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Mr Chris Pattas
General Manager
Network Regulation South
Australian Energy Regulator
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Dear Mr Pattas

CitiPower's and Powercor's Proposed Security Fee Scheme

I refer to the Consultation Paper – *CitiPower's and Powercor's Proposed Security Fee Scheme* released on 28 June 2010. CitiPower and Powercor offer the following comments for your consideration in this matter.

Alteration of calculation methodology

CitiPower and Powercor propose a change to the calculation methodology in respect of the amount of Incremental Revenue (IR) that applies to a security fee calculation set out in Appendix A of the Consultation Paper. Specifically in Example 1 in Appendix A , it applies an amount of five-years' of IR against which the amount of any security fee is calculated. This had been revised to be a figure of one-third of the present value of IR against which the amount of any security fee is calculated.

The effect of this alteration is that the amount of any security fee payable will be reduced, however there is no change to the methodology used to determine when a security fee is applicable, it only impacts on the actual amount of the security fee calculated. Thus this revision necessitates a revision to Example 1 in Appendix A. See a corrected version in Appendix A below.

Note also that there was a minor error in Example 2 of Appendix A (a misstatement of the industry type, with no impact on the result) and Example 3 (methodology demonstrated incorrectly, but with no impact on the result). These have been corrected in Appendix A below.

As a result of the adjustments described above, some components of the consultation paper based on the CitiPower and Powercor proposed scheme require alteration.

These alterations could be as follows:

Paragraph 4 of Section 2 CitiPower's and Powercor's proposed terms and conditions for charging security fees should be amended as follows :

> The proposed schemes calculate the amount of a security fee [~~from the average of the three risk factors~~] via a two stage process. Initially the average of the risk criteria Location and Industry, which are each given a rating from 0 to 5 in accordance with the criteria outlined at table 2.1, is obtained to gain a prima facie assessment of whether the location of the project and broad industry characteristics indicate that risks to IR realisation are high. If the overall risk factor is 'high' (a risk rating of 4) or 'very high' (a risk rating of 5), a subsequent assessment is made of the number of end customers at the site and their estimated contribution to the predicted revenues to ascertain if customer diversity mitigates risks. If the diversity score is not classified as high a security fee is deemed not applicable to the connection. If the score for diversity is classified as high the security fee is calculated as the product of the risk rating being the average of the three criteria weightings and one third of the present value of fifteen [~~five~~] years' incremental revenue divided by five. For example, if a customer is situated in a rural area (risk factor 4), is in the mining industry (risk factor 5) and there is only one customer involved (risk factor 5), the overall risk rating is calculated as (4+5+5)/3 = 4.67. This overall risk rating is classified as 'high', hence a security fee will be required. Assuming the incremental revenue is $200,000 per annum then the security fee over a five year period is calculated as [~~$200,000 * 5 years~~] a 15-year Net Present Value of Incremental Revenue of $1,600,370 / 3 = 533,457 * (4.67/5) = [~~$934,000~~] $497,893

Paragraph 5 of the same section should be amended as follows:

> It should be noted that, for CitiPower and Powercor, ~~five years of incremental revenue represents approximately 50~~ the security fee, if applicable, is based on one-third or 33 per cent of the net present value of the total incremental revenue based on a 15 year connection life for business customers as specified in Guideline No. 14.

Responses to Considerations and Consultation

The intention of CitiPower's and Powercor's security fee policy is to arrive at an appropriate balance between the interests of new customers connecting to the network and of existing customers on the network. CitiPower and Powercor believe that the policy strikes a fair and reasonable position that is also practically and administratively functional.

The AER seeks submissions specifically on whether:

- CitiPower's and Powercor's proposed security fee interest rate at the 90 day Bank Bill rate is appropriate and is consistent with the DNSPs' recognition of the interest as short term funding;
- a 0.25 per cent administration charge is appropriate;
- the location risk factors appear to be fair and reasonable;
- the industry risk factors appear to be fair and reasonable;
- the other terms and conditions appear to be fair and reasonable;

The following comments are provided in response to these issues:

<u>Interest Rate</u>

The regulated WACC is not viewed as an appropriate basis for the calculation of interest payments on security fees held by the companies as the security fees are effectively held in trust until such time as they are repaid or retained as the case may be. As such they are not available for investment in the business but are to be retained in working capital. Hence applying an interest rate equal to the WACC would impose an economic cost on the business and would create a disincentive to charge security fees. This could impact existing customers adversely.

Further CitiPower and Powercor note that the rate is consistent with the interest rate set out in the Energy Retail Code applicable to refundable advances.

<u>Administration Charge</u>

The use of an administration charge as an adjustment to the interest rate is based on being easier to administer than an up-front handling charge. The proposal is viewed as being fair and reasonable in that:

- The rate being set at 0.25% will result in an administration charge, if applicable, that is only a fraction of the interest rate to be paid on the security fee;
- No administration charge will be applied if the security fee is not refunded (although the business will incur administration fees irrespective of whether or not a refund is paid);

- The administration charge will not be material in the context of the security fee scheme. By way of example:

  In the example provide provided as Example 1 in Appendix A [as adjusted in this document] of the consultation paper, the administration fee withheld, if a full refund was applicable in year 1, would be:

  Security fee $497,893 x 0.25% = $1,245

  Note further that the administration fee will decline over time if refunds are paid (as the amount of the security fee held will decrease)

<u>Location Risk Factor & Industry Risk Factor</u>

The business believes that the key risk criteria applicable to assessing the risk associated with realising the IR of a connection to be prima facie the Location and Industry criteria, with Customer Diversity (the number of end customers) being assessed for its impact on mitigating these risks.

To reiterate the criteria:

> <u>Location:</u> This criterion is used to help assess the probable duration of the vacancy, should the site become vacant for whatever reason. The more remote the location the less likely that a site vacancy will be quickly filled, therefore the higher the risk that incremental revenue will be less than expected. The risk of a site vacancy in the CBD is comparatively lower than in the urban areas.
>
> <u>Industry:</u> Some industries are inherently more risky than others. This criterion is used to help assess the risk that the customer will experience financial difficulties due to changes in industry conditions, which in turn may result in changed usage patterns. For instance, government and residential sectors are considered low risk, and high tech and mining sectors are considered high risk.
>
> <u>Customer diversity:</u> This criterion is determined by the number of customers at the connection site. The larger a single customer's share of IR, the greater the risk.

<u>Other Terms and Conditions</u>

Guideline No. 14 provides that a DNSP may only collect a security fee, if it fairly and reasonably assesses that there is a risk that it may not earn the incremental revenue in relation to a connection offer.

CitiPower's and Powercor's proposals only require that a security fee is collected if there is considered to be a high or very high risk, based on the criteria ratings, that the IR is not collected. This is supported by the risk criteria explanations above.

The AER seeks submissions as to whether stakeholders consider that under this condition, the amount of the security fee will not be greater than the amount of incremental revenue which the DNSP fairly and reasonably assesses that risk as high, as prescribed by Guideline No. 14.

The classification of high risk is encapsulated in the risk criteria explanations above. This is supported by applying only one-third of the present value of the IR to the calculation of the security fee, which is viewed as a conservative assumption. This aligns with the concept that the greatest risks or uncertainty to a connection exist in the earlier years of operation.

The AER seeks comments on the fairness and reasonableness of the refunding security fees or part thereof over a five year period as outlined in the proposals.

The proposal for a five year period is viewed as appropriate for the following reasons (being a re-iteration of Appendix A):

- The greatest uncertainty with regards to the incremental revenue for a connection exists in the first five year period, with the risk generally reducing over the remainder of the 15 year economic life of a non-residential connection;
- A shorter period was not adopted because it can take several years for a customer to achieve full load;
- A longer period was not adopted because the benefits of a longer period didn't outweigh the additional administration costs; and
- A five year period represents a balance between mitigating as much risk as possible whilst minimising customer impacts and administration costs.

CitiPower and Powercor do not intend that a shortfall of incremental revenue in a given year to be offset by above estimated incremental revenue received in other years.

CitiPower and Powercor do not intend to adjust for retrospective outcomes in the annual review of a security fee as it has the view that overall the security fee proposal is fair and reasonable and that in instances where there are subsequent revenues received above the estimated amounts it is also probable that there have been or will be additional costs incurred that have not been factored into the connection analysis.

This is because in general the security fee policy will only apply to large connections (given the $750,000 present value IR threshold) and where the revenues are higher than anticipated it is likely that the load on the system is higher than anticipated, and hence actual incremental costs may be more than was anticipated in the connection offer. These costs could be for the initial capital cost, for ongoing operational and maintenance expenditure, and for Marginal Cost of Reinforcement (MCR).

In addition the proposed method is administratively simpler.

CitiPower's and Powercor's proposed scheme requires about 50 per cent of the total projected network revenue (depending on the risk rating) of the more risky businesses in net present value terms to be payable as a security fee. The AER seeks submissions on whether this amount is within the acceptable realm of balance between the interests new and existing customers.

As indicated in Section 1 above, the scheme requires one-third (33%) of the net present value of total projected network revenue of the more risky businesses to be paid as a security fee.

CitiPower and Powercor believe that this is an appropriate position given that the greatest uncertainty with regards to the incremental revenue for a connection exists in the first five year period, with the risk generally reducing over the remainder of the 15 year economic life of a non-residential connection.

If you require further information, please do not hesitate to contact Wendy Cotton on telephone (03) 9683 4288 or email wcotton@powercor.com.au

Yours sincerely

[signed]

Brent Cleeve
MANAGER PRICE REVIEWS

Revised Appendix A: CitiPower's proposed security fee scheme

What is a security fee?

Some projects may require a security fee to be paid. The Security Fee is applied to manage the risk associated with CitiPower not receiving the distribution revenue amount that was assumed when the connection offer was prepared. Subject to the required load being achieved the security fee is refundable with interest. The customer's load is assessed from the customer's weighted average maximum billed demand for the preceding 12 months.

Risk Factors

Incremental revenue may be less than expected due to:

- Site vacancy: There is a risk that a site will be vacant for part of the period of time that revenue is assumed to accrue for the purpose of determining customer contribution (15 years for non-residential and 30 years for residential). A vacancy may occur for a number of reasons, including customer insolvency or changing business conditions.
- Energy intensity: The energy consumption of the customer may change over time.

Risk criteria are assessed to determine the overall level of risk applicable to a customer connection. If the risk score is high a security fee may be required.

The risk criteria used are as follows:

- Location: This criterion is used to help assess the probable duration of the vacancy, should the site become vacant for whatever reason. The more remote the location the less likely that a site vacancy will be quickly filled, therefore the higher the risk that incremental revenue will be less than expected. The risk of a site vacancy in the CBD is comparatively lower than in the urban areas.
- Industry: Some industries are inherently more risky than others. This criterion is used to help assess the risk that the customer will experience financial difficulties due to changes in industry conditions, which in turn may result in changed usage patterns. For instance, government and residential sectors are considered low risk, and high tech and mining sectors are considered high risk.
- Customer diversity: This criterion is determined by the number of customers at the connection site. The larger a single customer's share of IR, the greater the risk

Please see Table 1 below for criteria ratings.

Table 1 Criteria Ratings

Risk Rating Factor	Location	Industry	Customer Diversity (largest customer's share of IR)
0		Essential Services	
1 Very Low	CBD	Residential (low/high density) Public Admin/education	<25%
2 Low	Urban	Accommodation/ food services Commercial/residential occupancy Health care/social assistance Wholesale/retail trade	>=25% <50%
3 Medium	Regional	Industrial estate Telecomm/information media Transport, postal/warehousing other	>= 50% < 75%
4 High	Rural	Agriculture, forestry/fishing Manufacturing	>= 75% < 100%
5 Very High	Remote Rural	Mining	=100%

When will a Security Fee be required?

A security fee may be required where it is assessed that there is a high risk that CitiPower will not receive the distribution revenue.

Assessment will only apply where the NPV of the incremental revenue (IR) calculated for the purposes of determining the connection charge is greater than $750k. (The NPV of the IR is calculated over 30 years for residential and 15 years for other customer types in accordance with Guideline No.14)

If the connection project triggers the revenue threshold above then an assessment is carried out to determine the risk. If the risk to CitiPower is assessed as being high, a security fee will be required.

In assessing whether a security fee is required, CitiPower considers three risk factors, location, industry type, and customer diversity. The weighted average of the risk criteria "industry type" and "location" is assessed to gain a prima facie assessment of whether broad industry characteristics and the location of the project indicate that risks to IR realization are high. The risk is assessed on a scale of 0 to 5 and ratings of 4 or 5 are regarded as high risk. If the risk is classified as high on the basis of “industry type” and ‘location” then a further assessment is made of the number of end customers at the site and their estimated contribution to the predicted revenues to ascertain if “customer diversity” mitigates risks. If the score for “diversity” is also classified as high then the average of the three risk criteria is calculated to determine the risk factor, otherwise no security fee is required.

The security fee is calculated from the product of the risk factor and [~~five years’~~] one-third of the present value of the IR applicable to the connection. This [~~The five year IR figure~~] is analogous to classifying 1/3 of the present value of the forecasted revenue used to calculate the connection charge as high risk and is viewed as a conservative assumption.

This revised methodology more accurately assesses risk levels and security fee amounts, and ensures that risk assessments can be conducted quickly and easily.

The Security Fee will be calculated by CitiPower and included in the offer for connection services.

The following examples are provided to demonstrate the risk assessment and calculation of the security fee.

Example 1:

Consider a mining enterprise in a rural location, only one customer involved and annual revenue of $200,000

Location = “Rural”; Risk Rating = 4

Industry = “Mining”; Risk Rating = 5

Average risk rating for “Location and Industry” = 4.5 therefore assess for third criteria, “Customer Diversity”. Only single customer therefore Risk Rating = 5

Overall Risk Rating = (4 + 5 + 5) / 3 = 4.67

Therefore Security Fee = $200,000 per annum = a 15 year NPV of IR of $1,600,370 [~~*~~] / 5 years = $533,457 * 4.67 Risk Rating = [~~$933,400~~] $497,893

Example 2:

Consider an Industrial estate in a regional location, with 10 customers with the largest one being 30% of the total load and the annual revenue is $200,000

Location = “Regional”; Risk Rating = 3

Industry = [~~“Mining”~~] “Industrial Estate”; Risk Rating = 3

Average risk rating for “Location and Industry” = 3, not high risk therefore no further assessment and no Security Fee required.

Example 3:

Consider a forestry enterprise in a rural location, consisting of two customers, the largest one being 55% of the total load and the annual revenue is $200,000

Location = “Rural”; Risk Rating = 4

Industry = "Forestry"; Risk Rating = 4

Average risk rating for "Location and Industry" = 4 therefore assess for third criteria, "Customer Diversity". Largest customer = 55% therefore Risk Rating = 3

[~~Overall Risk Rating = (4 + 4 + 3) / 3 = 3.67~~

~~Overall Risk Rating less than 4 (High) therefore no Security Fee required.~~]

As the Customer Diversity figure is less than 4, the overall risk rating is not classified as high, therefore no Security Fee required.

Security Fee Refunds

CitiPower will allow an annual rebate of the Security Fee over a five year period. CitiPower will compare the weighted average maximum billed demand against the estimate used for that year in calculating the customers capital contribution incorporated into the connection offer. In each of the five years CitiPower will refund to the customer a sum equal to one fifth of the initial Security Fee adjusted pro rata if the weighted average maximum billed demand was less than the estimated maximum demand, with interest.

In other words if there is a shortfall in the weighted average maximum billed demand for that year the rebate will be reduced by the shortfall expressed as a fraction of the estimated maximum demand. Any shortfall for any year may not be off-set against additional revenue received for any other year or vice versa.

The first qualifying year of the rebate period commences on the date of completion of the works. Subsequent rebate periods will follow at successive 12 month intervals from the first period.

Interest is paid on the annual rebate. Interest is not payable on the amount of the reduction of any rebate. The interest rate is based on the average monthly 90 day Bank Accepted Bill rate published by the Reserve Bank of Australia, less 0.25%, from the date CitiPower receives the security fee.

Any security fees which are not refunded will be recognised as a customer contribution to the network augmentation. This assessment commences 12 months after the date of completion of works, and is performed annually for a five year period.

Why is a security fee required?

The purpose of collecting a security fee is to afford some protection to the distributor and its existing customers against the intending customer failing to take up the electrical load advised to the distributor and included in the calculation of their incremental revenue. To the extent that anticipated revenue is not realised, a financial cost is incurred. This cost will flow to the distributor during the current regulatory period and other customers in subsequent regulatory periods.

This approach helps to ensure that other customers and the distributor aren't required to subsidise inefficient costs.

Administration Fee

The administration costs will be recovered by an adjustment to the interest rate. The adjustment to the interest rate is easier to administer than an up-front handling charge, expressed as a percentage of any security fee required. Administrative costs are incurred whether or not a refund is made.

Period

A five year period has been proposed for the following reasons:

- The greatest uncertainty with regards to the incremental revenue for a connection exists in the first five year period, with the risk generally reducing over the remainder of the 15 year economic life of a non-residential connection;
- A shorter period was not adopted because it can take several years for a customer to achieve full load. This period includes the construction period which can be up to 18 months from the time of the connection;
- A longer period was not adopted because the benefits of a longer period didn't outweigh the additional administration costs; and
- A five year period represents a balance between mitigating as much risk as possible whilst minimising customer impacts and administration costs.

Ownership changes

The original contracting party would be paid any refund, unless there was adequate evidence to indicate that the Distributor’s contractual obligation had been novated to another party.