SA Power Networks

17 June 2013

Mr Moston Neck
Director
Australian Energy Regulator
400 George Street
Brisbane QLD 4000

Dear Sir

Shared Asset Guidelines: AER Draft Cost Sharing Method

We refer to the AER draft cost sharing method provided to the ENA on Tuesday 11 June 2013, with the clarifications provided to our Mr Walker on 12 June and confirmed in the videoconference with the ENA of 13 June.

SA Power Networks supports the objectives for this method expressed by the AER in the videoconference: that the cost sharing method be simple, consistent, robust, and compliant with the Rules. SA Power Networks sincerely appreciates the opportunity to comment on the draft method.

SA Power Networks is broadly supportive of the draft method, subject to the abovementioned clarifications that are discussed below. However SA Power Networks believes that with only minor amendment, this method could be made far more effective: far simpler, more robust, and more clearly consistent with the Rules.

Our discussion of these issues is provided in the same framework as the AER's draft method, and assumes an understanding of the draft method.

Step 1: Initial filter

Incentive

SA Power Networks understands step 1 has been included to simplify the application of the Guidelines for those NSPs with immaterial unregulated services revenue. However, the inclusion of a bright line materiality threshold based on revenue has the potential to influence commercial decisions and create undesirable outcomes.

A clear example is that of an NSP with relevant unregulated services revenue just below the materiality threshold. Any decision to grow relevant services (other than by way of a very large increment) will be influenced by the shared asset cost sharing impact of the proposed method. For

example, the NSP could choose not to provide an otherwise economic service, or to otherwise modify its behaviour in a way that without the threshold would be considered inefficient.

SA Power Networks is concerned that a cost sharing method that creates such a disincentive or inefficient behaviour may be inconsistent with the National Electricity Objective and the Rules, particularly the first shared asset principle.[1]

SA Power Networks understands that the AER considers the application of a reasonable sharing proportion[2] in step 3 provides an effective incentive to NSPs. SA Power Networks discusses this issue further under step 3, below.

Materiality

Further, the draft method's use of revenue as the basis of the materiality tests could be seen to be inconsistent with the third shared asset principle[3], which indicates that the materiality test should be based on the relative use of the asset for unregulated services.

SA Power Networks notes that in some circumstances (i.e. for some services, but not all) unregulated services revenue could reasonably reflect the use of an asset for unregulated services. SA Power Networks notes that that the guidance provided by the AER in respect of the assessment of the value attributable to "unregulated revenue earned with shared assets" in step 2 (which is the critical materiality test in the draft method) will be crucial to ensuring that the use of revenue as a materiality test is appropriate.

Step 2: Materiality test

SA Power Networks notes that the critical materiality test outlined in step 2 is based on a measure of revenue, so the problems raised with a bright line materiality test noted above will apply equally to step 2.

The establishment of Shared Asset Unregulated Revenues

As it is currently drafted, the draft method appears to target shared asset costs relating to services in which the regulated assets are crucial to, if not the substance of, the service, such as NBN Co facilities access services and other such asset dependent services. SA Power Networks believes this is a reasonable model, given our understanding of the AEMC's intentions, and the way that these intentions have been reflected in clause 6.4.4 of the Rules. However, while the draft method appears consistent with the Rules in the context of shared asset dependent services, it does not appear so when other, non-shared asset dependent services (both described below).

It is important to note at this point that the draft cost sharing method, notwithstanding that it involves an assessment of asset costs, effectively results in the reduction of the ARR by an amount virtually the same as the amount that would be the result of applying the sharing proportion[4] to shared asset unregulated revenues.[5] The sharing proportion put forward in the draft method is

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1 Clause 6.4.4(c)(1).

2 Reflected by "X" in the draft method handout.

3 Clause 6.4.4(c)(3).

4 Reflected by "X" in the draft method handout.

5 "Shared asset unregulated revenues" is also referred to in the draft method as "unregulated revenues earned with shared assets" (in step 2). The AER confirmed these are the same during the video conference.

33.3%. It is therefore obvious that the assessment of the value attributable to "unregulated revenue earned with shared assets" is critical when many different services are provided.

For example, one of the unregulated services SA Power Networks provides is pole and duct rental for telecommunications purposes. The organisation's ability to provide this service is clearly dependent on the existence of the relevant poles and ducts, the costs of which would be expected to be reflected in the regulated asset base. Without endorsing the sharing proportion put forward by the AER, it appears that the draft method has been developed with services such as this (shared asset dependent services) in mind. Subject to the issues we raise under step 3, below regarding revenues "recovered" through unregulated services, SA Power Networks agrees that shared asset dependent services are potentially appropriate for a cost sharing method such as the AER's draft.

However, such a method is obviously far less appropriate for services that are not dependent on the use of regulated assets. Contrast another example of services provided by SA Power Networks – the construction of electrical infrastructure for commercial clients in a highly competitive market. This service is effectively one of project management, where varying but most often significant components of labour, services and materials are outsourced, subcontracted or passed through, but are all reflected in revenue. SA Power Networks provides several services generating significant revenue in this way, and also provides them from locations outside of South Australia and/or unconnected with the distribution network.

The use of regulated assets in the provision of such services[6] fluctuates over time, but is intuitively far from material.[7] Further, such services are clearly not dependent on the use of regulated assets, as they can easily be and very often are, rented. It is very clear that the gross revenue earned by the provision of such services is absolutely unrepresentative of the physical use of any regulated assets.

SA Power Networks therefore believes that step 2 of the draft method (as it is currently drafted) must be changed as it is not appropriate as a materiality test for all types of services, and could therefore generate an inappropriate value for shared asset unregulated revenue to carry into step 3.

Having brought this issue to the AER's attention on 11 June, on 12 June the AER advised SA Power Networks (and later the ENA) that the unregulated revenue **earned with** shared assets mentioned in step 2 should be interpreted as the unregulated revenue **directly related to the use of** shared assets. This means that an allocation or apportionment must be made.

Apportionment

SA Power Networks notes that for unregulated services other than asset dependent services, achieving even reasonable certainty in this will be extremely difficult and therefore time consuming, and costly, as it would be likely to require change to accounting and other systems. Further, given even an intuitive understanding of the use of regulated assets in non-asset dependent services, it is reasonable to expect that the resulting benefit would not far outweigh the regulatory cost involved. To this equation you need to add the regulatory cost of assessing the shared asset cost sharing implications of all relevant commercial decisions, and the cost of implementing solutions that but for the shared asset cost sharing method would be considered inefficient. It is clear to SA Power

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[6] Conceivably vehicles, buildings, etc.

[7] The AER's Issues Paper suggested a physical asset use based materiality threshold of 20% might be appropriate.

Networks that there is little to be gained, and potentially much to be lost, by the application of the Guidelines to assets that are used only marginally in the provision of unregulated services.

That is, the requirement to make an apportionment in respect of the use of assets by services that currently use a clearly immaterial amount of regulated assets, will create an ongoing regulatory burden and inefficiency the cost of which is likely to outweigh the benefit to standard control services customers.

We emphasise here that the application of the Guidelines poses significant risks to standard control services customers as well as NSPs. If the shared asset cost methodology drives NSPs to choose not to provide services, whether existing or new, or to provide services by means that avoid the use of regulated assets, most of the operating costs that would have been attributed to those services will have to be met by standard control services customers rather than be shared with unregulated services.

SA Power Networks does not believe that these problems can be resolved within the framework, even as clarified by the AER, represented in the draft method. Even if the AER provides carefully considered guidance or shortcut methods for determining revenue **directly related to the use of** shared assets, all relevant commercial decisions in respect of the provision of unregulated services other than those in which the asset is the substance of the service will require this consideration, and this is likely to drive inefficient outcomes.

Step 3: Cost reduction method

As noted above, while step 3 does involve an assessment of asset costs, it effectively reduces the ARR by a proportion of shared asset unregulated revenues, where the (sharing) proportion is determined by the AER. SA Power Networks' comments are therefore focussed on the sharing proportion.

Since providing the draft method, the AER has noted that the sharing proportion needs to give effect to the balancing of the first two (essentially conflicting) shared asset principles: that NSPs should be encouraged to provide additional services with regulated assets; and that cost sharing may not be dependent on relevant profitability.

ENA discussions with the AER make it clear that there is no easy solution to this dilemma. However it is clear that the AER has a responsibility to balance the shared asset principles in any cost sharing method developed under the Rules to give best effect possible. SA Power Networks believes that the AER should take the following issues into consideration in that process.

- Clause 6.4.4(a) says the AER **may** reduce the ARR by an amount it considers **reasonable** to reflect the costs of an asset the NSP is **recovering** by charging for an unregulated service.
    - SA Power Networks believes the use of the words **may** and **reasonable** in this clause gives the AER significant discretion to create a simple, reasonable, and effective cost sharing regime.
    - SA Power Networks believes that the use of the word **recovering** is very important and should be given significant weight by the AER. It seems reasonable to interpret **recovering** to mean "after other incremental costs have been accounted for", because the contrasting interpretation, "having no regard to the other incremental costs of providing the service", seems quite unreasonable when considered in the light of the

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first shared asset principle (where incremental costs are the costs incurred as a direct consequence of providing the service). Further, this interpretation is not inconsistent with the second shared asset principle as noted in our next two points.

- The second shared asset principle, at clause 6.4.4(c)(2) says that a shared asset cost reduction should not be **dependent** on the shared asset unregulated services being profitable.
    - To be dependent is to be determined by or contingent on something. This meaning clearly reflects the AEMC's intention that the Guidelines should not insulate NSP's from all relevant commercial risks.
    - SA Power Networks believes that the second shared asset principle simply means cost sharing should not be contingent on or determined by profitability. It does not mean that the AER must disregard the fact that there will be incremental costs associated with the provision of most unregulated services.
    - We note that incremental costs in respect of unregulated services will vary widely between asset dependent and non- asset dependent services.

- The first shared asset principle, at clause 6.4.4(c)(1) says that NSPs should be encouraged to use regulated assets to provide additional services where it is **efficient** and doesn't prejudice standard control services.
    - SA Power Networks believes that this principle must be considered paramount and given most weight. As noted above, to the extent that the Guidelines are inconsistent with this principle, they will drive inefficient outcomes that will be detrimental to all stakeholders.
    - To emphasise the above point, the use of the word **efficient** should reasonably be interpreted to mean **cost efficient**, or in other words, where the benefits of providing the service outweigh the costs. SA Power Networks believes that this further supports the argument that the cost sharing method must have regard to the incremental costs of providing unregulated services, or at least account for the fact that they exist in the consideration of the sharing proportion used in the cost sharing method.
    - The use of revenue based materiality thresholds creates issues with NSP incentives, as discussed above. SA Power Networks notes that for these issues to be alleviated by the application of a fair and reasonable sharing proportion, the sharing proportion must be significantly lower than the 33.3% put forward in the AER's draft method.
    - It is noted that rather than comply with the Guidelines, NSPs may propose an alternative cost sharing method as part of their regulatory proposal.

Ignoring for the moment the problems with incentive and apportionment we have noted above, SA Power Networks believes that for the sharing proportion to work effectively as the AER intends, the value of that proportion must be very much lower than the 33.3% put forward in the draft method. Where the sharing proportion applies to all services, and it is effectively based on revenue, it must be set at the lowest reasonable level to reflect the different cost structures between unregulated services, the relative risk of providing these services, and the fact that NSPs will have varying portfolios of these services.

Proposed amendments to the draft method

SA Power Networks has identified problems with incentives caused by a bright line revenue materiality threshold, with the inappropriate use of revenue as a proxy for material use for many services, with the complexity caused by the requirement for apportionment, and with inefficient behaviour caused by the inclusion non-shared asset dependent services. We have also noted the difficulty in choosing a sharing proportion that delivers a material benefit to standard control services without destroying some unregulated services.

SA Power Networks notes that most of these issues could be resolved by making one minor change to the draft method. It is recommended that the first line of step 2 be changed from: "Identify unregulated revenues **earned with** shared assets (all services, all RAB assets)" to: "Identify unregulated revenues **dependent on the use of** shared assets (all services, all RAB assets)".

The meaning of "dependant on the use of" may need to be clarified. SA Power Networks would see this as where the asset is the substance of the service. A practical test might be whether the service could reasonably be provided without the use of the regulated asset. For example, SA Power Networks could not provide pole rental without the poles.

SA Power Networks believes this change will provide the following benefits:

- It satisfies, without undue complexity, the requirement of the third shared asset principle that cost sharing should be applied when the use of the asset is material. Where the service depends on the use of the asset, it is clearly material.

- It removes the potential complexity and cost to the AER and NSPs involved with, as relevant, developing and applying guidelines in respect of the assessment of the relevant use of shared assets (required for the calculation of revenue directly related to the use of shared assets) for non-asset dependent services.

- It eliminates the costs to NSPs and standard control services customers associated with other inefficient behaviours driven by the method.

- As regards the two points immediately above, it removes potentially significant and highly probable costs associated with benefits to standard control services customers that are likely to be insignificant at best.

- It captures all unregulated services where the revenue is predominantly and directly related to the use of shared assets, providing a regime in which the benefits clearly far outweigh the costs, thus satisfying the first shared asset principle.

- It allows for a higher cost sharing proportion than where non-asset dependent services must be taken into account, as it removes much of the regulatory risk associated with applying the cost sharing proportion to marginal services.

SA Power Networks has provided reasons above for its belief that the Rules give the AER the discretion to make this amendment in the aim of developing a simple, practical, and robust regime that delivers optimal outcomes. It occurs to SA Power Networks that the introduction of a regime

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with a highly justifiable if slightly restricted application holds far fewer procedural and regulatory risks than the alternative, and we therefore recommend this approach.

We would be pleased to discuss this recommendation, or any of the issues raised in this letter, at your convenience.

Yours faithfully

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General Manager Corporate Strategy

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