16 February 2010

Mr Chris Pattas
General Manager
Network Regulation South
Australian Energy Regulator
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Dear Chris,

Submission to the AER's Draft Distribution Determination for South Australia

SP AusNet welcomes the opportunity to provide this submission in response to the AER's Draft Distribution Determination for South Australia for the 2010–11 to 2014/15 regulatory period. SP AusNet is not directly affected by the South Australian Draft Decision, however there are some broader issues raised by the Draft Decision that may have a bearing on the AER's approach to regulatory decision making in other reviews, including the current review of Victorian distribution price controls.

SP AusNet has, along with the other Victorian distribution businesses (DBs), lodged a joint submission on issues relating to the WACC. In addition to that joint submission, SP AusNet also provides this submission that addresses matters relating to the AER's proposed treatment of ETSA Utilities' self-insurance costs.

ETSA Utilities' operating cost forecast included an allowance relating to self-insurance costs totaling $36.5 million (real, June 2010) over the 5 year regulatory period. The AER's Draft Decision rejected more than 90% of the forecast costs, allowing only $3.3 million. SP AusNet notes that ETSA Utilities' Revised Regulatory Proposal strongly rejects the AER's findings, commenting that[1]:

> "ETSA Utilities is disappointed that the AER has formed its decision and published its Draft Determination without engaging with ETSA Utilities to seek any clarification on many of the matters raised in connection with self-insurance. ETSA Utilities' detailed response on this matter is presented in Attachment G.5 of this Revised Proposal. ETSA Utilities is confident that sufficient supporting material is available to the AER to support an amendment to its Draft Determination."

[1] ETSA Utilities, *Revised Regulatory Proposal, 2010-2015*, 14 January 2010, page 128.

Evidently, ETSA Utilities is confident that the apparent miscommunication that has led the AER to reject the majority of the costs relating to self insurance can be resolved through further discussion. Notwithstanding ETSA Utilities' view, SP AusNet is concerned that the AER's approach reflects a marked departure from previous regulatory practice. A change in the AER's approach to self-insurance will affect many network companies in Australia. Whilst it is appropriate for the AER to refine and improve its regulatory decisions, introducing significant changes in the absence of broad industry and stakeholder consultation creates regulatory risk.

In addition to the broader issues regarding the lack of stakeholder consultation and the concomitant increase in regulatory risk, SP AusNet does not agree with important aspects of the AER's reasoning in relation to self insurance. For example, the AER presents the following reasoning to support its conclusion that some categories of risk are better addressed through cost pass through arrangements:

> "While this is a generally accepted method of funding loss events, the AER considers that care must be taken when self insuring its key income generating assets. Once an asset is destroyed or is severely impaired, there is a risk that there will be no income or means to fund the self insurance event. If a network service provider loses a key asset and is unable to earn income as a result, the network service provider may be unable to meet even a modest repair or replacement bill. This is in contrast to external insurance, where the losses are funded by an external party or insurer, and is not required to be funded from the income flow (or key income producing assets) of the business. In general, the AER considers that events affecting key income generating assets are better dealt with through the cost pass through mechanism. This ensures that the event can be judged in terms of efficiency and scale once the timing and quantum of the costs associated with the event are known with certainty."

The AER's assertion that a network service provider would be unable to "meet even a modest repair or replacement bill" if a key asset were destroyed or severely impaired is factually incorrect. The AER has provided no evidence to support its assertion. As network companies typically have very significant regulatory asset base values, with geographically dispersed assets, and operate within a defined regulatory framework, their capacity to raise funds would not be affected by the impairment of a particular asset.

The AER's conclusion that that "events affecting key income generating assets are better dealt with through the cost pass through mechanism" is also unsubstantiated. Whilst it is true that a pass through mechanism allows the AER to determine the amount of costs to be passed-through to customers, self-insurance naturally incentivises the network service provider to ensure that the costs of the event, when it occurs, are minimised. Furthermore, self-insurance provides an incentive on the network company to manage risks efficiently. In contrast to a regulated outcome, such as the AER's existing cost pass-through approach, self insurance has superior incentive properties, lower administrative costs, and it entails less exposure to regulatory risk. Self-insurance will therefore deliver better outcomes to customers. Unfortunately, the AER appears to have concluded mistakenly that self-insurance provides weak incentives for regulated businesses to minimise costs[2]:

> "The AER considers that allowing for any underground damage and environmental liability self insurance costs reduces the incentive to the business to prevent environmental damage."

The AER's conclusion is incorrect because the act of self-insuring means that the network service provider is acting as both the insurer and the insured during the regulatory period. The incentive properties in such an arrangement are, as noted above, to minimise the risks of events occurring and, should an event occur, minimise the resultant costs. In contrast, a pass through arrangement such as that which the AER has imposed in NSW, has comparatively weak incentive properties. These properties give rise to the need for the AER to conduct an inquiry after the event as to the prudency and efficiency of the network service provider's actions.

It is a widely accepted principle of incentive-based regulation that reliance on ex post assessments of performance provide a less satisfactory outcome than alternative arrangements – such as self insurance – which provide clear incentives for regulated companies to minimise costs. It is also widely accepted that the application of after-the-event reviews by a regulator to determine the level of revenue that a regulated company is permitted to recover typically entails a heightening of regulatory risk. As noted above, increasing the level of regulatory risk faced by regulated businesses is not in the long term interests of consumers.

The AER appears to have also concluded that self-insurance should only relate to costs that are 'uncontrollable'. For example, in relation to motor vehicle risks, the AER comments that[3]:

> "The AER considers that this cost is a business as usual cost (costs are incurred on a regular basis and can be forecast with accuracy), and as such should not be included in self insurance. Additionally, motor vehicle costs are not uncontrollable, with fleet management strategies and driver education programs all influencing the extent of motor vehicle event costs. Therefore the AER does not accept the proposed premium related to motor vehicle risks and concludes that the most appropriate premium for this category is $0."

Contrary to the AER's view, there are practically no risks that are 'uncontrollable'. Self insurance may prove to be highly effective for motor vehicle risks, as the network service provider has the benefit of pooling risk across a significant number of vehicles and can also introduce company policies aimed at reducing risk. To the extent that no other allowance has been included in the Draft Decision for the cost of insuring or self-insuring these risks the AER's conclusion that the premium of $0 for this category of self insurance is appropriate is evidently at odds with the revenue and pricing principles set

2 AER, South Australia Draft Decision appendices, 25 November 2009, page 502.

3 AER, South Australia Draft Decision appendices, 25 November 2009, page 498.

out in the National Electricity Law. In particular, the Law requires that a network service provider should be provided with a reasonable opportunity to recover at least its efficient costs.

SP AusNet also notes that the AER's preference to subject cost items to the pass through arrangements will, under the AER's current cost pass through mechanism, expose network service providers to the full costs of events that fall below the materiality threshold. Unless some other form of compensation in the building blocks is provided to cover this expected shortfall, the AER's approach will be inconsistent with the National Electricity Law's revenue and pricing principles noted above.

It is also useful to recall that the inclusion of materiality thresholds in the pass through regime are justified on the basis of the weak incentive properties and administrative costs associated with cost pass through arrangements. Evidently, the design of the pass through regime conflicts with the AER's view that its incentive properties are superior to those relating to self insurance.

SP AusNet's regulatory proposal (page 322) also explained that the application of a threshold as high as 1% of revenue would be inconsistent with the National Electricity Law requirement for the AER to provide SP AusNet with a reasonable opportunity to recover at least the efficient costs it incurs. Moreover, if a threshold as high as 1% of revenue is applied, the potential under-recovery of efficient costs is material, as operating expenditure increases flow directly through to lower profits. Therefore, a 1% of revenue threshold translates to reduction in profit of approximately 5% in that year. Having such a sizable proportion of profit at risk as a result of events outside of the business' control is inconsistent with the requirements of the National Electricity Law.

SP AusNet considers that the reasoning set out in this submission demonstrates that the AER's proposed treatment of self-insurance costs – as set out in the South Australian Draft Decision – is unsound from an economic perspective and inconsistent with the revenue and pricing principles set out in the National Electricity Law.

A copy of this letter and the joint Victorian DB submission on WACC issues is being provided to Mike Buckley (the AER's General Manager of Network Regulation, North Branch) as the points raised are also relevant to the AER's Draft Decision for the Queensland distributors.

We would be pleased to respond to any queries that you or Mr Buckley may have on our submission.

Yours sincerely,

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Director Regulation and Network Strategy

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