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14 May 2008

Mr Chris Pattas
General Manager
Network Regulation South
Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Dear Mr Pattas

Electricity Distribution – Proposed Guidelines, Schemes & Models

Thank you for providing the opportunity for Envestra to provide input into the process of preparing certain guidelines, schemes and models for the regulation of electricity distribution networks. Envestra is keen to participate in such processes to the extent that it can prior to the transfer of economic regulation for gas distribution to the Australian Energy Regulator (AER) later in the year.

Envestra is encouraged by certain aspects of the approach so far taken by the AER. This includes the apparent intention to issue a clear and consistent approach to economic regulation, while still providing the flexibility for businesses to depart from this framework where appropriate (including the recognition of certain transitory arrangements that might need to apply).

In terms of the draft guidelines themselves, Envestra considers there is scope to improve the effectiveness of the proposed efficiency benefit sharing scheme (EBSS), particularly as it relates to the proposal for the scheme to:

- provide a symmetrical application of all carryover amounts; and
- exclude capital expenditure from the EBSS.

The key aspect of any EBSS is to provide distributors with a continuous incentive to improve efficiency. Envestra considers that this important objective is achieved primarily by providing distributors with the ability to retain a share of the benefit of any efficiency achieved for the same period of time, regardless of when that efficiency was achieved.

Envestra believes that there is merit in making the EBSS symmetric within a regulatory period, but not between periods. This would ensure that the distributor is only rewarded for ongoing (or permanent) efficiencies on a continuous basis, while avoiding the risks related to a scheme that prevents the business from recovering its efficient costs in future regulatory periods.

To this end, the AER in its Explanatory Statement notes the relevant principle in the National Electricity Law that requires distributors to be provided with a reasonable opportunity to recover the efficient costs of complying with its regulatory obligations. The AER (pg. 8) suggests:

> *"Where multiple decrements result in a net negative carry-over amount, operating expenditures are combined with four other building blocks. Thus the overall revenue permitted may still be commensurate with, and provide a reasonable opportunity for a DNSP to recover, the efficient costs of complying with regulatory obligations."*

It is not clear how combining any net negative carry-over with the other building blocks is commensurate with, or provides a reasonable opportunity to recover efficient costs. Any amount that is taken away from any or all of the efficient cost building blocks will clearly deny the distributor a reasonable ability to recover its efficient costs.

Envestra considers that the intent of the 'reasonable ability' part of the efficient cost principle is more closely aligned with ensuing, for example, that the demand forecasts are reasonable. It is certainly not clear how a reduction in the regulatory building blocks could still provide the distributor a reasonable opportunity of recovering the efficient cost of service provision.

This issue is made worse when the 'inefficiency' is due to a recurring forecast error made at the time the benchmarks were set rather than any inefficiency per se. On this matter, the AER in its Explanatory Statement (pg. 8) notes:

> *"Where forecasts do not reflect the efficient level of opex, it is possible that the DNSP could suffer a windfall gain or loss. For this reason, the AER has sought to minimise the risk of windfall gains and losses by allowing the adjustment of forecasts for scale and scope and the ex post adjustment of forecasts for actual demand growth."*

Such adjustments are necessary in an effective EBSS to ensure that the direct impact on costs stemming from higher/lower than anticipated demand growth is taken into account. While this is a positive, it remains unclear how such adjustments mitigate any forecast errors made in determining the operating expenditure benchmarks themselves (for example, forecast errors in relation to the price and productivity growth assumptions incorporated into the expenditure forecasts).

The financial impact of not allowing the distributor to recover its efficient costs is made significantly worse when combined with the potential financial impact of factors such as the service incentive scheme, lower than anticipated demand growth and other forecasts errors. This negative financial impact is in turn likely to impact the timing and magnitude of other investment decisions required by the distributor to meet its regulatory obligations.

Envestra understands the desirability of the continuous incentive brought about by linking the EBSS and setting forecast expenditure based on the actual costs incurred in the fourth year of the regulatory period. However, this does not provide a strong reason for reducing efficient costs in subsequent years given that the 'base' year can be directly assessed by the AER if an (obvious) anomaly exists relative to past trends, thereby maintaining a continuous incentive.

Envestra therefore considers that any symmetric scheme should not prevent the business from recovering its efficient costs in subsequent regulatory periods. The EBSS can still be designed so that effective and continuous incentives exist without the need to limit the ability for a distributor to recover its efficient costs in the future, thereby encouraging the business to continuously invest in its network in a prudent and efficient matter.

If the AER decides to allow for net negative carryovers, then their size should be capped to reflect the potential detriment to the business and consumers of not allowing for efficient cost recovery in any particular year (similar to the rationale for capping the downside on the service incentive scheme). Envestra again states its view that including a net negative carryover would not strengthen the incentives to continuously improve efficiency.

Secondly, Envestra believes that it is not desirable for the EBSS to only provide an incentive on part of the distributors' total expenditure. Envestra notes the use of actual depreciation in the RAB roll forward, but such an incentive is not strong (and might simply be altering the time over which capital is returned to investors). Envestra's preference is for capital expenditure to be wholly included in the scheme.

The ability to defer capital expenditure is only one way that a distributor might achieve capital efficiencies. Another might include the ability to find better or lower cost solutions to address a particular issue (for example, to address security of supply concerns). Likewise, a proposed network expansion might no longer be prudent due to changes in circumstances since the regulatory decision.

The EBSS should provide an incentive to pursue these efficiencies, while any concern over project deferral should be directly addressed. This could occur, for example, by requiring the distributors to identify and explain that part of any capital underspend attributable to the deferral of a particular project.

The associated benefits could be provided if the duration of the deferral yielded a net benefit to consumers (that is, it was not included in forecast expenditure going forward for a prescribed period).

It should also be noted that the magnitude of the reward attached to capital expenditure is generally less than that applied to operating expenditure, typically been limited to the return on and of any capital under or overspend. This would mitigate any concern that the AER or other stakeholders might have over any perverse incentives created by the EBSS in reference to parts of a distributors' capital expenditure program.

Envestra hopes that this letter assists the AER to finalise its EBSS. Please feel free to contact me (08 8418 1125) should you wish to discuss this letter further.

Yours sincerely

Andrew Staniford
Commercial Manager