

1 February 2008

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

Dear Mr Pattas,

Guidelines, models, schemes and service target performance incentive scheme for electricity distributors

Thank you for the opportunity to comment on the AER's two November 2007 issues papers concerning the guidelines, schemes, models and service target performance incentive scheme (STPIS) being considered for use in the regulation of electricity distribution network service providers (DNSPs). Integral Energy welcomes the AER's decision to consult on these matters early as they constitute important elements of the AER's regulatory framework.

Detailed comments in relation to the issues raised are provided in Integral Energy's submission which is attached. In summary, Integral Energy submits the following:

- broadly speaking, it is desirable to develop a consistent national approach to DNSP regulation but such an approach will require time to develop and the methodologies adopted by the AER will need to provide appropriate flexibility to accommodate distribution-specific issues;
- the post-tax revenue model (PTRM) and asset base roll forward model (RFM) appear generally suitable for establishing DNSP building block revenues for direct control services;
- the PTRM should include an allowance for a return on working capital and that a suitable method for doing so would be to adopt the current IPART approach;
- capex should be recognised in the regulatory asset base on an "as incurred" basis rather than the AER's previously proposed "hybrid" approach;
- given the relatively lighthanded regulatory approach to estimating tax liabilities under the new post-tax framework, a limited level of assurance, rather than a full reconstruction, would be appropriate for confirming the accuracy of the opening tax asset base;

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- in relation to any efficiency benefit sharing scheme (EBSS):
 - the approach used in transmission and currently proposed by the AER in relation to regulation of the ACT and NSW DNSPs during the 2009 to 2014 period should *not* be implemented on the basis that it hasn't been demonstrated that it would achieve the objectives required under the Rules, namely, to provide a net benefit to customers via a continuous incentive on the business to make ongoing efficiency savings. Application of the proposed EBSS would also increase regulatory risk and the associated administrative burden on DNSPs;
 - the scheme should not include capital expenditure efficiency due to the inherent uncertainty and level of regulatory risk associated with trying to identify efficiency savings with respect to this type of expenditure; and
 - the scheme should not include distribution losses without a clear demonstration of the need for doing so, that any proposed methodology provided a robust measure of the associated economic impacts as well as a positive net benefit to customers and did not adversely impact other DNSP incentive schemes;
- the implementation of a STPIS should be a medium-term objective as the development of a framework that takes account of the circumstances of, and provides suitable incentives for, all regulated DNSPs will require time; and
- the STPIS should not penalise planned outages as these are necessary for the efficient, safe and secure supply of electricity by the network.

Should you wish to discuss any aspect of this submission, please contact Michael Martinson on (02) 9853 4375.

Yours faithfully



Richard Powis

Chief Executive Officer

Integral Energy submission to the AER on guidelines, models, schemes and service target performance incentive scheme for electricity distributors

1 February 2008



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Introduction

Background

Under recent amendments to the National Electricity Rules (Rules), the Australian Energy Regulator (AER) will become responsible for the economic regulation of Distribution Network Service Providers (DNSPs). This will commence on a staggered basis with the regulation of ETSA Utilities from 1 July 2010. Transitional arrangements apply to the regulation of the ACT and NSW DNSPs, including Integral Energy, for the 2009 to 2014 regulatory period.

In November 2007 the AER published two issues papers concerning the following aspects of the regulatory framework as they will apply to the economic regulation of DNSPs generally:

- post tax revenue model (PTRM);
- roll forward model (RFM);
- cost allocation guidelines;
- efficiency benefit sharing scheme (EBSS); and
- service target performance incentive scheme (STPIS).

The AER seeks submissions from stakeholders. Following receipt of those submissions, the AER will undertake a formal consultation process commencing in the second quarter of 2008.

Assessment criteria

Before setting out Integral Energy's specific responses to the matters raised in the issues papers, it is worth identifying two key relevant criteria in respect of which any proposed ways forward in relation to those matters should be assessed. The Rules do not explicitly provide an overarching set of criteria for determining the appropriateness of specific regulatory mechanisms proposed by the regulator¹. However, those criteria are well understood from broader regulatory policy debate². They both derive from, and are consistent with, the national electricity market (NEM) objective. The two key relevant criteria are:

- economic efficiency in that the benefits of adopting a regulatory mechanism outweigh the costs of doing so; and
- best practice regulation — in the present context, this refers most directly to the desirability of consistency of treatment (of the same DNSP through time and of different DNSPs at the same time) and of transparency regarding the operation of the relevant regulatory mechanism.

¹ Although individual criteria can often be found in relation to specific matters. See, for example, section 6.5.8(c) of the Rules in relation to Efficiency Benefit Sharing Schemes (EBSS).

² See, for example, Utility Regulators' Forum, *Best practice utility regulation*, discussion paper (July 1999).

The reference to these criteria also provides a response to the AER's numerous invitations in the issues papers to comment on whether other Rule provisions exist that are relevant to the matters raised. As noted above, the Rules are largely operational and provide only limited guidance as to how to assess the merits of specific regulatory mechanisms where discretion is given to the regulator.

Revenue determinations for the ACT and NSW DNSPs for 2009-2014

Integral Energy has for some months been in discussion with AER staff in relation to a similar range of issues regarding the framework that will apply to the AER's regulation of the ACT and NSW DNSPs during the 2009 to 2014 regulatory period. The AER's position in relation to a number of those issues is yet to be finalised.

In this regard, and following best practice regulation, Integral Energy submits that it is important that the positions taken by the AER should, where possible, be consistent through time as well as across different DNSPs. That is, while Integral Energy supports the transition to a nationally consistent framework for the economic regulation of DNSPs, should the AER propose to regulate DNSPs generally (including the ACT and NSW DNSPs beyond 2014) in ways that differ from how it regulates the ACT and NSW DNSPs during the 2009 to 2014 period, then the rationale for those differences will need to be clear. Transitional mechanisms may also be appropriate in order to manage the impact on the DNSPs and their customers.

PTRM

Subject to the specific comments below, Integral Energy is generally satisfied that the AER's PTRM is appropriate for establishing DNSP building block revenues for direct control services.

Treatment of capital contributions

As noted in the issues paper, the current treatment of capital contributions varies from jurisdiction to jurisdiction. The current IPART treatment for NSW DNSPs is the same as that in Victoria, namely, exclude the capital contributions from the regulated asset base but include the value received as income for tax purposes. Integral Energy agrees that a consistent approach across jurisdictions is preferable and that either the IPART or an alternative approach is acceptable provided the methodology is transparent. In the interim, the most appropriate approach would be to keep the model standardised and deal with jurisdictional differences on a case by case basis.

Timing of capex recognition

The guidelines, models and schemes issues paper refers to the PTRM as using a hybrid approach in relation to recognising the addition of capital expenditure (capex) into the asset base. Integral Energy notes that the AER recently indicated its intention to move to a full "as

incurred” approach for the ACT and NSW DNSPs during the 2009 to 2014 regulatory period. Integral Energy supports this move on the basis that it is more appropriate for distribution assets, which typically involve shorter construction times.

Cash flow timing issues and working capital

Integral Energy agrees that there is merit in working towards a single set of cash flow timing assumptions when modelling revenue requirements. However, it also notes the reference in the issues paper to a conclusion by Allens Consulting Group (ACG) that a discrete allowance for working capital would be unnecessary if those timing assumptions could be made to be sufficiently accurate.

Integral Energy disagrees with ACG’s conclusion. It agrees with the point made in the issues paper that there is a tradeoff between improving the accuracy of the revenue stream by making more detailed cash flow timing assumptions and the increased administrative burden and regulatory risk associated with doing so. Beyond a certain point, it would become difficult to establish that the regulator’s assumptions improved accuracy rather than simply introduce a degree of arbitrariness. Presumably, the assumptions would need to be tailored to each DNSP in order to refine that accuracy. However, this would compromise the consistency of regulatory treatment across the NEM. The alternative would be to use the same set of assumptions and run the risk of providing an inadequate revenue allowance to individual DNSPs.

Integral Energy submits that, as a matter of regulatory principle, the AER should not impose a more detailed set of assumptions on all the regulated DNSPs unless it can demonstrate that the benefits of doing so outweigh the costs and that DNSP’s revenue allowances appropriately provide for the full recovery of efficient costs. Instead, Integral Energy submits that the most appropriate way forward is to include a return on working capital in the PTRM and to adopt the pragmatic approach to working capital used by IPART for the current NSW regulatory determination, namely, that it be calculated by reference to a specified number of days of receivables less payables plus inventory.

Pre-tax to post-tax regulation

Integral Energy accepts that, in the move from a pre- to a post-tax form of regulation (as is currently the case in the ACT and NSW), it is important to provide a level of comfort that the opening tax asset base values are accurate. However, the purpose of this exercise must be clear. It would be inappropriate to require a full reconstruction and roll-forward of the tax asset base in the context of a regulatory framework that models the tax treatment of revenues and expenses in a highly simplified way (albeit slightly less simplistically than a pre-tax framework). This would impose a large regulatory burden for only a relatively minor benefit.

There will always be a “drift” between the tax asset base and regulatory tax asset base over time as they will inevitably be based on differing requirements and assumptions. Unless the

AER proposes that the DNSPs conduct a full tax asset base revaluation on a regular basis, there is little merit in effectively requiring that the same step be taken at the changeover of regulator.

Other matters

Integral Energy also submits the following in relation to the proposed PTRM:

- indicative X-factors — Integral Energy agrees that the inclusion of indicative X-factor calculations in the PTRM would be useful;
- inflation bias — Integral Energy agrees that there may be issues associated with the use of Commonwealth Government securities in estimating forecast inflation. Integral Energy has, along with the other NSW DNSPs, commissioned expert opinion on this matter in the context of the 2009 to 2014 regulatory reset. Integral Energy suggests that the AER also take that advice, once submitted, into consideration for the purpose of general DNSP regulation; and
- the PTRM's linkages with information requirements — the totality of information provided should be streamlined wherever possible. The information should be sufficient to support a building block proposal that is compliant with the requirements of the Rules. The purpose and scope of the information required should be clear and should build on existing jurisdictional requirements in order to minimise transition costs.

RFM

Provided that the RFM accounts for the availability of actual or regulatory depreciation methodologies to be proposed by a distributor, and transitional roll-forward arrangements are followed, there does not appear to be a barrier to using the RFM adopted in transmission regulation.

Cost allocation guidelines

Integral Energy notes that the Transitional Rules for the NSW DNSPs provide for the adoption during the 2009 to 2014 regulatory period of IPART's Accounting Separation Code for Electricity Distributors. Integral Energy recommends that the AER transition towards a single set of guidelines for DNSPs over time using the jurisdictional guidelines as a base.

EBSS

General

Note that the text of this section largely reproduces the relevant part of Integral Energy's 4 January 2008 submission to the AER in response to the regulator's November 2007

preliminary positions paper on matters relevant to the distribution determinations for the ACT and NSW DNSPs for 2009-2014.

Integral Energy supports an incentive-based approach to regulation as a broad principle. However, Integral Energy would have serious reservations about the implementation of an EBSS in relation to operating expenditure (opex) were it to share the features of the incremental EBSS derived from transmission regulation and currently proposed by the AER in relation to the regulation of the ACT and NSW DNSPs for the 2009 to 2014 regulatory period (the proposed ACT and NSW EBSS).

Broadly, Integral Energy agrees that where:

- there is scope to share between business and customers the benefits of operating cost efficiencies achieved during the regulatory control period beyond those forecast at the outset of the period; and
- those savings can be achieved while maintaining or improving the safe, secure and reliable delivery of services to those customers,
- then it is appropriate, as part of a balanced regulatory package, to include a mechanism to reward businesses for finding those savings. It may also be appropriate to penalise a DNSP for failing to meet its forecast opex targets where there was no credible reason for doing so and where the imposition of a penalty would not jeopardise the delivery of services to customers.

These principles are reflected in the Rules which require inter alia that:

- the AER must implement an EBSS to provide for a fair sharing between DNSPs and customers of any efficiency gains or losses derived from actual opex being, respectively, less or greater than forecast (allowed) opex; and
- before doing so, the AER must have regard to the need to:
 - ensure that the benefits to consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme for the DNSPs; and
 - provide DNSPs with a continuous incentive, so far as is consistent with economic efficiency, to reduce operating expenditure.

Integral Energy has the following concerns in relation to the AER's proposed ACT and NSW EBSS and, by implication, any similar EBSS adopted under the general distribution regulation Rules.

First, it hasn't been demonstrated that the proposed EBSS provides a benefit to consumers sufficient to warrant any reward or penalty under the scheme. The basic intent of such a scheme is to remove the incentive on the DNSPs to "push" costs into the later years of the regulatory period since doing so allows the business to achieve returns greater than those

assumed by the regulator. Delaying expenditure would only be inefficient if it raised costs above efficient levels (for example, it may not reflect the requirement to increase activities in light of increased regulatory obligations or may not reflect the compounding impact of unit rate escalations if not adequately incorporated into the determination).

The incremental approach proposed by the AER provides an incentive to “pull” expenditure forward to levels above the efficient costs in earlier years in order to generate a trend of increasing opex savings throughout the period. The AER indicated in its November 2007 preliminary positions paper that it considered “the EBSS an important part of the regulatory framework encouraging DNSPs to reveal their efficient or true costs”³. Integral Energy submits that, if it remains unclear whether the scheme encourages efficient, timely expenditure throughout the regulatory period, then it must also be unclear whether the EBSS provides a net benefit to consumers.

Second, and related to this issue, is the fact that the incremental approach proposed by the AER fails to provide a continuous incentive. This is because it disincentivises DNSPs from delivering opex savings earlier in the regulatory control period where these are likely to be larger than savings able to be achieved later in the period. In such circumstances, the business would be penalised for making negative incremental savings in the remaining years of the period whereas, were the larger savings made later, the penalty would not apply⁴.

It is true that an EBSS should provide an ongoing incentive to reduce unit costs over time. However, the CPI-X regime by its very nature provides an incentive to reduce costs and it is not obvious that the AER’s proposed EBSS provides any materially greater incentive. Further, the EBSS incentive should not be at the expense of making (and sharing the benefits with customers of) genuine savings whenever they arise, whether early in the period or not. Put another way, a continuous incentive does not necessarily mean only an incremental one and an effective scheme would recognise the need for balance between the immediate and the incremental. The AER itself noted the importance of this design objective in its June 2007 issues paper where it stated that:

“the EBSS is therefore a mechanism that enable DNSPs to... face a more continuous incentive (*equal incentives in each year of the regulatory period*) to strive for efficiency gains⁵” [emphasis added]

To the extent that the proposed EBSS does not do so, it would fail to address the considerations set out in the Rules.

³ Page 24.

⁴ Note that, while the EBSS proposed by the AER does not discriminate between making a one-off saving in any particular year of the regulatory period, this is only true when considered in isolation from opex being either over or under forecast values in other years of the period — the net incentive effect under the incremental approach makes the timing relevant.

It may be the AER's intention to address this problem by, on a case by case basis, adjusting the outcomes of the application of the EBSS to prevent the imposition of a penalty where larger, genuine early savings are made. However, this raises a third and broader issue concerning the AER's proposed ability to make ex-post adjustments to EBSS outcomes. The November 2007 preliminary positions paper does not make it sufficiently clear in what circumstances such adjustments may be made. With four exceptions (changes in capitalisation policy, demand growth, recognised pass through events and uncontrollable factors nominated by the business in advance), the AER indicated that adjustments would generally only be permitted where the difference between forecast and actual expenditure lay "beyond the control of the DNSP"⁶. This raises the following concerns:

- the greater regulatory risk given the uncertainty of what constitutes the relevant circumstances — even the four exceptions are ill-defined in terms of their nature and threshold of application; and
- the increased regulatory burden arising from ex-post investigations and adjustments being made by the regulator — this raises the question as to what, if any, value can an EBSS be providing if a regulatory investigation is necessary whenever the business saves money?⁷

Integral Energy submits that, for the EBSS to have the potential to operate effectively, the AER would need to provide further clarity around the circumstances that would attract an ex-post review and the potential impact of, and processes involved in undertaking, such a review itself.

Fourth, Integral Energy remains concerned that the AER's proposal to treat EBSS carryovers symmetrically has the potential to significantly penalise customer service quality outcomes. As with the service target performance incentive scheme (STPIS), penalties should be capped in order to manage this risk. By contrast, positive incentives should not be capped. This is because, while it may be reasonably assumed that imposing a penalty based on what is considered by the regulator to be an efficient level of opex would impact service levels, it is inappropriate to assume that providing a reward for minimising costs will automatically lead to higher levels of service. Rather, the latter is more properly characterised as an incentive for the efficient use of funds.

⁵ AER, *Issues Paper, Electricity Distribution Network Service Providers, Draft Efficiency Benefit Sharing Scheme, June 2007*, p 3.

⁶ Page 23.

⁷ If an EBSS was in place and yet the AER remained concerned that savings achieved by the business early in a regulatory control period was the result of deliberately conservative forecasting, this would suggest that the EBSS has failed to address the problem it was intended to solve.

Finally, and as previously noted in Integral Energy's submission in relation to the AER's November 2007 issues paper, the AER must ensure that the operation of the EBSS does not threaten incentives regarding the viability of non-network solutions.

Treatment of capex

Integral Energy submits that capex should not be included in any EBSS.

As noted by the AER in its issues paper, the nature of capex makes it a problematic exercise to determine with confidence whether any differences between forecast and actual expenditure are the result of efficiencies or not. This was recognised by the Victorian Essential Services Commission (ESC) which, in its 2005 distribution revenue determination, declined to allow the Victorian DNSPs an efficiency carryover for capex underspent in the 2001 to 2005 regulatory period. The ESC stated that:

"Reductions in capital expenditure below forecast can be the result of any, or a combination of, efficiency gains, the deferral of capital expenditure projects between regulatory periods, changes in external expenditure drivers or overstatement of expenditure requirements when the forecasts were set.

In light of these various sources of spending below forecast, it is difficult to isolate whether or not the efficiency carryover mechanism has provided any greater efficiency incentive than already provided within the current five year regulatory review cycle.⁸"

The problem of identifying genuine efficiencies stems from a number of reasons including the relative "lumpiness" of capex compared with opex, the fact that the timing of capex projects are often somewhat flexible and can move away from forecast dates for sensible reasons and that they are inherently complicated and therefore problematic to benchmark.

Combined with the fact that the volume of capex is typically relatively large compared to opex, this makes it difficult to be confident that any benefits to consumers likely to result from an EBSS that extends to capex are sufficient to warrant any reward or penalty under the scheme for the DNSPs.

It is also difficult to see how it would be possible for an EBSS to provide DNSPs with a continuous incentive to reduce capex as required by the Rules. The fact that the South Australian scheme adopts a cumulative, rather than an incremental efficiency mechanism, appears to be an admission that the inherent year to year variability of capex makes it impractical to determine the level of genuine ongoing efficiency.

⁸ ESC, *Electricity distribution price review 2006-2010: October 2005 price determination as amended in accordance with a decision of the appeal panel dated 17 February 2006*, p 431.

The problem cannot be overcome by claiming that pass throughs and adjustments to forecasts when calculating carryover amounts would serve to mitigate the effects of this uncertainty. For example, a higher allowance for pass throughs doesn't automatically reduce the likely size of any difference between forecast and actual capex. To make this claim would be to confuse the total amount of risk with the total amount of forecast capex. Nor does it especially matter if the uncertainty is symmetrical or not if the relative size of the differences between forecast and actual capex combined with the (potentially arbitrary) associated rewards and penalties arising from the operation of an EBSS creates sufficient uncertainty for the DNSP that it cannot, in practical terms, target ongoing efficiencies in relation to the total volume of its capex program from year to year.

Finally, and as noted by the AER, the inclusion of capex in any EBSS runs the risk of "swamping" any incentive to generate opex efficiencies. Integral Energy also agrees that the uncertain effects of a capex-inclusive EBSS would have implications for the operation of a demand management incentive scheme and STPIS.

Treatment of distribution losses

Integral Energy agrees with the AER that it would require clear evidence that distribution losses exceeded efficient levels prior to taking regulatory action to optimise them. Further, it is not clear that including those losses in an EBSS would be the most effective approach to optimisation as elements of those losses largely lie beyond the control of DNSPs. Irrespective of whether an EBSS or some other mechanism were used for such a purpose, the AER would need to demonstrate that the methodology for calculating the economic value of losses was robust and that the cost of its implementation did not outweigh the benefits to customers. Finally, the impact of the incorporation of distribution losses into an EBSS would need to take account of the impact on incentive mechanisms such as jurisdictionally based guaranteed service levels, any demand management incentive scheme and STPIS.

In light of these considerations, Integral Energy submits that it would be premature to extend any EBSS to include distribution losses at this stage and that the priority should instead be given to ensuring that the existing incentive mechanisms, operating to their current scope, operate effectively, both individually and collectively.

STPIS

Integral Energy supports the gradual transition to a national STPIS framework through the harmonisation of existing jurisdictional schemes. It is important to emphasise that this would need to be a medium-term exercise as careful consideration would need to be given to ensuring that:

- the selected indicators, target performance levels and incentives and/or penalties are suitably appropriate for all regulated DNSPs operating in a wide variety of circumstances — this also requires that there be a suitable set of data available to inform these decisions and, in this regard, Integral Energy supports the operation of the S-factor paper trial in NSW as part of the 2009 to 2014 regulatory period as previously foreshadowed by the AER;
- the STPIS fully takes into consideration the impact of jurisdictional requirements such as licence conditions relating to service standards;
- there isn't a duplication of, or inconsistent, requirements between any national and the jurisdictional schemes during the transitional period;
- the interplay between the components of the STPIS, such as a guaranteed service level (GSL) scheme and a financial S-factor scheme, are clear and do not result in double penalties to a DNSP for a single underlying breach;
- any excluded events associated with the STPIS are well understood and developed as part of the framework;
- any interaction between the STPIS and other AER incentive schemes, such as any EBSS or demand management incentive scheme, is well understood; and
- the benefits to be obtained from the STPIS schemes are greater than the total costs of compliance.

Subject to the considerations listed above, Integral Energy:

- agrees in principle that the introduction of both GSL and S-factor mechanisms would be appropriate as they target different aspects of service performance, namely, minimum and average network performance; and
- submits that the schemes should not penalise planned outages as these are necessary for the efficient, safe and secure supply of electricity by the network.