ESC08D00139
ESCOSA04/0003(1)

Level 8
50 Pirie Street Adelaide
South Australia 5000

GPO Box 2605 Adelaide
South Australia 5001

Telephone (08) 8463 4444
Facsimile (08) 8463 4449
Freecall 1800 633 592

www.escosa.sa.gov.au
escosa@escosa.sa.gov.au

6 February 2008

Mr. C. Pattas
General Manager
Network Regulation South Branch
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

REGULATION OF ELECTRICITY DISTRIBUTION NETWORK SERVICE PROVIDERS: ISSUES PAPERS

The Essential Services Commission of SA ("the Commission") welcomes the opportunity to comment on two Issues Papers released by the AER in November 2007, namely:

- Guidelines, models and schemes for electricity distribution network services providers; and
- Electricity distribution network service providers: Service target performance incentive scheme.

Detailed comment on the issues raised by the AER in these papers is provided below. However, the Commission first wishes to make a general statement in relation to the development of the regulatory schemes contemplated by the AER in the Issues Papers.

The Issues Papers discuss the establishment of a nationally consistent Efficiency Benefit Sharing Scheme (EBSS) and Service Target Performance Incentive Scheme (STPIS) to apply to DNSPs. Reference is also made to the development of a Demand Management Incentive Scheme later in 2008 and to other guidelines and schemes that may be developed by the AER under the NER. Each scheme is discussed separately by the AER, with an apparent focus on areas where differences may be warranted from those schemes that apply currently to TNSPs and to the specific design elements and incentive properties of the schemes adopted by other jurisdictional regulators.

While there is some discussion of certain linkages that exist between these schemes, the Commission recommends that the AER consider all relevant incentive schemes as a package, with a view to determining the best overall outcome required from a new STPIS, rather than considering disparate elements of those schemes on a stand-alone basis. There are significant interdependencies that exist between each scheme, and with other aspects of the revenue determination framework, such as the approach to setting expenditure benchmarks and the form of price control. All of these elements are critical to the setting an appropriate balance between service level incentives and efficiency incentives and, as a result, it is difficult to cherry-pick selected elements of various schemes and combine them into a cohesive whole.

The Commission also believes that the design of the incentives framework will need to take into account differences between DNSPs and their ability to respond to incentives, along with differences in consumer preferences. For example, consumer surveys conducted by the Commission have indicated that SA consumers are not willing to pay for improvements in reliability of supply, but this need not be the case in other states.

The Commission's detailed comments on the matters raised in the Issues Papers are as follows:

1. Guidelines, models and schemes for electricity DNSPs

Post-Tax Revenue Model

The Commission agrees that the PTRM, which assumes that all cash-flows except for capex occur at the end of each regulatory year, will result in overcompensation of DNSPs. Under this approach, price controls are set on the assumption that the majority of revenue is received at the end of year whereas, in fact, revenues will be received by DNSPs throughout the course of each regulatory year.

While the proposed present value adjustments discussed by the AER will alleviate some of this bias, the AER may also wish to consider modelling cash flows on the basis that all costs are incurred at the mid-point of each regulatory year, as a proxy for assuming that expenditure is incurred evenly throughout the year.

Capital Contributions

In considering the treatment of capital contributions received by the SA electricity distributor, the AER should take into account the requirements of clause 7.3(b)(iii) of the Electricity Pricing Order, which requires capital contributions to be removed from the regulatory asset base for all future regulatory periods in SA.

X Factors

It is unclear how indicative X factors could be calculated in advance of the determination of aggregate revenue requirements. To the extent that the AER is suggesting that it is looking to provide guidance on some of the principles for determining whether to adopt multiple X factors and whether or not any price increases/decreases are better dealt with through an initial price adjustment or by smoothing the impact over multiple years, the Commission recommends that the AER retain some discretion to address the particular impact on customers resulting from each DNSP price reset.

Asset Roll Forward

The Commission notes that clause 7.3 of the Electricity Pricing Order specifies certain requirements relating to the roll-forward of ETSA Utilities' asset base in future regulatory periods, which the AER should take into account in future regulatory periods in SA.

Cost Allocation Guidelines

Issues surrounding the use of regulated assets in the provision of both regulated and unregulated services, and the allocation of costs between these services, will require careful consideration by the AER.

The Commission notes that, under its 2005-2010 Electricity Distribution Price Determination, it effectively allowed a 100% allocation of the regulated asset base to the provision of prescribed services, but that it introduced a "P-Factor" in the price control formulae, which acts as a proxy for cost allocation between prescribed and non-prescribed services. The P-Factor allows distribution customers to share some of the benefits that ETSA Utilities earns by using regulated assets to provide excluded and unregulated services, by adjusting the maximum average revenue control such that 40% of ETSA Utilities' pre-tax annual profits earned from non-prescribed services that utilise prescribed assets are returned to customers.

Efficiency Benefit Sharing Scheme (EBSS)

The Commission believes that there are strong grounds to apply an EBSS to capex, in order to provide continuous efficiency incentives and to avoid inappropriate capitalisation of opex.

The Commission understands the arguments regarding difficulties in forecasting capex and the potential windfall gains or losses from such forecasting error. However, uncertainty of future capital projects, whether distribution or transmission projects, can be addressed in other ways that do not mitigate the effectiveness of the efficiency carryover mechanism in providing for continuous incentives. For example, pass-through or off-ramp arrangements are commonly used by regulators to address future events that are sufficiently uncertain as to warrant any related expenditure being considered at the time of the event rather than at the time of the price review.

The Commission also suggests that arguments that a capex EBSS may overcompensate a network business where the business defers capex from one regulatory period to another should be investigated further. The Commission notes that even in the absence of an efficiency carryover mechanism, the CPI-X regulatory regime inherently creates an incentive for a regulated business to defer capital expenditure from one period to the next. Where deferred capex is included in expenditure benchmarks in the following period, it is still possible for the business to retain more than 100% of the benefit of such deferral even without an EBSS. Therefore, removing the EBSS from capex may not necessarily resolve the deferral problem.

The Commission believes that the deferral incentive is more appropriately addressed through the expenditure benchmark setting process rather than through the EBSS. This would ensure that the desirable properties of applying an EBSS to capex, including providing for continuous capex incentives throughout the regulatory period and avoiding the creation of an artificial incentive to capitalise as much operating expenditure as possible, could be retained.

2. Service Target Performance Incentive Scheme

Relationship to framework and approach process (section 1.5)

The Commission notes, as an initial matter, that while there are often direct linkages between, for example, reliability standards (SAIDI, SAIFI etc) and their associated targets (allowed minutes/region etc) and metrics included within Service Incentive schemes (SI schemes), this need not be the case.

For example, while the Commission has established comprehensive reliability and customer service standards, with associated targets, in SA through the Electricity Distribution Code (refer clause 2 of the Electricity Distribution Code by way of example), only certain standards are considered by the Commission for the purposes of the SI scheme (as specified in Schedule 2 of the Electricity Distribution Code).

This degree of connection will be an important matter for the AER to consider in developing its high level principles. In particular, the nature of the relationship between jurisdictional reliability and customer service standards and the operation of the STPIS will need to be carefully articulated in terms of which incentives are being offered to DNSPs and how those incentives are in the long-term interests of consumers.

Purpose of STPIS (section 2.1).

While it is correct to say that schemes such as STPIS are aimed at providing incentives to meet service standard targets, two further matters need to be acknowledged.

First, one of the strengths of STPIS is that it need not be broad-brush in approach and application. If, as is the case in SA in the current regulatory period, it is considered that performance in relation to certain customer classes or standards warrants particular attention, then the STPIS may be targeted on those areas (to the exclusion of more general incentives). This, of course, reinforces the point made above as to the nature of the linkage between service standards (set by jurisdictions) and the economic incentives being imposed under the STPIS (as set by the AER).

It is the Commission's view that a targeted scheme should be applied in order to influence DNSPs' performance in relation to poorly performing parts of the network or the business (the latter in respect of customer service standards particularly). Underpinning that view is the premise that rewards for performance improvement which are based on merely providing better performance in sectors which are already doing well, to the detriment of poorly served sectors, are not properly targeted.

Secondly, any discussion of the means by which service standards are enforced is incomplete without a consideration of means other than STPIS. For example, under arrangements in SA in the transmission sector, the Commission has set service standards (exit point reliability standards) through the Electricity Transmission Code and the AER has specified the nature of the relevant STPIS.

Under such a model, where standards are not met, there will be an STPIS impact; importantly, however, there may also be a regulatory impact insofar as a failure to meet standards specified in an industry code means, in turn, that the business has also failed to meet a licence condition (compliance with industry codes being a mandatory licence condition required under the Electricity Act 1996 (SA)). As a result, there are a range of options open to the regulator which provide other incentives on DNSPs to meet standards.

The risk in conflating two separate issues, that is, STPIS and other regulatory responses to failures to meet service standards, into a single issue is that of perverse outcomes. Both matters need to be considered together and distinctly in the overall design of regulatory controls for distribution services.

National Framework (section 2.3)

As indicated previously, the development of a national STPIS will need to consider if the incentives that are considered appropriate for one DNSP, should be applied to other DNSPs. In order for the scheme to be effective, the financial incentives to improve service under the STPIS must be greater than the DNSPs costs of improving such service but should be less than consumers' willingness to pay for these improvements. It may not be the case that a certain level of financial incentive will be meet this criteria in all cases.

Public reporting schemes (section 3.1)

Public reporting of network performance against specified targets within standards is, as correctly identified by the AER, a fundamental part of economic regulation. The Commission would note that one of the issues to consider in the context of such reporting is what any next steps might be in cases where targets are not met: is it sufficient, as might be implied from the Issues Paper, to rely on a "name and shame" approach or is there a deeper role for public reporting?

GSL Schemes

The Commission supports the concept of GSL schemes as a useful regulatory tool. A number of observations are relevant to the discussion of such schemes in the Issues Paper:

- Funding: while a regulator may choose to include an expenditure allowance in relation to the payment of GSLs, this is not a necessary outcome. For example, allowances may themselves be best designed to contain an incentive element based on benchmark or historical performance. Moreover, to the extent that any GSL scheme is "fully funded", then the incentive element of that scheme would necessarily be compromised. It is noted that the Commission's existing reliability GSL scheme was funded to reflect historical performance, such that a financial reward can be earned by the DNSP if performance improves from the historical standard, and a financial penalty earned if it is worse than the historical standard.
- Compensation: one critical matter is that GSL payments are not compensatory in a legal sense (i.e., no proof of injury or damage is required or assumed in a GSL scheme). Instead they may best be considered as liquidated damages payments: the payment of a pre-agreed sum of money for breach of a contractual obligation. This, of course, goes to a fundamental assumption about the nature of the relationship between DNSPs and customers and the rights and obligations that exist between them. The Commission understands that matter to be receiving consideration through the MCE consultation process (under the auspices of the Retail Policy Working Group) and notes that issues such as GSL schemes need to be considered in light of that work.

Interaction between GSL schemes and s-factor schemes (section 3.4)

As noted above, there is not necessarily a complete linkage between service standards set by jurisdictions and elements of STPIS schemes. For example, not all standards need to be included with such schemes in order to provide the necessary incentives.

The Commission does not agree with the statement made in the Issues Paper that "*GSL schemes are aimed at **maintaining** minimum service levels to worst served customers*" (emphasis added).

It is the Commission's view that GSLs don't seek to maintain minimum service levels, but rather are aimed at providing DNSPs with an incentive to improve its service levels, to the extent that it is cheaper to do so rather than pay the GSLs. That is to say, if the DNSP pays out GSLs rather than fix any problems because the former is less costly, then this is the correct incentive.

Reliability Indicators (sections 4.1, 6.1 and 9.2.1)

The Commission notes the observations made in the Issues Paper regarding the agreed standard definitions developed by jurisdictional regulators and the likelihood of having sufficient accurate historical data to set targets. Based on its experiences in this area, the Commission would caution against any assumptions of that nature.

For example, issues such as whether low-voltage historical performance is included in measures of reliability and on what basis, or the nature of data captured (through an outage management system or a manual process), let alone the extent to which different regulators have pursued the standard definitions, all will have a significant impact on the data.

The Commission also notes the various measure-setting methodologies identified in the Table at section 6.1. Again, there are, in the Commission's view, likely to be significant issues in terms of the length and reliability of any data sets available for at least the next 5 years which warrant close attention in the development of any scheme.

By way of example, the Commission has previously identified (in 2002) that historic performance data in SA in certain areas was so poor that it was not able to be relied upon in the regulatory context, which required development of new base-line targets based on assumptions. Such work may be required in the future by the AER.

If you wish to discuss the matters raised in this submission with the Commission, please contact Nathan Petrus on (08) 8463 3767 or Adam Wilson on telephone (08) 8453 4354.

Yours sincerely,

Patrick Walsh
Chairperson