grid australia
BACKBONE OF THE NEM

19 August 2010

Mr Chris Pattas
General Manager
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Australian Energy Regulator
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Via email: AERinquiry@aer.gov.au

Dear Chris

Victorian Electricity Distribution Draft Decision 2011-15

Grid Australia welcomes this opportunity to make a submission to the AER's consultation process for the Victorian electricity distribution price determination for the period 2011-15. This submission provides some high-level comments on the Draft Decision published by the AER on 4 June 2010.

Grid Australia considers there are aspects of the AER's approach that raise broader matters of principle. These relate to apparent changes in the AER's approach to assessing opex and capex forecasts, which do not appear to be consistent with the framework set out in the National Electricity Rules (NER). In particular, Grid Australia notes that the Draft Decision:

- appears to rely disproportionately on a 'revealed costs' approach to determine forecast capex;
- applies criteria for the approval of opex 'step changes' that are too narrow to deliver a reflection of efficient costs; and
- adopts an approach for Victoria which appears inconsistent with the application of the NER by the AER in other jurisdictions. Grid Australia is concerned that this could undermine regulatory consistency and certainty.

These issues are briefly discussed in turn.

Basing forecasts on revealed costs

The Draft Decision relies heavily on a historic trend analysis to determine future expenditure requirements.

While having regard to historical expenditure to inform a regulatory determination is consistent with the NER which sets out "the actual and expected capital expenditure of the Distribution Network Service Provider (DNSP) during any preceding regulatory control period" as one of the capex factors,[1] outturn costs are only one of the 10 capital expenditure factors which the AER must have regard to in deciding whether to accept the capex forecast.

In Grid Australia's view, it appears that the AER has relied disproportionately upon historic expenditure to establish the capex allowances. This is highlighted in the Draft Decision:

> *"The approach of the AER is to begin its assessment of the Victorian DNSPs' proposals by having regard to historical performance (actual capital and operating cost expenditure) in comparison with that forecast, both in previous periods and in relation to that forecast over the forthcoming regulatory control period."*[2]

In the Victorian Distribution Draft Decision, this approach is applied across entire capex proposals, and not just the replacement and non-system capex categories as has been the case in other recent reviews.

Further, the AER's historical analysis disregards the final two years of available data (ie: 2009 actual capex and 2010 expected capex) on the basis that the AER does not use unaudited data. In contrast, in the AER's recent reviews of ETSA Utilities, Ergon Energy and Energex, the AER's historical trend included the estimates for the final two years of the regulatory period. This is also the approach consistently adopted by the AER for transmission businesses.

Grid Australia questions the appropriateness of applying a different level of emphasis on out-turn costs from one determination to another and completely excluding relevant data, notwithstanding that it is unaudited. In particular, as identified above, the Rules require the AER to have regard to actual and expected expenditure in deciding whether it is satisfied that the capital and operating expenditure objectives in the Rules have been met.

Consideration of opex step changes

The AER's approach in the Draft Decision to assessing opex step changes takes the form of a two stage process. The first stage is to establish whether or not the step change is linked "to changes in the regulatory obligations and subsequently changes in the operating environment"[3]. If this first threshold is met, then the AER will then proceed to assess the prudency and efficiency of the step change and, in doing so, will have "regard to whether the proposal has appropriately quantified all cost savings and benefits"[4].

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[1] NER, clause 6.5.7(e)(5)

[2] AER, *Draft Determination for Victorian Electricity Distribution Businesses*, p vii.

[3] Ibid, p 258

[4] Ibid, p 260

This approach differs from the criteria that the Australian Competition Tribunal (ACT) upheld when assessing EnergyAustralia's appeal on step changes. The ACT's criteria stated that the business should demonstrate that[5]:

> *(a) it is related to a fundamental change in the business environment arising from outside factors or offset by cost efficiencies in other areas;*
>
> *(b) it is attributable to the imposition of new or changed obligations due to external factors including, if relevant, mandated improvements in service levels;*
>
> *(c) it is of a type that will improve service levels voluntarily as opposed to being mandated - in respect of which customers' willingness-to-pay for the improved service should be demonstrated;*
>
> *(d) it will bring cost savings or benefits to customers - in respect of which, the business should be able to demonstrate that:*
>
> > *(i) it is continually looking for better ways of using its resources and improving its processes and systems to improve service levels or achieve cost efficiencies;*
> >
> > *(ii) it has defined the savings and benefits in terms of their nature and the expected time of their realisation; and*
> >
> > *(iii) where the savings and benefits are quantifiable, they have been quantified in sufficient detail for cost-benefit analyses to be prepared and that the cost-benefit analyses justify the investment; or*
>
> *(e) alternatively, if it does not meet any of these criteria, the business has demonstrated that it will continue to operate efficiently as a whole, despite the cost increase.*

Grid Australia considers that promoting efficient investment requires the AER to allow expenditure that provides net benefits to consumers (i.e. where the benefits to consumers of making that investment outweigh the costs of making that investment), or is the least cost method of meeting a regulatory obligation. This is reflected in the requirements for the assessment under the Regulatory Investment Test for transmission and distribution, the National Electricity Objective, and the pricing principles set out in the National Electricity Law. Grid Australia's approach is consistent with efficient market outcomes in that it encourages regulated network businesses to enhance the level of service they provide to customers, if the incremental benefit from the provision of that service outweighs the incremental cost to the business to provide that service.

The Draft Decision also appears to be inconsistent with the interpretation established by the ACT in the EnergyAustralia case. Grid Australia considers that regulatory certainty would be enhanced if the AER gave greater weight to interpretations established through merits appeal decisions.

Grid Australia notes that the AER's narrower approach to assessing opex step changes may deny customers services that exceed the mandated minimum standard. Grid Australia does not consider that the AER's approach is consistent with promoting the long term interests of consumers, i.e. it does not promote the National Electricity Objective. Network companies should be funded to improve service levels, providing that the proposed investments are justified in terms of efficiency and prudency.

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[5] Australian Competition Tribunal, *Application by EnergyAustralia and Others [2009] ACompT 8 – Corrigendum*, p. 55.

Importance of consistent regulatory outcomes across jurisdictions

Grid Australia is concerned about the potential for regulatory inconsistency in different jurisdictions. One objective of the recent national energy reforms is to ensure that all participants are regulated consistently in accordance with clearly defined rules.

Therefore, it is concerning that the AER appears to have conducted a different kind of review in Victoria on the grounds that the Victorian DNSPs are operating at an efficient level. In particular, the AER notes that:

> *"... trend analysis, together with comparative benchmarking of Victorian DNSPs with DNSPs in other jurisdictions, shows that Victorian DNSPs compare very favourably to those in other states. This means that the revealed costs of the Victorian DNSPs are a sound base for determining the starting point for evaluating their regulatory proposals."*[6]

Putting to one side the question as to whether it is correct to conclude that Victorian DNSPs are more efficient than their counterparts, Grid Australia is concerned that the AER has adopted an approach of 'rolling forward' historic expenditure without proper regard to the forecast information submitted by the Victorian businesses. It is counter to the purpose of incentive regulation if efficient network companies are denied revenue entitlements because they are efficient. This would also appear to be contrary to the fundamental building-block approach established in the Rules.

Grid Australia considers that the AER must make every effort to apply the requirements of the NER consistently across the jurisdictions.

Further, while condition-based replacement is widely understood to be the best approach to asset replacement, in the Victorian Draft Decision the AER has based its substitute forecasts on the outputs of a replacement model which heavily relies upon asset age without any meaningful consideration of the condition of assets. This is in contrast to the AER's Queensland Distribution Price Review Decision in which it acknowledged:

> *"The AER considers that a condition based approach which takes into account a range of factors (one being asset age) is more likely to result in an efficient outcome."*[7]

The AER's changed views in relation to the use of historical expenditure and emphasis on age-based asset replacement in the Victorian Draft Decision appears to have produced a different interpretation of the meaning of "benchmark capital expenditure that would be incurred by an efficient DNSP"[8] compared to other recent regulatory determinations.

In contrast to the approved increases in capex in Queensland, NSW and South Australia, the AER's Victorian Distribution Draft Decision provides capex allowances for a number of the DNSPs at, or below, the current level of actual expenditure. In this regard, it does not appear as though the AER has given sufficient weight to the levels of forecast demand growth to be met compared with its approach in decisions in other jurisdictions. This is in a context where forecast demand growth in Victoria is comparable to that in other jurisdictions. Similarly, the AER does

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[6] AER, *Draft Determination for Victorian Electricity Distribution Businesses*, p vii.

[7] Ibid, p. 110.

[8] NER, Clause 6.5.7(e)(4)

not appear to have given the same weight as in each of these other jurisdictions to the following similar cost drivers faced by Victorian network businesses:

- continued peak demand growth, and increased penetration of air conditioners;
- increased network utilisation;
- ageing assets; and
- programs to address network security and environmental risks.

The difference in interpretation of efficient benchmark capital expenditure taken in the Victorian Distribution Draft Decision compared to that applied in other jurisdictions undermines the potential benefit of consistent application of the NER across jurisdictions, namely, improved regulatory certainty. A key objective of establishing a national regulatory framework and a national economic regulator was to provide more consistent regulatory decision-making and outcomes across the NEM. Grid Australia therefore encourages the AER to apply a more consistent approach in its decision making.

In making its Final Decision, Grid Australia encourages the AER to reconsider how its decision:

- complies with the requirements of the NEL and NER;
- promotes regulatory certainty; and
- allows Victoria's DNSPs to deliver safe, secure, reliable supply of electricity in a manner which promotes the long term interests of customers.

Grid Australia would be pleased to discuss any aspect of this submission with the AER. If you require any further information, please do not hesitate to contact me on (02) 9284 3434.

Yours sincerely,

Philip Gall 19/8/2010

Philip Gall
Acting Chairman
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