Response to proposed guidelines, models and schemes for electricity distribution networks

14 May 2008

1. Overview

Key points

- **Guidelines and models should be applied principally as a safe-harbour provisions**
- **Further detailed work beyond these guidelines and models should occur following successful transition**

The Energy Networks Association (ENA) welcomes the further opportunity to comment on the package of Australian Energy Regulator (AER) guidelines, models and schemes for electricity distribution network service providers released in April 2008.

Assuming economic regulatory functions for electricity distribution networks will present a challenge for the AER in incorporating a variety of jurisdictional regulatory practices into a national regulatory framework. In this early phase of transition, ENA considers that it is important for guidelines and models set out by the AER to serve as high-level 'safe-harbour' provisions for distributors.

Many of the detailed comments by energy network businesses on the guidelines therefore focus around the need to preserve flexibility for distributor's regulatory proposals to reflect their particular circumstances. For example, there may be a case for a diversity of approaches applying to efficiency carryover mechanisms applying across networks, and a re-examination of appropriate sharing ratios. Similarly, network businesses should preserve the choice to opt for higher-powered service performance incentive schemes where this matches the desired risk profile of the business.

An opportunity to examine the proposed guidelines and models and discuss them at the AER's recent workshop has also raised further comments and suggested improvements across the documents. ENA considers that if changes suggested in this submission are adopted, the final guidelines and models will be a workable set of regulatory instruments. ENA supports the AER's decision to defer further examination of a number of more complex issues of detail - such designing an incentives scheme around distribution losses or moving away from transparent, simple and commonly applied cash flow timing assumptions – until the regulatory framework has completed this transition phase.

2. Background

The Energy Networks Association is the national representative body for gas and electricity distribution network businesses.

Energy network businesses deliver electricity and gas to over 12 million homes and businesses across Australia through approximately 800 000 kilometres of electricity lines and 75 000 kilometres of gas distribution pipelines. These distribution networks are valued at more than $35 billion, and each year energy network businesses undertake capital investment of more than $5 billion in network reinforcement, expansions and extensions.

3. Response to issues raised on guidelines, models and schemes

3.1 Post-tax revenue model

Energy network businesses generally support the post tax revenue model (PTRM) developed by the AER.

The AER has proposed the development of a PTRM that incorporates capital contribution as part of the asset calculations. Consistent with previously stated position, ENA considers that alternative jurisdiction-specific approaches to the treatment of capital contributions for distribution should be dealt with through each specific reset process.

The ENA agrees with the AER's proposed approach of deferring any further consideration on cash flow timing assumptions until the issues can be considered jointly with the transmission sector in the future. This approach is important for regulatory consistency, and the objectives of examining the issue comprehensively and focusing on higher priority transition issues.

3.2 Cost allocation guidelines

The AER has stated that it will assess the cost allocation methodology on the basis of whether it is consistent with, and gives effect, the guidelines. While this reflects the relevant rule obligation ((6.15(4)(b)) as the ENA has stated previously, the AER should at the first round err towards acceptance of distributor proposed methodologies that are based on existing jurisdictional arrangements, and pursue harmonisation following the assumption in each jurisdiction by the AER of full regulatory monitoring and enforcement functions.

3.3 Efficiency benefits sharing scheme

Sharing ratio

Energy networks businesses do not consider there is a case for developing detailed default views on efficiency sharing arrangements applying across a diverse set of distribution network assets.

ENA recognises that an effective 30/70 sharing ratio has been a common feature of some efficiency carryover arrangements across several jurisdictions, whilst other jurisdictions have seen different sharing ratios and incentive arrangements adopted.

Providing a 30/70 sharing ratio for a five-year carryover period may not provide sufficient incentive to secure efficiency gains an environment where network businesses have been exposed to incentives for cost efficiencies for in most cases at least two regulatory periods. This suggests that early relatively low cost efficiency gains may have been made, and that more expensive gains will require larger up front capital investment. It is recognised that in other jurisdictions, complex incentive carryover schemes have not been in place.

As a consequence of this diversity of practice and circumstances, the ENA considers the AER should instead consider benefit sharing schemes and practical issues regarding their interactions with other schemes on their merits through the regulatory framework process.

The AER has stated that it will reconsider the appropriateness of the carry-over period where it is presented with evidence that a distributor is approaching its efficiency frontier. ENA considers it important that, to give effect to this commitment, criterion be developed to assess whether a distributor is reaching its efficiency frontier. Where it is determined that a distributor is approaching this frontier, the sharing ratio will need to be adjusted to provide sufficient ongoing incentives.

Rationale for allowance for negative carryovers

The AER indicated at the electricity distributor guidelines forum in April that the reason for negative carryovers is to counterbalancing any perverse incentives for fourth year expenditure differences in comparison to the other years in the regulatory period. It was acknowledged that as an alternative, the fourth year operating expenditure can be reviewed and compared to the other years and adjusted accordingly. ENA considers adjustment of fourth year costs to be problematic and that failure to use the outturn fourth year costs undermines the efficiency carry over mechanism.

Role of guideline on benefit sharing scheme

As a general principle, ENA believes that all substantive provisions related to the preparation and application of a distributor's efficiency sharing scheme should be detailed in the guidelines. ENA is concerned that, as currently drafted, the guidelines will rely heavily on the use of regulatory information instruments to provide the level of detail that distributors will require in effectively developing and applying the efficiency sharing scheme.

Capital efficiency schemes

ENA does not consider it appropriate for the AER to exclude capital expenditure from the efficiency benefit-sharing scheme. Consistent with a national framework that is sufficiently flexible to reflect a range of business strategies and network circumstances, a distributor should have the choice to propose a capital efficiency scheme where it is

willing to expose itself to the risks of such a scheme. Such a scheme may play an important role in sustaining incentives for non-network solutions to localised constraints.

Incentive mechanisms to address distribution losses

Energy network businesses already seek to minimise distribution losses both in network planning and operational decisions. At this time there is insufficient evidence to suggest that distribution losses are at inefficient levels, or that their levels could be meaningfully managed or mitigated in response to what would be a complex new incentive mechanism.

For these reasons, ENA agrees with the AER's decision to not develop a specific incentive mechanism around distribution losses.

3.4 Service target performance incentive schemes

Convergence towards a common approach to service target performance should be a 10-15 year medium-term objective, minimising duplication during the transition phase.

The AER has stated that the scheme is designed to allow for flexibility, and this is crucial to ensure a smooth transition for distributors.

Proposed cap on revenue at risk

The AER has provided for a cap of three per cent revenue at risk but will provide distributors with the opportunity to differentiate arrangements applying to their networks. ENA has a number of queries on the proposed operation of the scheme, including:

- the empirical rationale for a discretionary decision to impose a 3 per cent cap
- the definition of revenue to be used in a 3 per cent cap at risk
- whether underperformance or over performance outside of the cap are subject to carrying forward
- how any perverse incentives introduced by a cap will be mitigated

ENA supports the concept of a distributor being able to nominate 3 per cent revenue at risk cap as a 'safe harbour' provision, but considers that distributors should also have the flexibility to propose schemes that are either:

- low powered, particularly as a transitionary mechanism; or
- high powered and which do not feature maximum caps, reflecting the policy choice of governments to not impose a maximum threshold through the recently finalised National Electricity Distribution Rules.

Scope of exclusions

ENA considers the scope of available exclusions to be insufficient, and to risk the scheme operating in a perverse manner that would undermine the ultimate objectives sought by the community.

Exclusions should be expanded to recognise existing permitted jurisdictional exclusions, for example directions from all emergency service personnel, NEMMCO and automatic under-frequency load shedding. That is, the scheme should be designed to exclude both single large events and those events which, although smaller in terms of individual impact, are either outside the distributors' control or in aggregate are likely to result in unreasonable penalties being incurred.

An additional issue which rules on exclusions should accommodate is that eligibility of events should be assessed on a rolling 24-hour period from the commencement of the event, rather than a midnight-to-midnight assessment.

This avoids the timing of extreme weather events, for example, arbitrarily affecting eligibility for exclusion, and consequently the overall risk profile of revenues. Alternatively, a distributor should be permitted the flexibility to submit that a severe event constitutes a 'major event day' in those circumstances where the midnight to midnight timeframe for assessment would otherwise preclude the event's eligibility.

Planned interruptions

ENA disagrees with the proposed approach of treating planned interruptions in the same way as unplanned interruptions for the purpose of the incentive scheme.

Including planned interruptions within the service target performance incentive scheme is inconsistent with maximising incentives to maintain the network and there are potential negative incentives concerning the safety of network operation that are unnecessarily introduced through taking this approach. These considerations recently led to the approach current proposed by the AER, which was in force for a time in Victoria, being reversed as these issues were recognised by both distributors and the ESC.

The approach is also economically unsound as it presumes that customers are indifferent between planned outages (fixed time interruptions commonly occurring in business hours with several weeks or days notice) and unplanned outages, which are by the nature episodic and of varying durations. The ENA is unaware of any evidence to support this presumption, which is at odds with customer's capacity to avoid or shift at least elements of their electricity usage.

Relationship with jurisdictional minimum service standards (where applicable)

ENA seeks clarification about the relationship between the STPIS, minimum service standards imposed under state-based arrangements and targets applied in establishing capital expenditure and operating expenditure requirements.

ENA consider these issues should be reflected in the guidelines. It is ENA's view that jurisdictionally set minimum standard are the standards to which distributors need to design, operate and be funded in their distribution determination to achieve. The purpose of the STPIS thereafter should be to penalise or reward distributors for their year-on-year actual performance improvements/decrements (which would not require reference back to the minimum standards).

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