centre Vict Australia
Tel 61 3 9695 6000 Fax 61 3 9695 6666 www.sp-ausnet.com.au

The existence of shared assets does not diminish the value of the existing network to customers, but using the same set of resources they do 'grow the pie' by creating new services that have incremental value.

The shared asset rules are designed to address an issue of distribution – the proposition being that when customers of regulated services are paying for an asset that generates some additional benefits, it is fair that they share in some of those gains. The new Shared Asset Rules provide that opportunity for customers to share in the benefits.

Importantly, it is wrong to approach the shared asset mechanism as a punitive tool. At times, the Draft Explanatory statement veers into this territory: describing asset sharing as a 'problem' that needs to be fixed (Section 1.1); and, by referring to shared asset revenues as 'over-recovery', implying the purpose of the mechanism is to claw back customer losses, rather than redistributing benefits.

The first Shared Asset Principle reflects the positive, value building nature of shared assets by prioritising the development of such services:

> *Unregulated services' use of standard control or prescribed transmission assets should be encouraged when it does not affect regulated services.*

SP AusNet notes that the Shared Asset Principles set out in the Rules, in particular through the wording of the first principle, tend to distinguish between prescribed transmission services (or standard control services) and 'the provision of other kinds of services' (refer clauses 6A.5.5(c) and 6.4.4 (c)). This is a broader notion than that which the AER is actually required by the Rules to account for in cost sharing, being limited to those services which are not subject to the network services framework of the Rules (refer clauses 6A.5.5 (a) and 6.4.4 (a)). The draft Shared Asset Guidelines appear to correctly interpret the Rules in this matter, however it will be critical that care is taken to correctly identify 'non-regulated' service revenue in applying the cost sharing mechanism. SP AusNet considers it would be helpful if the AER was to recognise this nuance in the Explanatory Statement.

Failings of a (purely) revenue based mechanism

While SP AusNet did not make a submission to the Issues Paper, we did participate in the AER's industry workshop and also contributed to the ENA submission. Through these avenues, we expressed our concerns with the AER's cost reduction mechanism, which is based directly on shared asset revenues without reference to incremental costs. As the AER has maintained its approach, it is worth reiterating our main concerns.

Principally, the issue is that 10% of shared asset revenues does not mean 10% of the benefits generated, and it may mean more than 100% of the benefits.

The rationale for the AER's cost reduction method centres on the premise that "unregulated revenues are the best indication of the extent of asset cost recovery achieved by service providers through charging for unregulated services"[1]. However there are situations where 'shared asset revenue' is not equivalent to the costs being recovered (from users of the unregulated service) for use of the shared asset. An example of such a situation would be where the shared asset revenue is also recovering the costs of

[1] Draft Explanatory Statement, p.17

unregulated assets, and unregulated operating costs that are used to deliver the unregulated service. The purely revenue-based approach only makes sense in situations where shared asset revenues are effectively ‘rents’ for shared asset use, that is, where there are no other costs of providing the service.

The consequence of the situation described above is that where 10% of revenue is more than 100% of the benefits, then the service becomes unviable and everybody is worse off: NSP; regulated service customers; and unregulated service customers. And, because unregulated services are typically not monopolies, NSPs cannot simply raise the price for those services to make them viable again. In these circumstances, all parties would be better off if the size of the shared asset cost reduction could be decreased to below the value of the benefits from the shared asset service.

Balance on sharing benefits ‘about right’

Despite the concerns just outlined, SP AusNet is satisfied that on balance the cost reduction method set out in the draft guideline is a pragmatic solution, albeit one that can be improved upon with some drafting changes, and that may need to be revisited if NSPs or potential unregulated customers identify a significant pool of services that the AER’s mechanism is blocking from future development, and the AER finds that society would be better off if those services were provided.

In developing the shared asset guidelines, the AER has needed to address a series of complexities, including issues of scope, difficulties of measurement, reliance on information about services that are unregulated and the need to balance the burden of the regulatory mechanism with the materiality of the benefit that can be shared with customers. The Rules also provide a challenge in as much as they lay out, at least from an economic perspective, somewhat conflicting principles: of protecting the development of services that share assets, while not being contingent on profit.

The AER acknowledged some of the concerns about a purely revenue based method, and said they considered the implications of this in determining a 10% share as the appropriate cost reduction proportion. Given some of the other difficulties of designing a cost reduction method, SP AusNet supports that the 10% figure gets the balance about right. For some services that use shared assets and have significant incremental costs, the benefit sharing ratio will still be very high. However, this will balance against services where the sharing ratio is closer to the 10%.

One adjustment to the mechanism proposed in the draft guideline that would more effectively mitigate the risk that some services would be unviable, would be to broaden the AER’s discretion to allow alternative cost reduction methods in some circumstances. SP AusNet supports the ENA submission, which discusses this in more detail.

The importance of certainty to the development of new services

For NSPs to be encouraged to pursue commercial arrangements for services using shared assets, it is important that the shared asset guidelines provide clear guidance on how arrangements will be treated under the regime. An environment which provides NSPs with reasonable foresight of the share of benefits to flow to customers, will provide the necessary confidence when NSPs enter contracts for these new services.

The inclusion of a detailed method in the AER's draft guideline is an important step to provide this certainty. Likewise, the AER's stated approach of not seeking ex post reconciliations under the Rules is endorsed. However, the AER has left open the door to a change in approach (Explanatory Statement, p.13) in the future. Should such a change be contemplated, it is important to ensure that NSPs are not expected to include speculative revenue streams in their shared asset forecast. To the extent that this results in a small period where there is no sharing of revenues for new services this is appropriate, providing an incentive to develop new services, for which new revenues will flow to customers in later periods.

As already noted, the AER has sought to simplify matters to the maximum extent possible. While this is generally to be applauded, there are a number of areas where the guidelines require further detail and clarification, to minimise future disputes over interpretations through individual price determinations. These include clearly defining what is covered in the definition of shared asset revenue, and incorporating the point from Section 3.3.1 of the Explanatory Statement regarding the ability to apportion revenues where unregulated services make limited use of regulated asset explicitly in the Guideline. The guidelines could also be clearer on what is considered to be a change in asset use from a network business's Cost Allocation Methodology.

Closing remarks

This submission is intended to be read alongside the submission of Energy Networks Australia, which SP AusNet supports. We would be happy to meet with the AER at any stage to discuss matters of interest. Please contact Katie Yates, Principal Economist at 03 9695 6622 if you wish to discuss any aspect of this submission further.

Yours Sincerely,

Tom Hallam
Manager Economic Regulation