Submission

to

Australian Energy Regulator's Draft Decision & Revised DNSP Proposals – Review of the Regulatory Proposals by the NSW Electricity Distributors

16 February 2009

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Executive Summary

The Energy Users Association of Australia (EUAA) welcomes the opportunity to provide a submission to the Australian Energy Regulator's (AER) regulatory review of the three NSW Electricity Distributor's (hence DNSPs) regulatory proposals for the period 1 July 2009 to 30 June 2014**.** The EUAA is a non-profit organisation focused entirely on energy issues with membership exceeding 100. Our membership includes many of the largest electricity users in New South Wales who will be directly affected by this review**.** As this is the first regulatory review of electricity distribution businesses by the AER, the quality of the process and outcome is particularly important in terms of the future health of economic regulation of distribution businesses

The EUAA strongly urges the AER to adhere to principles behind network pricing:

- Outcomes, including prices and service levels, that mimic outcomes that would be expected in a competitive market;
- Low cost, efficient & effective operations meeting defined technical system and customer service levels;
- Efficient and timely investments to meet growth and defined system security standards;
- Cost reflective tariff rates and tariff structures; and
- Predictability over time to provide greater confidence in long term investments, especially in energy intensive industries.

The summary of the major points made in this submission are:

1. The NSW DNSPs have submitted revised average price impacts in their January 2009 proposals that are above both their June 2008 proposals and well above the AERs determination in November 2008. (The following charts compare the initial average price impacts for 2009-10 and the average price impacts for the remainder of the regulatory period) submitted to the AER during the regulatory determination process).

Country Energy revised proposal (Chart 1) sees initial average price increases for 2009-10 at 24.6 percent compared with 23.1 percent in their original proposal and 19.7 per cent in the AER Draft determination. For the remainder of the regulatory period 2010-14 (based on the June 2008 and the AERs determination) the average price increase 6.8%.

Energy Australia' revised proposal (Chart 2) sees initial average price increases for 2009-10 of 39.3 percent compared with -29.4 percent in their June 2008 proposal and 24 per cent in the AER Draft Determination. For the remainder of the regulatory period 2010-14 (based on the June 2008 and the AERs determination) the average price increase 10.4%

Integral Energy' revised proposal (Chart 3) sees initial average price increases of 19.5 percent for 2009-10 compared with 18.2% from their June 2008 proposal and 15.4 per cent in the Draft Determination. For the remainder of the regulatory period 2010-14 (based on the June 2008 and the AERs determination) the average price increase 3.5%.

Chart 1: Country Energy average price increases 2009-10 to 2013-14

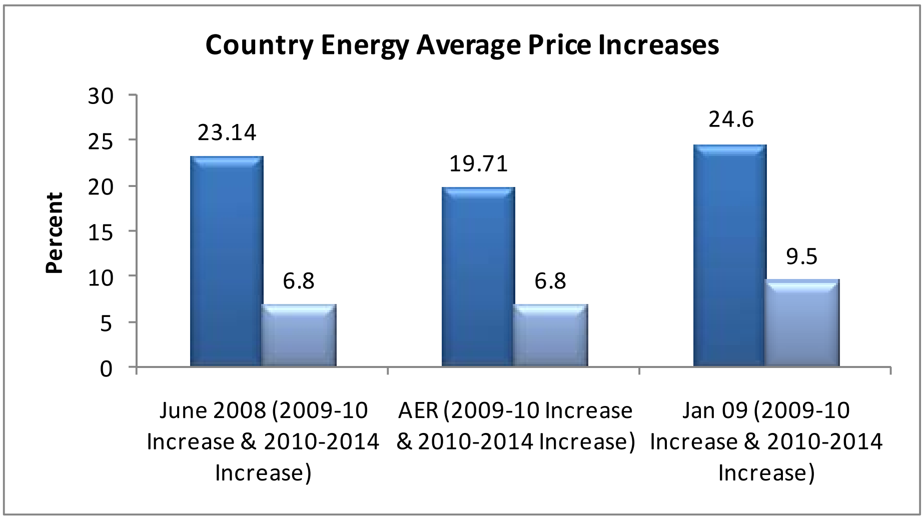


Chart 2: Energy Australia average price increases 2009-10 to 2013-14

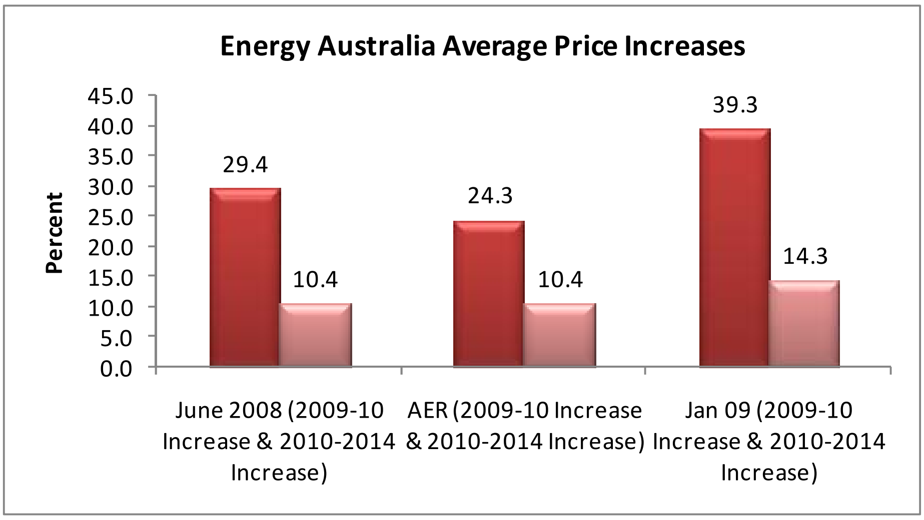
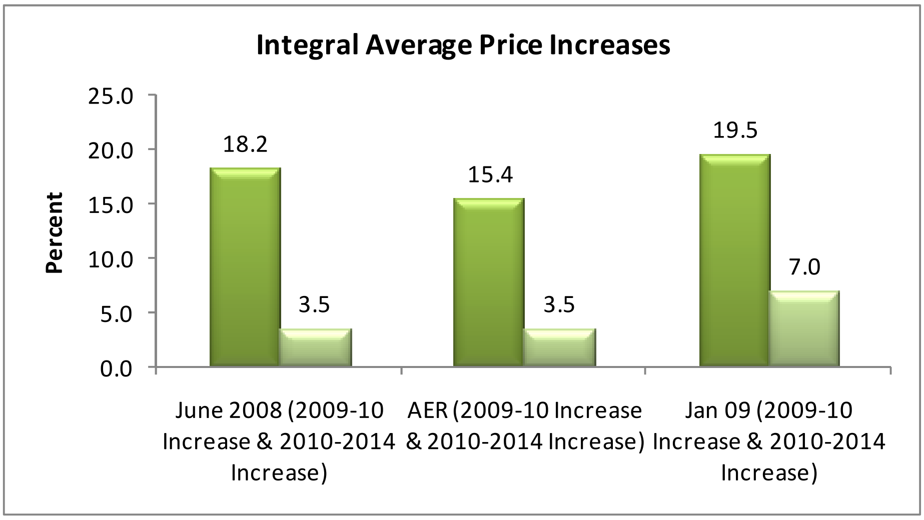


Chart 3: Integral Energy average price increases 2009-10 to 2013-14



Despite the significant increase is average prices sought, the proposals do not provide sufficient relevant quantitative data to support the case for such large increases, which will impact negatively on the competitiveness of Australian energy users. Such large price increases over the next 5 years, a period of cost pressures on multiple fronts including higher electricity costs, gas cost pressures, a carbon price, renewable energy costs and higher network charges, will create unacceptable price increases for EUAA members. They also come at a time of expected significant (and perhaps prolonged) economic downturn for Australia, which is placing additional pressures on energy users, who are forced to bear the costs of this determination. Many of these companies are already under pressure and have had to make difficult decisions to curtail their operation, reduce capex and opex and shed jobs. It is no exaggeration to say that such cost pressures could put the viability of some businesses at risk. By contrast, the NSW distributors' proposals (original and revised) and the AER's draft determination seem to be adopting a 'business as usual' approach as though the economy is still in boom times. The AER should be cognisant of the broader influences of its decision in assessing the DBs' proposals.

2. While the DNSPs have revised their demand forecasts downward from their June 2008 proposals, the EUAA requests that the AER perform a robust analysis of the revised forecasts so that they accurately reflect the economic environment in which they are deemed to occur, including the latest data on declining economic activity. As outlined in the body of the submission, official forecasts at both nationally and for NSW have recently been revised downwards significantly. This is not reflected in the original and revised proposals from the DNSPs or in the AER Draft Determination. The risk of not getting this right is that users will be required to fund assets and other expenditures by the DNSPs that will never be undertaken.

3. The reasons for the low impact – past and future – of Demand Management (DM) programs on curbing peak demand should be investigated, and actions taken so that DM becomes a serious part of DBs' approach to managing their networks better and more cost effectively. However, under the DBs' proposals, DM will continue to remain not much more than a token gesture during the 2009/2014 regulatory period. The need for a more central role for DM in the distribution system is commonly expressed, including by the AER, but not much seems to happen. However, the need is becoming more-and-more urgent as peak demand continues to grow and puts stresses on the DNSPs systems. All DNSPs agree that investing capital in network upgrades to meet these peaks is very costly. DM offers are far more cost effective solution. The recent load shedding by distributors in Victoria and South Australia due to high temperatures and high peak demand shows the importance of the issue and the need for action.

4. Performance indicators measuring operational productivity and asset productivity are needed to provide assurance at a high level that the DNSPs are operating efficiently and that there is a program in place for continuous productivity improvements. We can see no evidence of this in either the DNSPs' proposals or the AER Draft Decision – a most disappointing and unsatisfactory outcome for energy users. The EUAA would urge the AER to give economic efficiency as much importance as the other factors in assessing the reasonableness of the expenditure proposals.

5. It is not acceptable to end users that, after four regulatory reviews of the NSW distribution networks over 15 years; we still do not have a decent service level performance regime in place for the businesses. This is a disgrace. Whilst this is the first regulatory review of the NSW distribution businesses by the AER, we would urge them to do more on this in the Final Determination to

ensure that such a regime is in place well before the end of the next regulatory period. This should include service reliability and service quality aspects. We note that Victoria has had such a regime in place for two regulatory periods, as has South Australia. Only then will end users begin to have some appreciation of what the increased costs that are being proposed as part of this determination are actually delivering to them in terms of service levels. We suggest that the AER consider establishing a working group of the NSW distributors and end users, chair by it, to deliver such a regime within 12 months of the beginning of the next regulatory period.

6. There is a lack of transparency and comprehensiveness in ensuring cost reflective tariffs in the regulatory process that leads to a lingering suspicion that business customers carry a disproportionate share of the cost burden of the distribution network. The EUAA would urge the AER to look at means of tightening the regulatory oversight of the tariff (rate) design process to ensure that the principles of "user pays" and "no cross subsidy" are fully and unambiguously adopted by the DBs in their tariff design.

7. The EUAA supports the AER's Draft Determination on the matter of tightly defining and limiting the ability to pass through costs. It also agrees with the AERs' view, expressed at the NSW Public Forum on 30 July 2008, that pass through events need to be tightly defined in the first instance so that there is a proper sharing of risk between businesses and consumers, and DNSPs do not use pass through events to remove all risks. The EUAA has significant reservations about the AER's proposal to allow pass through for Retail Events related to possible privatization of NSW electricity retail businesses and their separation from the DNSPs. These should be paid for out of the proceeds of any privatization not by end users through distribution charges.

8. Finally, the EUAA feels that certain aspects of the so-called 'incentive' approach to the economic regulation of transmission and distribution businesses in the National Electricity Market, such as price outcomes, capex and opex outcomes, service levels, cost reflective tariffs, promotion of demand management, have not produced the results promised by the policy makers. A cost-plus mentality seems to have emerged with every larger increases in network businesses' expenditures from one regulatory period to the next, there is an absence of comparative benchmarking such that the performance of network businesses cannot be properly assessed and the need for the regulatory regime to promote greater efficiency by the network businesses seems to have been put aside. Users are now seriously questioning the value of the regime and what it is capable of delivering to them. The EUAA therefore believes that, after ten years, it is time to conduct an extensive review of the regime and to access its performance. From an end users point of view, the regime has degenerated into an excuse for cost escalations from one regulatory review to another, associated impacts on prices and it is less and less delivering what it was meant to – efficient network monopolies with outcomes that mimic those that would be seen in a competitive market.

1. Introduction

The EUAA made its "Submission to the Australian Energy Regulator (AER)'s Review of the Regulatory Proposals by the NSW Electricity Distributors for the period 1 July 2009 to 30 June 2014" in August 2008, in response to the price and service proposals by the NSW DNSPs. Having considered the original DNSPs proposals and all submissions from stakeholders, the AER released their findings in the document "New South Wales Draft Distribution Determination 2009-10 to 2013-14" in November 2008, which, among other things, required the DNSPs to make revisions to their original proposals. In response, the NSW DNSPs provided revised proposals in January 2009 taking into account the points made by the AER in its November 2008 Draft Decision.

The EUAA is now pleased to make this submission commenting on the AER Draft Decision and the Revised DNSP proposals. This supplementary EUAA submission should be read in conjunction with the original EUAA submission, though some issues have been re-iterated which in the EUAA view, has not yet been fully addressed in the AER draft.

1.1 Customer Impact of the Proposals

As emphasised at the AER public forum in December 2008, energy users are facing rising costs challenges on multiple fronts – the costs of electricity are rising and our members are now paying (on average) 50 percent more for their contracted power than they were under existing retail contracts.[1] In addition, gas prices are increasing due to a lessening of competition and in the future there will be a greater demand for gas both domestically and internationally; and LNG exports from Queensland will put further upward pressure on prices. The addition of the *Carbon Pollution Reduction Scheme* and the expansion of the *Renewable Energy Target*, where the target is to have 20% of electricity generation to come from renewable sources by 2020, will create additional cost pressures for end users. It is no exaggeration to say that these cost pressures could drive some users out of business or result in a scaling back of operations and job losses. This would not be advantageous to energy users, the electricity supply chain or the Australian economy at the cusp of a recession. The AER cannot solve all these issues in this review but needs to see this review in this context and recognise that its determination will have a significant impact on the competitiveness and future wellbeing of Australian energy users.

In addition, the current economic woes have seen some of the world's largest companies revise down their capital expenditures, slash their workforces and delay investments in new projects. These decisions have been especially influenced by an environment of falling commodity prices

[1] Based on a survey of EUAA members in 2008.

and reduced demand for resources from developing countries such as China. The International Monetary Fund has said that the current economic climate is the worst global recession in 60 years and forecast that the Australian economy will shrink this year and probably beyond.[2] Of all the States, New South Wales, the subject of this review, is the economy already most deeply in recession, and therefore this review is very susceptible to overly optimistic forecasts of electricity demand.

EUAA members in NSW have made adjustments to their operations under the current economic climate. For example, Boral has closed down two brick manufacturing plants in NSW[3]; and retailer Harvey Norman has closed four of its office supply stores citing the current economic down turn as the contributor behind the decision to close those stores[4]. However, the NSW DNSP proposals and the AER Draft Decision propose to carry on business as usual. This is extraordinary considering the major adjustments that other sectors of the economy have made over the past four months and will continue to have to make well into the next regulatory period. The economic downturn will also result in reduced demand for electricity which will have flow on effects, including in that portion of capital expenditures aimed at meeting forecast network growth.

Even though the NSW distribution businesses are regulated monopolies there is no certainty on prices for customers. This seems contradictory to energy users as regulation should give greater certainty as to price changes. The distribution businesses have given some indication of the costs to users in their revised regulatory proposals;[5] however, the EUAA would like to see more done to create certainty for end-users as to the potential impact of distribution charges on businesses and households.

The AER has stated that it 'will consider what can be done to create more certainty for users in dealing with price increases in transmission charges.[6] While these comments are welcome and relate to the TransGrid review, the EUAA would like to see similar action taken for increases in NSW distribution charges. The EUAA seeks clarification from the AER as whether it is proposing similar action for NSW distribution charges.

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[2]

[3] www.theaustralian.com.au '*Construction hopes for rebuild*'

[4] www.theaustralian.com.au '*Harvey Norman's Office a No-Go*'

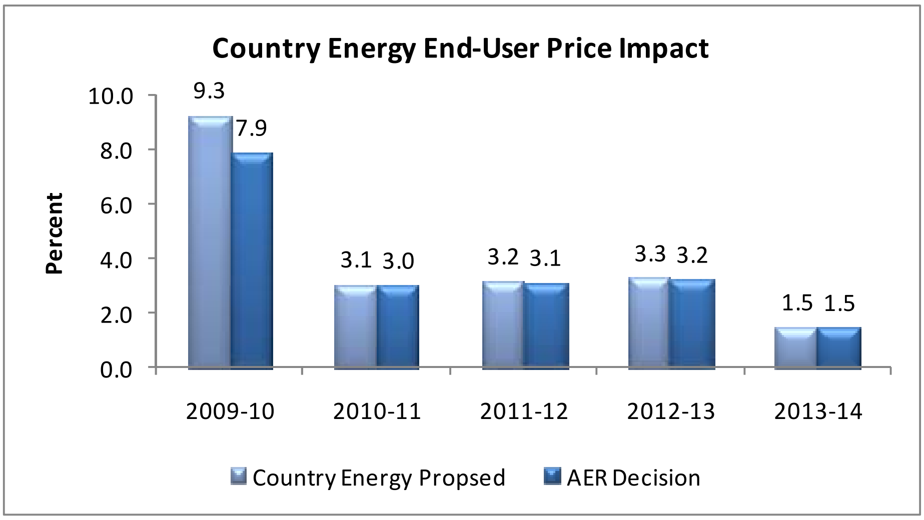
[5] For example, Integral Energy *Revised Regulatory Proposal to the Australian Energy Regulator 2009-2014.* p 85.

[6] AER *Minutes of the Pre-determination Conference for NSW transmission and distribution draft determinations (1 July 2009 to 30 June 2014) p6. Comment by Mr Steve Edwell.*

1.2 Price Impact

The following charts show the average price impact as the percentage increase in the distribution charges for the customers of Country Energy, Energy Australia and Integral Energy.

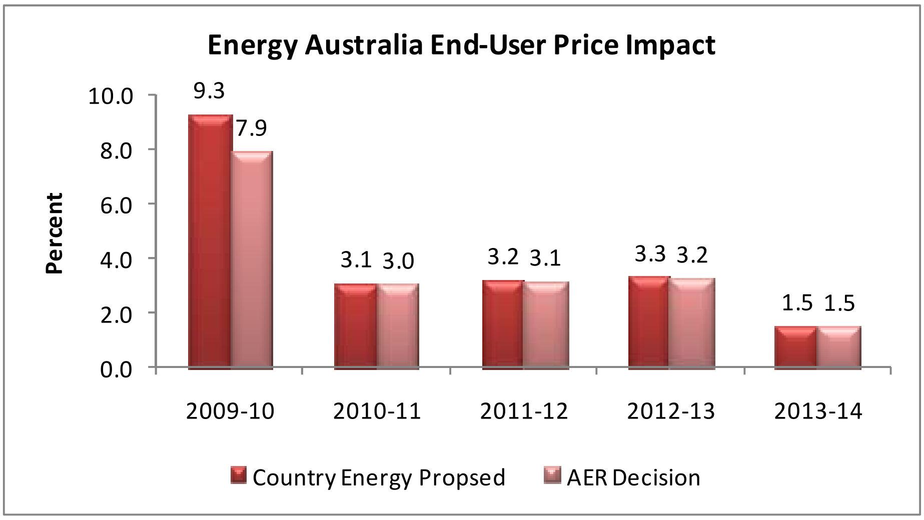
Chart 4: Country Energy End-User price impact[7]



Based on the AERs determination 2008 Country Energy's customers would see price impacts of 7.9 percent for 2009-10 and over 3 percent from 2010-2011, with their only relief coming into the final year of the regulatory period.

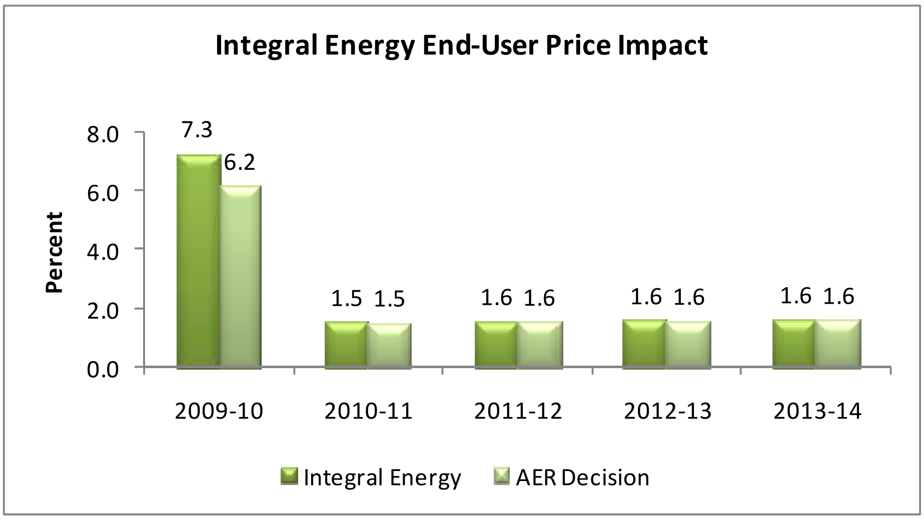
[7] Draft Decision NSW Draft Distribution Determination 2009-10 to 2013-14

Chart 5: Energy Australia end-use price impact[8]



Based on the AERs determination proposal Energy Australia's customers would see price impacts of 9.7 percent in 2009-10 and price increases over 3 percent for the remainder of the period.

Chart 6: Integral Energy end-use price impact



Based on the AERs determination Integral Energy's price increases of over 6 percent in 2009-10 and over 1.5 percent for the remainder of the regulatory period.

Despite the reductions in the percentage increases that end use customers would see as a result of the AER Draft Distribution Decision end-users still face substantial increases in their distribution charges, especially EUAA members in NSW who spend several million dollars a year in electricity purchases. It is important to note that the price rises faced by the customers of the relevant DNSP

[8] Ibid.

are based on the draft decision and not the revised revenue requirements submitted to the AER in January of this year, which are higher than their original proposals. End-users could see even larger increases than what is demonstrated above. The EUAA would like to reiterate that the impact of these proposed distribution price increases will place further pressures on end users when they are facing distressing economic times placing further pressures on their strained financial resources.

1.3 National Regulatory Approach Needed

Electricity distribution and transmission is a mature technology and each business providing these services is a natural monopoly within its service territory. While each of these businesses is in some ways a unique business, many of the business drivers in the Australian National Electricity Market (NEM) are comparable, with differences governed by issues such as customer mix, customer dispersion, geography and climate. In this regard, the EUAA hopes that the AER will adopt standard policies and processes in its future regulatory determinations of various jurisdictional distribution and transmission businesses, and thus improve the effectiveness of the regulatory process and the quality of the outcomes for end users.

Such a uniform approach has much to commend it from a customer perspective as well, since many EUAA members operate in more than one jurisdiction and have to deal with many distribution and transmission businesses not only on matters of pricing but also on connections, service reliability and quality. Greater reliance on comparative benchmarking across Network Service Providers (NSPs) is critical to giving customers greater certainty that what they are paying is closer to efficient costs. It is extremely disappointing that, after a decade of so-called 'incentive regulation', there is still very limited use made of benchmarking and the AER has not progressed this important matter in this review to date. We would urge them to take further steps in this direction as part of the Final Decision.

One example of the need for standardisation is in the documentation of the DNSPs' proposals. While the proposals by these businesses are very comprehensive in their coverage of the various regulatory issues, they differ in their scope, structure and format, particularly the Energy Australia proposal. There are differences in the presentation (how and where) of even high level comparative information, such as:

- The regulatory determinations of forecasts of demand, energy, capital expenditure, operating expenditure and service standards during the current regulatory period (2004/2009), and the actual performances against their promises are not presented in a transparent fashion.

- The forecasts of the above for the next regulatory period (2009/2014), and how they are justified in light of their actual performance against such targets for the current period. (2004/2009).

While diversity in presentation of one's case may be desirable and is, to some extent, probably unavoidable, the fact remains that a similar document structure of all DB's proposals would assist the public consultation process and would enable a more thorough and effective way of comparing different proposals by stakeholders (customers), who are not as close to the details of the issues as the proponents and the *AER.*

The EUAA is happy with the format of the AER 2008 *Distribution Draft Determination* as its layout was clear and the AER position and justification was clearly stated. It was also clear how the AER dealt with the submissions it received from stakeholders; however, the EUAA would like to reiterate its position that the proposals submitted by the DNSPs follow a standard format and that this issue has not been adequately addressed by the AER.

2. General Comments on the Distributors' Proposals

The EUAA comments in this section have been structured so that they are applicable to all three Distributors proposals to varying degrees. The comments address mainly the principles and rationale underpinning various issues, rather than the veracity of specific details and numbers in the three proposals. We believe that forensic analysis of such proposals is contrary to the intent of so-called incentive based regulation and, in any case, the resources available to us would not permit this.

The Distributors' requests for large price hikes may be a reflection on the ineffectiveness of past regulatory processes and determinations. What ever the case may be, the proposed large increases make it even more important that the AER carefully scrutinise the proposals and ensure that its review is robust and thorough. As mentioned earlier, energy users are already facing significant costs pressures on multiple fronts, are facing the likelihood of a significant recession and will be depending on the AER to produce an exceptional outcome in this review that matches the challenges facing users and the economic times.

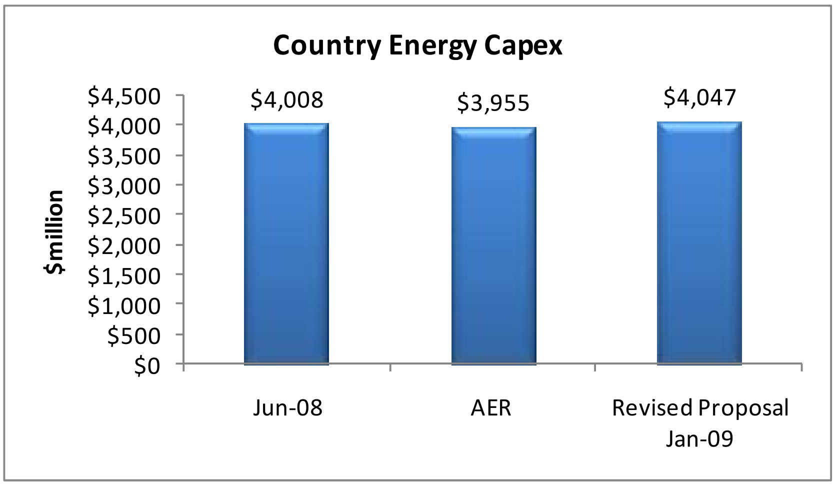
A very thorough assessment by the AER of the previous regulatory processes and determinations, as well as the Distributors' performances in the 2004/2009 regulatory period (against their promises) is necessary to understand why and how such high requirements for capital expenditure and operating expenditure have accumulated in all the Distribution networks. Operating costs appear to lack any substantial benchmarking and meaningful efficiency and productivity improvements which is a standard business practice for businesses operating outside of economic regulation.

This is a pre-requisite before the AER can reasonably assess the revised set of proposals. Without such an understanding, there is no guarantee that rate shocks will not occur again in the future. We are disappointed that the Draft Decision has not done this and urge the AER to remedy this in its Final Decision.

2.1 Capital Expenditure

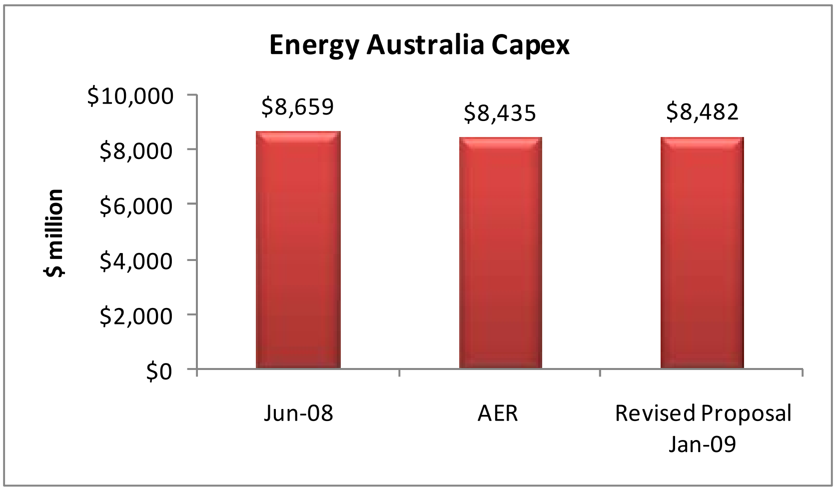
The EUAA is pleased to see that the AER has made adjustments to the capex proposed by the NSW DNSPs in their June 2008 proposals; however, the EUAA is still concerned over the capex proposed in the NSW DNSPs revised proposals and the AER Draft Determination. While making some adjustments the EUAA feels that the adjustments in the Draft Determination should have gone further. End-users would like to see the DB's justify their proposals more robustly and provide the information to assure us that the costs that our members will be required to pay are well founded. We strongly urge the AER to undertake a robust analysis of the revised proposals provided by the NSW DNSPs in January 2009, especially as the DNSPs, apart from Integral Energy, have elevated their capital expenditures above their June 2008 figures and well above the AER determinations; this is extraordinary in an environment of economic downturn. This applies particularly to Energy Australia and we fail to understand why their revised proposal should increase capex significantly above what was already a highly questionable original proposal.

Chart 7: Country Energy's capex.



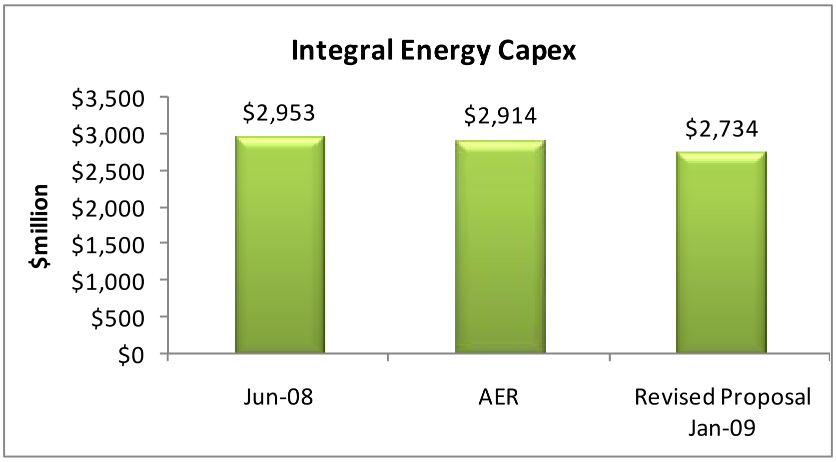
Country Energy's revised capex is nearly $40m above is June 2008 proposal and approximately $90m over the AERs determination.

Chart 8: Energy Australia's Capex



Energy Australia's revised capex (including transmission services) lower than its June 2008 proposal but approximately $57m above the AERs determination.

Chart 9: Integral Energy's Capex.

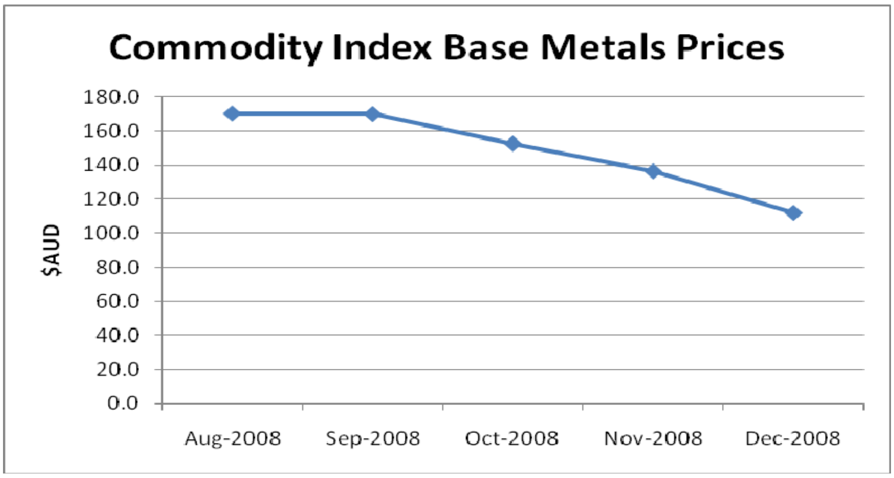


Integral Energy is the only DNSP who has made revised capex that is lower than both its original proposal and the AERs determination and the EUAA applauds Integral Energy for doing so.

The current global economic woes have seen falls in materials costs domestically and globally. The Reserve Bank of Australia's Index of Commodity Prices shows a decrease in commodity prices of 4% in December 2008. [9]

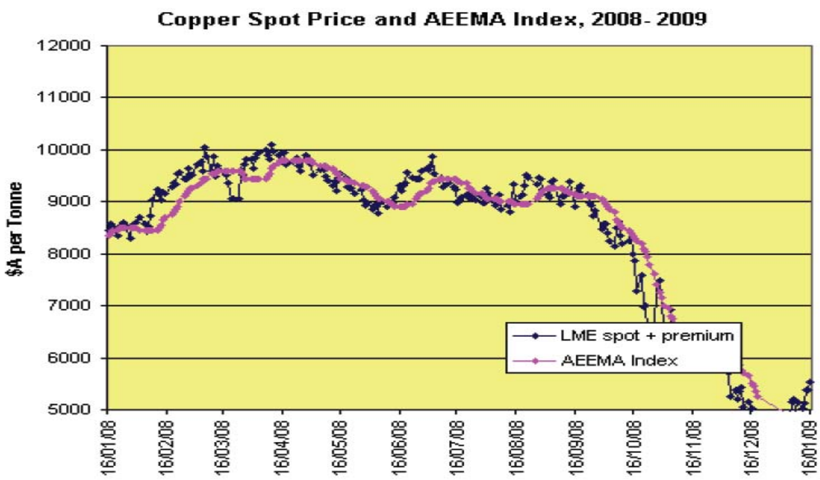
[9] Reserve Bank of Australia '*Monthly Statistical Release*' Index of Commodity Prices 2 Feb 2009

Chart 10: RBA Commodity Index for Base Metals Prices



The above chart demonstrates the falls in base metals prices since August of 2008. Reserve Bank of Australia data shows that base metals prices have declined from a high of $A170 per tonne to around $A110 per tonne in December of 2008.

Chart 11: Copper Spot Prices Jan 2008-Jan 2009[10]



The above chart shows the falling copper spot prices and the Australian Electrical and Electronic Manufacturer's Association (AEEMA) copper prices index. This index shows substantial falls in copper spot prices from $A9000 per tonne in August-September 2008 to just over $A5000 per tonne in mid to late 2008.

The AER has stated that it will "review the cost of capital close to the final determinations so that it accurately takes into account the predicted economic climate as the cost of capital has fallen to

[10] Olex Cables Australia www.olex.com.au/Miscellaneous/Copper-Price.htm.

9.72% as at 17 October 2008 from 11% in the middle of 2008."[11] The AER has further suggested that the other input costs such as falling commodity prices will be reviewed closer to the final determination.[12] The EUAA welcomes this and expects that such revisions will result in significant reductions.

2.2 Operating Expenditure

The DNSPs have submitted revised opex expenditures that deviate from their June 2008 proposals. County Energy's revised opex is approximately $2,212m up from $2,159m and the AERs November determination of $1,977m. Energy Australia is the only DNSP who has submitted a revised opex that is below its June proposal; it has reduced its opex from $3047m down to $2,992m, however this revised figure is approximately $350m above the AERs determination of $2,637m. Integral Energy's revised opex is $1,485m up from $1,477m and the AERs determination of $1,460m.

Wage growth is a significant part of the opex for the DNSPs. Since the worsening economic climate wage cost pressures have fallen. As a result, the Reserve Bank of Australia has revised its Wage Price Index for 2009-10 to 3.5% down from 4% in 2008-09 and expects this index to remain static at 4% for 2010-11 to 2011-12. The RBA now supports an easing in current and expected labour costs from business as wage pressures have eased in the economy.[13]

The EUAA feels that the opex costs are inflated and yet again there are few efficiency improvements in the opex forecasts by the DNSPs. The EUAA feels that the AER should make a robust assessment of the revised opex expenditures provided by the businesses to ensure that these expenditures are cost effective and efficient.

2.3 Service Level Regime

Service performance is discussed in the proposals under two categories: System Reliability and Power Quality. Reliability and power quality are closely linked to capital expenditure and, to a lesser extent, operating expenditures, but the proposals do not clearly set out the linkages between them.

The EUAA feels that it is not good enough for the AER to not impose on NSW DNSPs targets for improvements in service levels. Energy Australia expressed the view in its January 2009 revised revenue proposal that the Service Target Performance Incentive Scheme should use the definitions, methods and exclusions consisting with its current licence conditions under the NSW Department

[11] AER *NSW Draft Distribution Determination 2009-10 to 2013-14.* 21 November 2008 p xv.
[12] Ibid. p xxxvi
[13] RBA Statement on Monetary Policy Feb 6 2009 p 61.

of Water and Energy (DWE). Energy Australia feels that service targets should focus on improving the performance of an individual DNSP relative to its service standard obligations under its NSW DWE licence.

The AER has said that the existing data set used by IPART for assessing service standards is not reliable enough to have service targets for the businesses at a national level; and that the businesses already have targets established by the NSW Government. This is not a valid reason for delaying the imposition of a STPIS and the EUAA requests that the AER clarify the logic behind this position.[14] It is disgraceful that after four regulatory reviews over 15 years there is still no independent and transparent service level performance regime as part of the regulation of the NSW distributors. As the AER is now responsible for regulating the NSW DNSPs, these service targets should be transferred to the AER for the 2009-10 to 2013-14 regulatory period. Robust service targets would at least allow end users to more transparently see what service they are getting for their significantly increased distribution charges.

We would strongly urge the AER to take a firmer line on this and insist on the inclusion of such a regime as soon as possible into the next regulatory period. We therefore suggest that the AER chair a working group made up of the NSW distributors and end users tasked with developing such a regime within 12 months of the start of the next regulatory period.

System Reliability:

In our August submission, the EUAA outlined in some detail its concerns with the DNSP proposals to address the reliability issues, referring to SAIDI and SAIFI indices as performance measures. For example, in its original submission, Integral Energy had reproduced SAIDI and SAIFI performance target for 2009/2014 as per the NSW Licence Conditions in Tables 5.4 and 5.5 (Page 58), which remain constant during the period. Integral Energy's proposal said "Integral Energy's planned targets will lower (i.e. improve) SAIDI over the 2009 regulatory control period". Energy Australia had provided data on expected percentage improvements in SAIDI and SAIFI up to 2006/2007 to 2010/2011, but not actual values, and not beyond 2010/11.

There are few details on quantifiable improvements in the duration and frequency of interruptions for the customers of Country Energy, Energy Australia and Integral Energy. Neither has there been any discussion based on past performance or correlations, if any, between expenditure levels and improvements in SAIDI and SAIFI. Transparent improvements in system reliability for the customers of the DNSPs are not an unreasonable request, especially as they are paying for the expenditure programs through higher tariffs. The EUAA made these points in its original submission to the AER and would again request that this issue be looked at as part of the final

[14] AER *Minutes of the Pre-determination Conference for NSW transmission and distribution draft determinations (1 July 2009 to 30 June 2014) p6. Comment by Mr Steve Edwell.*

distribution determination to ensure that end-users are getting value for the capital expenditures they are paying for through their higher tariffs.

Power Quality:

Power quality such as voltage level, voltage unbalances and harmonics is very important to many EUAA members, who feel the impact of power quality on their business operations. However, none of the proposals provide any quantifiable data on power quality – current or forecast – such that it is difficult to know the impact of the significant proposed increases in expenditure over the next regulatory period on improvements to power quality.

It was understood from IPARTs previous determination that sufficient data would be gathered by the DNSPs on power quality during the current regulatory period that would provide a basis for more quantified performance targets for the 2009/2014 period on power quality. This does not seem to have occurred. The EUAA requests AER clarifications on this matter. We would be interested in understanding the reasons behind the apparent non-delivery of this aspect of the previous IPART determination. In any case, it is unacceptable to end users that they are now being asked to wait a further 5 years for the information needed to commence a robust regime. The AER must ensure that the same failure to deliver does not happen again.

2.4 Service Target Performance Incentive Scheme (STPIS)

The AER has not accepted Energy Australia's suggestions to use the existing data set being collected under the licence conditions imposed by the NSW Department of Water and Energy. The AERs key reasons for collecting a nationally consistent separate set of data during 2009-14 period (with the aim of establishing a financially linked STRIS scheme for the 2014-2019 period are: (Page 235)

- *existing performance data in NSW was not considered robust enough for use in setting targets linked to financial penalties in the immediate future;*
- *the timeframes mandated by the transitional chapter 6 rules meant that there was limited opportunity to consult and develop a robust STPIS to apply for the next regulatory control period*; and
- *for the 2009-2014 period, rely on the existing mandated performance licence conditions imposed on DNSPs by the Department for Water and Energy "which were likely to drive improvements to reliability during the next regulatory control period and the consequences of this for setting performance targets could not be adequately assessed.*"

As "the AER has developed and published its National Distribution STPIS following stakeholder consultation in early 2008" the AER may not include any new parameters other than what is stated in table 12.1 of the Draft (Pages 239 and 240). However, the AER has promised to consult with the DNSPs (and we would hope also end users) in setting the values for performance targets for the 2014-19 period.

As the AER has determined that "*existing performance data in NSW was not considered robust enough for use in setting targets linked to financial penalties in the immediate future*", the EUAA would like clarification on why the existing data from the NSW Department for Water and Energy was not considered robust enough? We appreciate that this data may not be ideal but the alternative seems to be that users must wait yet another five years for a STPIS.

2.5 Demand Management

The importance of DM to the cost effective operation of the NSW DNSPs' networks – and hence that network charges that end users are forced to bear – was succinctly captured by Mike Buckley of the AER at the December 2009 Pre-Determination Conference, as per the minutes:

> "*Mike Buckley (AER) advised (that) MMA concluded that growth in energy consumption is slowing but not to the same extent as growth in maximum demand. Subsequently, this is driving disparity in pricing as more network is needed to deliver smaller amounts of energy for short periods of time. Mr Buckley further advised that this results in a need for increased investment to serve maximum demand even though energy consumption is not growing at the same rate as maximum demand.*"[15]

Thus, the key performance indicator for a successful DM policy / program would be the reduction in the disparity between the growth rates for energy and maximum demand. However, most of the debate and comments on DM by the DNSPs and the AER seem to be centred on incentives, recovery of revenue loss, and not much about the outcome and effectiveness of DM, i.e. cost effective peak demand reduction.

The events in Victoria and South Australia on 28, 29 and 30 January, which saw significant involuntary load shedding by distributors in both States due partly to unforeseen maximum demand under conditions of successive high temperature days, have again highlighted the importance of demand management to the system. Effective demand management would have prevented some of the problems that occurred. The risks illustrated by these events also apply in NSW. We have literally run out of time on this and the AER should act now to deal with these issues in a far more

[15] Pre-determination Conference for NSW transmission and distribution draft determinations (1 July 2009 to 30 June 2014) December 9 2009

robust way than outlined in either the DNSPs proposals or the Draft Decision. The Final Decision needs to have a more robust approach on demand management.

The AER relies on three initiatives to promote DM: (i) the existing 'D-factor' scheme, (ii) the proposed Demand Management Incentives Scheme (DMIS) and (iii) the requirement by AER to consider the extent to which a DNSP has considered, and made provision for, efficient non–network alternatives in assessing its total forecast capex.

i. D-factor: As pointed out in the detailed submission on demand management in the EUAAs submission the AER in August 2008, "the D-factor regime has had very little impact to date."[16]. We are not convinced that an extension of the regime into the nest regulatory period as proposed by the AER will deliver substantially better outcomes, notwithstanding that the AER has proposed some improvements, which may have some positive impact. Close monitoring of outcomes should be provided for.
ii. DMIS: Integral Energy and Country Energy have suggested in their revised proposals that they should also receive a DMIA of $1 million as there should be no differentiation in the size of the service provider and the allowance. Granting of these allowances should be in line with transparent and quantifiable programs that address demand management. We are sceptical of the value of providing such incentives direct to distributors unless they are more than tokens and require the distributors to work closely with end users, their representatives and other DM providers to ensure that robust outcomes are delivered. We would urge the AER to re-examine this aspect and strengthen it accordingly in its Final Determination.
iii. AER Requirement: The impact of DM programs is in reducing the growth in peak demand which leads to deferral of capital expenditures. Energy Australia proposes to spend about $33 million on DM programs in the next regulatory period and expects a deferral of about $ 55 million in capex due to non-tariff DM programs and $ 29 million due to time-of-use DM programs.[17] These are very modest compared to the total capex of $8.4 billion (revised January 2009) proposed by Energy Australia. Similar data for the other DNSPs are not given, but can be expected to be on about a *pro-rata* basis.

All in all, the EUAA feels that neither the proposals nor the Draft Determination give any indication of DM playing a major role in any significant deferral of capital expenditure or in improving the performance of the NSW distribution networks over the next regulatory period. The AER should look seriously at how DM can be lifted out of its present 'pilot scale' status into full scale programs over the next regulatory period, keeping in mind that DM programs have been

[16] EUAA Submission to the AERs NSW Distribution Regulatory Review p.14
[17] AER *Australian Energy Regulator's Review of the Regulatory Proposals by the NSW Electricity Distributors November 21 2008.* pp 225-226.

talked about by Australian electricity utilities, Governments and regulators since the early 1990s, with very little action to show for it.

We would recommend that the AER consider how it can strengthen the role of DM in NSW distribution networks over the next regulatory period and that it put in place systems to allow outcomes from its review to be measured and assessed independently. We would also urge consideration of a Steering Group, chaired by the AER, to assess this, and empowered to recommend modifications if necessary. The AER could also seriously consider including a regime of 'DM incentives and targets' on the NSW distributors.

2.6 Demand Forecasts

The declining economic environment will result in businesses scaling back operations and delay investment in new projects, in addition to reducing their labour costs. This will result in a reduced demand for electricity even at peak periods, as customers become more wary of their expenses. Economic recession over much of the next regulatory period (now seen to be increasingly more likely) and greater energy efficiency will also have an impact in reducing the growth in demand suggested by the DNSPs.

The EUAA notes that the DNSPs have made revisions to their demand forecasts taking into account the declining economic environment which has the potential to dampen the demand for electricity. In addition, the EUAA requests that the AER robustly undertake analysis of the future economic climate for NSW so that the capex expenditures related to dealing with peak demand and load growth in an environment of economic decline, are more reflective of the period of time in which they are sought.

We note that the Commonwealth Government and the NSW Government have been rapidly revising their growth forecasts downwards. The Australian Government has revised its economic growth forecast to slow from 1.9 percent growth in December 2008 to a ¼ percent growth for the first half of 2009; and to pick up again around December 2009 to ½ a percent. The NSW Department of Treasury has revised its forecast GSP from 2.5 percent to 1.5 per cent for 2008-09 and 1.75 percent for 2009-10.[18] There are other commentators who believe that the actual outcomes could be worse.

Based on these reduced economic growth projections both nationally and statewide, the EUAA requests that the AER provide a robust re-assessment of the revised demand projections by the businesses to ensure that the forecasts accurately reflect the decline in economic growth for NSW.

[18] 2008-2009 Mini Budget.

2.7 Pass through Provisions

The EUAA has concerns over the various proposals by the DNSPs on the application of pass-through provisions submitted to the AER in 2008 and their revised proposals in 2009. The AER has started its analysis with the definitions of 'pass through':

> "*The transitional chapter 6 rules allow for two categories of pass through events in electricity distribution:*
>
> - *Defined events—the following four events set out in chapter 10 of the NER as pass through events:*
>   - *a regulatory change event*
>   - *a service standard event*
>   - *a tax change event*
>   - *A terrorism event.*
> - *Nominated pass through events—other events that the DNSPs may propose to the AER to include as nominated pass through events in its distribution determination"*[19]

Based on this logic, the AER has quite rightly not accepted a raft of pass through events nominated by the DNSPs and the EUAA supports this approach, with an exception discussed in the ensuing paragraphs.

The AER has accepted "Retail project event" as a pass through event, which is defined as:

> "***Retail project event****: Any legislative or administrative act of the NSW Government to separate the retail electricity business of a DNSP in whole or in part from the electricity distribution function of the DNSP (including by way of a sale of the DNSPs retail business), which materially changes the costs to the DNSP of providing direct control services in the next regulatory control period*."

The AER states in its Draft Decision that (Page 280):

> "*If the NSW electricity retail businesses are privatised the DNSPs' costs of providing direct control services may increase due to loss of synergies. The AER considers that privatisation is likely to occur as a result of an administrative decision of the NSW Government, which would not be covered by the definition of a regulatory change event. Accordingly, it is appropriate that this event should be included as a pass through event*"[20]

The EUAA does not agree with this logic. The costs associated with, and occurring as a result of, the separation of retail and distribution businesses should be funded out of the sale proceeds received by the NSW Government arising from the privatisation, and not by end users out of NSW

[19] AER *Australian Energy Regulator's Review of the Regulatory Proposals by the NSW Electricity Distributors* p 270

[20] AER *Australian Energy Regulator's Review of the Regulatory Proposals by the NSW Electricity Distributors* p 280

distribution charges. Accordingly, the EUAA would request the AER not to accept this as a pass through event.

At the NSW review public forum on July 30 2008, the AER expressed the view that that pass throughs need to be tightly defined in the first instance so there is a proper sharing of risk between businesses and consumers and that the distributors should not use pass throughs to remove all risk.

The EUAA notes that Country Energy and Integral Energy have added a pass-through event not included in their original proposals. The *insurance event* is to cover material changes to existing insurance costs or terms where insurance becomes unavailable. Country Energy and Integral Energy have also redefined the terms in their original revenue proposals in the hope that the redefinitions will allow these rejected events to be passed through to customers.

The EUAA is satisfied with the AERs decision to not classify the pass-through events in their June 2008 proposals as nominated; however it does not support the decision on a retail change event being classified as a pass-through event. Furthermore the EUAA requests that the AER continue strenuously assess the validity of the *insurance event* pass-through event and the redefined pass-through events[21].

[21] Integral Energy's revised regulatory proposal, January 2009 pp 73-81

3 A Review of "Light handed" Regulation

While it is not within the bounds of this review, the EUAA believes that there is a need to conduct a thorough review of the effectiveness of the foundation principles underpinning "light handed" network pricing regulations over the past decade.

Some questions to address in such a review would be:

- The rising network prices that end users are being subjected to, despite a regime that promised to use so-called 'incentive regulation' to increase efficiency and productivity of the networks.
- The seemingly ever upward ramp up of capex and opex from one regulatory review to another.
- The lack of benchmarking of performance in respect of capex and opex.
- The rampant use of regulatory gaming by network businesses, which the regulatory regime seems not to discourage.
- The inadequacy of STPIS despite ten years of more of trying.
- Should there be greater regulatory oversight of the NSPs tariff / pricing process than what has been the case so far? The intensity of the regulatory process stops at determining the aggregated revenue requirements ("the size of the cake") and there is less oversight of tariff design for different customer segments ("how the cake is cut").
- Is there a need for greater transparency in the pricing submissions to ensure that the principles of 'user pays' and 'no cross subsidy' are being applied in tariff determinations?
- Is the currently employed test for cost reflectivity adequate? The gap between the stand-alone supply costs and the incremental costs is wide enough to accommodate a range of tariffs. Should there be, in addition, cost of supply studies that use the contribution by each tariff class to system peak demand as a basis for cost allocation to tariff classes? If such peak demand data by tariff classes are not available, should the network service providers be required to carry out programs to collect such data in time for the 2014-2019 Regulatory period submissions?
- Why has the take up of Demand Management by the NSPs been not effective? Is it probably partly due to the fact that it is not in the best commercial interests of DNSPs to promote DM under the current regulatory arrangements, given that their revenue is largely driven by demand (kW) and energy (kWh).
- Could an alternate approach for the AER be to target the DM incentives directly at the end-customers who, in fact, make the decisions that determine the electricity peak demand?

The EUAA would urge the immediate need for such a review. Energy suers are rapidly loosing confidence in the current set or arrangements given the deteriorating track record to date in terms of what value for money it is delivering to them.

4. Concluding Remarks

The EUAA is deeply concerned at the high levels of price increases sought by the three NSW Distributors over the next regulatory period and suggests that the AER should conduct an in-depth analysis of some of the fundamental principles that underpin the current regulatory paradigm. Specifically, the AER and all stakeholders need to understand all the factors behind this "tsunami" of proposed energy price increases facing NSW end users during the 2009/2014 period. This includes pressures on the costs of wholesale electricity, gas cost pressures, the impact of the CPRS and expanded Renewable Energy Target and the increase in energy costs that will occur with the TransGrid revenue determination.

The distribution businesses have provided revised 'X' factors in their January 2009 proposals that are well above their June 2008 proposals and well above the AER draft determination. These increases cannot possibly be justified in an environment of worsening economic decline not only for NSW but Australia wide and internationally. They are totally at odds with this environment and with the actions of businesses in the real, as opposed to the regulated, economy. They will also impose an additional, unwanted, burden on energy users.

The EUAA feels that the DNSPs proposals (original and revised) are unrealistic taking in the current economic climate and that the AERs draft determination has not sufficiently recognised this with the result that end users would be forced to pay for unjustifiably high costs. The EUAA therefore requests that the AER undertake robust analysis to ensure that the revenue requirements of the distribution businesses are not inflated and realistic in all the circumstances likely to exist in the next regulatory period.

In addition, while the DNSPs have revised their demand forecasts downward from their June 2008 proposals, the EUAA requests that the AER perform a robust analysis of the revised forecasts so that they accurately reflect the economic environment in which they are deemed to occur, including the latest data on declining economic activity. The risk of not getting this right is that users will be required to fund assets and other expenditures by the DNSPs that will never be undertaken.

It is not acceptable to end users that, after four regulatory review of the NSW distribution networks over 15 years; we still do not have a decent service level performance regime in place for the businesses. This is a disgrace. Whist this is the first regulatory review of the businesses by the AER, we would urge them to do more on this in a Final Determination to ensure that such a regime is in place well before the end of the next regulatory period. This should include service reliability and service quality aspects. We note that Victoria has had such a regime in place for two regulatory periods, as has South Australia. Only then will end users begin to have some appreciation of what the increased costs that are being proposed as part of this determination are actually delivering to them in terms of service levels.

With regard to demand management, the EUAA feels that neither the DNSPs proposals nor the AER Draft Determination give any indication of DM playing a major role in significant deferral of capital expenditure. This gap is all the more important given the very substantial capex proposals of the DNSPs and the growing peak demands on the system. AER should look seriously at how DM can be lifted out of its present 'pilot scale' status into full scale programs over the next regulatory period. The events in Victoria and South Australia on 29, 29 and 30 January, with involuntary load shedding in the distribution networks due to higher than expected maximum demand highlight clearly why this is necessary and urgent.

We support the AERs attempts to severely limit the definition of pass through events originally proposed by the DNSPs but query the AERs proposed acceptance of 'Retail Events' as a legitimate reason for pass through. As a minimum, the definition of what constitutes a permissible pass through event needs to be more tightly and consistently determined. More generally, we note the asymmetry that characterises pass through provisions, with all the downside risk being borne by end users due to the superior knowledge and information possessed by the regulated businesses. We also note that the concept of pass through is inconsistent with the stated objective of so-called 'incentive regulation' being to mimic the outcomes of a competitive market. In a competitive market, the pass through of costs is dependent on the actions of your competitors.

Furthermore the EUAA feels that certain aspects of the so-called 'incentive' approach to the economic regulation of transmission and distribution businesses in the National Electricity Market, such as price outcomes, capex and opex outcomes, service levels, cost reflective tariffs, promotion of demand management, have not produced the results promised by the policy makers. The EUAA therefore believes it is timely to conduct an extensive review of the so-called incentive regulatory regime and to access its performance. From an end users point of view, the regime has degenerated into an excuse for cost escalations from one regulatory review to another, associated impacts on prices and it is less and less delivering what it was meant to – efficient network monopolies with outcomes that mimic those that would be seen in a competitive market. This regime has been in place for ten years or more and there is now sufficient data for a robust review.