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16 August 2010

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

Dear Mr. Pattas

Victorian electricity distribution network service providers distribution determination 2011-2015 : Draft decision

TRUenergy appreciates the opportunity to provide a response to the Victorian electricity distribution determination 2011-15 – Draft decision.

In short – we welcome the Draft decision and support it.

We note the Draft decision is supported by strong analytical and empirical evidence. As a result, we would only welcome changes to the Draft decision in limited circumstances - where irrefutable evidence is submitted as the basis for a change.

In responding to the Draft decision, we limit our feedback to the following areas:

- Incentive regulation applied by the AER
- Outsourcing & third party related transactions
- Demand forecast for 2011 -2015
- Assessment of operational expenditure (opex) x & capital expenditure (capex) requirements for 2011-15
- WACC
- S factor

Key issues

A: Australian Energy Regulator (AER) applies incentive regulation and delivers efficient distribution prices in Victoria in the past 10 years

TRUenergy supports the incentive regulation used by the AER in the Draft decision – and over the past 10 years – as it has delivered "efficient" distribution prices.

In this regard, we submit:

- Distribution Network Service Providers (DNSPs') actual level of expenditure in the past 10 years - on both opex & capex – indicates they responded well to the incentives in the regulatory framework. Their level of expenditure has been lower than their own forecasts & the Essential Services Commission of Victoria (ESCV's) allowances over the past 10 years. In responding to the incentives in the regulatory framework, DNSPs have provided "efficient" distribution prices in Victoria.

- The AER's "revealed cost" [1] approach - which has been used as a starting point to determine an efficient level of opex and capex for DNSPs in 2011-15 - is supported. As we have previously argued, DNSPs have been operating efficiently in the past 10 years. As a result, we submit the "revealed cost" approach is a suitable starting place from which to determine the "efficient" level of expenditure required by the DNSPs in the next regulatory period.

B: AER assessment of opex & capex requirements for 2011-15

TRUenergy supports the method used by the AER to establish the "efficient" level of expenditure –on both opex & capex – for the next regulatory period.

In this regard, we support:

- The AER's conclusion that determined DNSPs' forecasts could not be relied upon to give a precise estimate of future needs. As we understand, there was a clear tendency to over estimate future needs.

- The AER's conclusion that the benchmarking and trend analysis that showed that DNSP historical costs were a better guide to overall future capital spending than DNSP forecasts.

- The AER process of applying a range of alterative approaches and the use of external consultants to determine if replacement and augmentation expenditure were "efficient".

C: Outsourcing & third party related transactions

TRUenergy supports the method used by the AER to determine the "efficient" prices for services outsourced by DNSPs to third parties.

We understand that the Victorian DNSPs have been outsourcing related party transactions extensively.

In this regard, we support:

- The AER's decision to accept contract charges in forecasts only where a transaction passes a "presumption threshold". The threshold test asks:

- [1] The AER uses DNSP historical costs as guide to predicting overall future capital spending rather than DNSP forecasts under the revealed cost approach.

- Whether the DNSP had an incentive to agree to non arm's length arrangements with the contractor?

- If it did, was a competitive open tender process conducted?

We believe the AER has been unable to make this presumption after reviewing most DNSPs major arrangements.

As a result, it developed a process to determine the "efficient" costs of providing services through these arrangements. As we understand it, the AER accepted the contractor's actual direct costs and allowed a "margin" above these costs - where this reflected "legitimate economic reasons". We believe this represents a sensible approach to dealing with a complex problem. As such, we support any AER decisions as an outcome of this process.

D: Demand forecasts for 2011-15

TRUenergy supports the AER's decision to reject the DNSP demand forecasts.

The AER determined DNSP demand forecasts were significantly different from their historical numbers and the AEMO demand forecasts for the next 5 years. We believe the DNSPs' energy forecasts for the regulatory period 2011-2015 should be adjusted in line with the trends presented by AEMO.

TRUenergy previously raised concerns with the energy forecasts submitted by a range of DNSPs in this review. For example, in SP AusNet's original proposal, they forecast a significant reduction in energy consumption going forward into the next regulatory period from 2011-2015.

The following (table 5.2) in its regulatory proposal provides a "snap shot" of the energy forecasts that they predict over the next regulatory period.

Parameter	2011	2012	2013	2014	2015
Energy Consumption (MWh)	7,821,431	7,756,120	7,621,548	7,563,299	7,638,345

Data source: SP AusNet EDPR Regulatory Proposal November 2009

TRUenergy observes that the energy forecasts put forward by SP AusNet reduce on average by approximately 1.10% every year from 2011 to 2014.

TRUenergy notes that this negative growth rate contrasts to the 1.25% growth in energy forecasts in the current regulatory period. The principal justifications for the negative growth in energy forecast by SP AusNet are expressed in the SP AusNet regulatory proposal.

SP AusNet argues that:

1. The negative growth rate in energy forecasts over the regulatory period 2011-2015 reflects a number of policy related issues. For example, the introduction of a premium feed in tariff on energy consumption is one example.

2. SP AusNet has incorporated the expected time of use tariffs into its energy forecasts. Whilst the primary objective of this tariff is to reduce peak and shoulder energy consumption, SP AusNet modelling indicated that it will also lead to marginal reduction in overall energy consumption. Also, the AMI roll out will lead to energy reductions early in the forthcoming regulatory control period, with positive consumption growth of around 1% returning in final year of the next regulatory period.

TRUenergy does not produce specific energy forecasts for the SP AusNet distribution area. However, we use a number of sources to help us get a better understanding of the energy forecasts demand over the regulatory period for the SP AusNet distribution area for 2011-2015.

In particular TRUenergy uses the AEMO Statement of Opportunities (SOO), which provides a valuable source of information on the projections of annual energy for Victoria. TRUenergy acknowledges that these forecasts apply to the state wide – compared with the SP AusNet forecasts that apply only to their distribution area. However, these projections do include the following critical assumptions for the forthcoming regulatory period and so TRUenergy believes that they can be used as a credible and prudent basis for forecasting energy growth within the SP AusNet distribution area:

- The Carbon Pollution Reduction Scheme
- The Expanded Renewable Energy Target
- Minimum Energy Performance Standards
- Federal Insulation Program
- Energy Saver Incentive
- Advanced Metering Infrastructure

TRUenergy regards AEMO's energy forecasts as reliable and realistic given they are undertaken by an independent body. We regard them as more credible than the SP AusNet energy forecasts.

Table B.3 Victorian Annual Energy Projections (GWh)

Financial Year	Medium	High	Low
2010-2011	47,127	49,221	45,665
2011-2012	47,781	50,023	45,420
2012-2013	48,630	51,141	46,206
2013-2014	48,836	52,142	46,280
2014-2015	49,361	53,332	46,638

Data source: AEMO Statement of Opportunities 2009 table B.3

TRUenergy observes that the annual energy projections (GWh) for Victoria actually increase annually by approximately 1.15% under the medium growth scenario as forecast by AEMO from 2011 to 2015. Under the high growth scenario, which we think is relevant given these forecasts were undertaken in the height of the Global Financial Crisis and therefore err on the side of being conservative, annual energy projections increase by approximately 2% from 2011-2015. Therefore, we believe that the SP AusNet energy forecasts for the regulatory period 2011-2015 should be adjusted in line with the trends presented in this information from AEMO.

E: WACC: The Market Risk Premium (MRP)

TRUenergy supports the AER decision of an MRP of 6.5%.

Whilst we consider the market evidence suggests that an MRP of 6% is more appropriate, we definitely agree that the proposed MRP of 8% can not be supported by market evidence.

All the DNSPs put forward a MRP of 8% in the current price proposal. In their regulatory proposals, they argue that the ongoing uncertainty regarding the outlook for the global economy and the capital markets, coupled with the available evidence on the cost of equity faced presently by regulated utilities provide persuasive evidence that demonstrates that a value of 6.5% for the MRP is inappropriate and that in the particular case of the forthcoming determination for SP AusNet, departure from that value is justified. On this basis, they submit an MRP of 8%.

In the Statement of Regulatory Intent on the revised WACC parameters (Distribution) published in May 2009, the AER acknowledges the additional uncertainty associated with the global financial crisis justified an increase in the MRP from 6% to 6.5%. However, the AER made it clear that prior to the on-set of the global financial crisis, an estimate of 6% was the best estimate of a forward looking long term MRP, and, accordingly, under relatively stable market conditions – assuming no structural break had occurred in the market – this would remain the AER's view as to the best estimate of the forward looking MRP.

TRUenergy submits that the relatively unstable market conditions that were current during the global financial crisis do not currently exist. Even when the GFC was at its peak, the AER did not consider that the weight of evidence suggested that a MRP significantly above 6% should be set. [2] As such, and based on the analysis provided by the AER in the past in the Statement of Regulatory Intent on the revised WACC parameters (Distribution) published in May 2009, we can see no firm case exists for increasing the MRP to 8%. On the contrary, the return to a more stable situation in the Australian capital markets suggests that the MRP should go back to its traditional historical value of 6%.

F: S factor

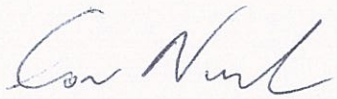
TRUenergy supports this revised "S" factor scheme to be applied by the AER in the next regulatory period. Under the revised scheme, the total "S" factor revenue that SP AusNet is able to achieve is capped at 5% of its total regulated revenue.

Under the current Essential Services Scheme (ESC), there is no cap on the amount of revenue that a distributor can achieve under the scheme. As a result of this, this could lead to a large amount of "S" factor revenue being achieved in any one year.

G: Conclusion

We are pleased that to have the opportunity to respond to the Draft decision. And, we welcome any further discussions regarding this submission. Therefore, if you have any queries regarding this matter, please do not hesitate to contact Con Noutso – Regulatory Manager at TRUenergy on Tel: (03) 8628-1240 or via email on (con.noutso@truenergy.com.au).

Yours Sincerely



Con Noutso
Regulatory Manager

[2] Statement of Regulatory Intent on the revised WACC Parameters (the Distribution Statement) May 2009 p. 238
"Whilst it can not be which of these scenarios explain current financial conditions, both are possible, and both suggest an MRP above 6% at this time may be reasonable. However, having regard to the desirability of regulatory certainty and stability, the AER does not consider that the weight of evidence suggests a MRP significantly above 6% should be set."