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Merits Review  
C/- MCE Market Reform  
Department of Industry, Tourism and Resources  
GPO Box 9839  
Canberra ACT 2601

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Dear Sir

## **Review of Decision-Making in the Gas and Electricity Regulatory Frameworks**

Thank you for the opportunity to comment on the Discussion Paper released by the Ministerial Council on Energy Standing Committee of Officials on 10 October 2005.

This submission is made on behalf of CitiPower, Powercor Australia and ETSA Utilities who, as electricity distribution businesses, will be directly affected by the scheme implemented for review of decision making in the gas and electricity regulatory frameworks. These businesses have common ownership through Cheung Kong Infrastructure and Hong Kong Electric Holdings.

### **Introduction**

- 1 Powercor, CitiPower and ETSA strongly support Option A - Limited Merits Review - as set out in the MCE Discussion Paper of 10 October 2005 titled 'Review of decision-making in the gas and electricity regulatory frameworks' (**Discussion Paper**).
- 2 Powercor, CitiPower and ETSA have reached this view based upon their experience in two Victorian electricity distribution price determinations - in 2005 (Essential Services Commission) and in 2000 (Office of the Regulator-General) and the South Australian review in 2005.
- 3 Attached are five examples of substantial errors that would not be able to be corrected under the proposed Option B. These examples are drawn directly from regulator's final decisions in 2000 and 2005. These are purely factual errors, which by definition are

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likely to be unintentional errors of a type that are to some extent inevitable in what is a complex and significant regulatory process.

- 4 Regulatory errors such as these directly affect the incentives to invest in distribution infrastructure to the detriment of consumers and businesses alike. Furthermore, the absence of a viable option by which to seek redress of such regulatory errors would further exacerbate the uncertainty faced by network businesses in both the electricity and gas industries. This uncertainty has a direct impact upon the incentive to invest in distribution infrastructure, a point highlighted by the Exports and Infrastructure Taskforce in its report to the Prime Minister in May 2005:

'... there is an inherent tension between regulation and efficient investment. In practice, regulators inevitably have a degree of discretion and that discretion creates risks that investors in infrastructure need to take into account.'<sup>1</sup>

- 5 Powercor, CitiPower and ETSA strongly agree with the statement set out at paragraph 5.14 of the Discussion Paper that:

'While there was previously no merits review available in respect of economic regulatory decisions in electricity, revenue determinations directly affect the commercial interests of electricity network service providers, in similar ways that decisions about access arrangements in gas significantly affect the commercial interests of gas pipeline owners and operators. For this reason, together with the discretionary nature of the decision-making power in respect of electricity transmission revenue determinations, there may be policy justification for introduction of Model A merits review for these decisions'

### **The impact of regulatory decisions**

- 6 The decisions of the AER on network regulation directly impact both the returns that network businesses are able to earn on their investments in network infrastructure and, ultimately, the profitability of such businesses. Very few businesses in Australia face such far reaching and substantive revenue regulation. Consequently, the impact of regulatory error, both on the financial viability of such businesses and the incentives for them to make further investments in regulated assets, is unusually large. On this basis alone, judicial review is inadequate to provide such businesses with a substantive opportunity to correct regulatory error.

### **The broad discretionary nature of regulatory decision**

- 7 Decisions of the AER are unlikely to be completely free of error due to the nature and broad discretionary powers available to the AER as an economic regulator. A broad discretionary power inevitably creates the opportunity for regulatory error.
- 8 The complexity of the economic regulatory decisions required in respect of gas and electricity networks make it highly unlikely, if not impossible, that rules regarding the exercise of such discretion can be comprehensively and clearly drafted such that a more limited form of review, such as judicial review, would be sufficient to correct regulatory error.

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<sup>1</sup> 'Australia's Export Infrastructure', Report to the Prime Minister by the Exports and Infrastructure Taskforce, May 2005, 20. We note that while this report primarily considered roads, rail, ports and airports, as 'export oriented infrastructure', it is explicitly stated on page 13 of the report that 'infrastructure' also includes facilities that provide inputs into production processes such as electricity, gas and water.

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- 9 Thus, by the very nature of the economic regulatory decisions required in respect of gas and electricity networks, the most appropriate mechanism for review of decisions made by regulators of these industries is a limited form of merits review as proposed in Option A.

### **The nature of regulatory decisions**

- 10 Many electricity and gas networks are natural monopolies with substantial sunk investments. Therefore, one role of the regulator is to determine prices/revenue such that the natural monopolies do not unjustifiably earn excessive rents from the exercise of market power. Put another way, a regulator is often seen as a 'consumer advocate' or 'buyer's agent' who enters into a contract for service with the network owner including a price of the provision of the service by the network owner.
- 11 If the regulator as 'buyer's agent' sets the price to cover only operating costs, so as to ensure the network owner does not shut down, but does not permit the reasonable recovery of capital costs, the network owner will earn no return on its capital investment. Such action will significantly decrease the incentives for the network owners to continue to invest in new infrastructure investments.
- 12 Network owners must reasonably expect to recoup the opportunity cost of their investment so that they are no worse off by investing in efficient network infrastructure than by investing in alternative investments that are open to them. In order to achieve this, regulators must permit network owners to recover both a reasonable return of capital and a reasonable return on capital.
- 13 A reasonable return on and of capital will depend upon the value of the regulated asset base and the allowed rate of return. There are complex and multifaceted issues associated with the determination of both of these figures and it is largely for this reason that it is necessary to confer the regulator with such a broad discretion. It is for largely the same reason that mere judicial review of whether a regulator was acting within power is insufficient to correct regulatory error, since the limited scope of judicial review prevents a court from getting to the 'nub' of the issues.
- 14 Furthermore, a reduction in the discretion conferred upon the regulator will adversely impact upon the efficiency of the initial decision. Thus, it would not be practical to seek to reduce the scope of the discretion conferred upon the regulator, since this would only be likely to increase the amount of regulatory error in need of correction.
- 15 Judicial review is appropriate where the empowering legislation is very prescriptive leaving the decision maker with a narrow task to complete. However, in the case of network regulation it is almost impossible for the National Electricity Law, National Electricity Rules and National Gas Law to be so prescriptive as to significantly reduce the nature of the discretion of the regulator. As such, judicial review is not suited to correcting regulatory errors made in respect of electricity and gas networks.
- 16 As set out in the attached examples, the scope of regulatory error can be large and varied. Therefore, a limited form of merits review is required to enable network owners to seek a reasonable return of capital and a reasonable return on capital.

### **ENA submission**

- 17 Powercor, CitiPower and ETSA agree with the positions and the response set out in the Energy Network Associations response to the Discussion Paper.

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18 The response of the ENA to each of the specific questions set out in the Discussion Paper are incorporated into this paper in full.

If you require further information in relation to this submission, please do not hesitate to contact Rolf Herrmann, Manager Regulation, on telephone (03) 9683 4282.

Yours sincerely

Richard Gross  
General Manager – Regulation and Pricing

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## Attachment

### Example 1

#### *2000 Electricity Distribution Price Review - Error in calculation of Efficiency Carry Over*

Powercor appealed the final determination of the 2000 electricity price review to the Appeal Panel (**Appeal Panel**) on the ground that in calculating the 'X factor' in respect of Powercor for each of the calendar years 2001-2005, the Office of the Regulator General (**Office**) wrongly determined that Powercor had a negative or zero efficiency gain for the five year regulatory period as a result of determining Powercor's efficiency gain for the first regulatory period by relying on regulatory accounts for the 1999 year that did not, for the purpose of calculating efficiency gains, accurately or fairly represent Powercor's distribution expenditure for the 1999 year.

In its statement of Reasons, the Appeal Panel noted that:

'it should not be the case that some distributors businesses are credited with efficiency improvements whilst others are not solely because of their fortuitous choice of accounting base chosen when submitting their 1999 regulatory accounts'

In this instance, the Appeal Panel decided that an error of fact had occurred and decided that the determination should be set aside and remitted to the Office for amendment. This type of error would also not be susceptible to judicial review processes.

### Example 2

#### *2000 Electricity Distribution Price Review - Error in determining compensation payable to Powercor for damage caused by voltage variations*

Powercor appealed the final determination of the 2000 electricity price review to the Appeal Panel on the ground that the Office wrongly determined the compensation payable to Powercor for damage caused by voltage variations by determining compensation on the basis of:

- the number of Powercor's urban customers
- rather than
- Powercor's total number of customers.

The Office stated in its determination that:

'the key cause of compensation payments is surge damage caused by lightning (other causes of voltage variations have a relatively minor impact). In establishing a benchmark, the number of urban customers would be an appropriate normalising factor with some adjustment for the susceptibility of distributors in area to lightning strikes'

Evidence obtained by Powercor established that there are other significant causes of surge damage, especially in connection with pole fires caused by specific local conditions and therefore that it was incorrect to assert that 'other causes of voltage variations have a relatively minor impact'.

Furthermore, Powercor had a significant number of rural customers served by low voltage lines who were no less likely than urban customers to experience damage due to voltage variations. As

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such, Powercor considered that the Office's approach in considering only the number of urban customers was in error.

The Appeal Panel accepted Powercor's submission that an error of fact in a material respect had occurred in this case and decided that the determination should be set aside and remitted to the Office for amendment. The Final Determination was subsequently amended to provide an allowance of \$9.1 million over the 5 year period for Powercor, which is the amount of Powercor's actual costs for surge damage compensation. This type of error would not be susceptible to judicial review processes and if merits review had not been available Powercor would have been significantly under funded for its costs in this regard.

### **Example 3**

*2000 Electricity Distribution Price Review - Error in removing \$1.2m from AGL's forecast Opex in relation to indirect overheads attributable to street lighting*

AGL incurred \$3.2m of Opex in relation to street lighting. The Office determined that an amount should be deducted from AGL's Opex such that Opex in relation to street lighting was not included.

The Office deducted \$4.4m from AGL's Opex, being the \$3.2m as well as 'a small allocation for indirect overheads'. AGL assumed that the difference (\$1.2m) had been removed by the Office on the basis that this was to account for indirect overheads.

AGL appealed to the Appeal Panel in respect of the \$1.2m since no part of AGL's Opex forecasts included any indirect overheads related to public lighting.

At appeal, the Office conceded that it had incorrectly removed \$1.2m from AGL's Opex

The Appeal Panel decided that the determination should be set aside and remitted to the Office for amendment.

### **Example 4**

*2000 Electricity Distribution Price Review - Error in the efficiency carryover calculation and expenditure on growth in excess of forecast growth*

AGL Electricity appealed the final determination of the 2000 electricity price review to the Appeal Panel on the ground that in calculating the efficiency carryover, the Office erred in not recognising the expenditure necessarily incurred where actual growth has exceeded forecast growth in the current regulatory period.

The Panel noted that the Office adopted a 'rule of thumb' approach to implement the efficiency carry over which measured efficiency by comparing actual total costs (including operating and maintenance costs, and capital costs) as achieved in 1999 with the benchmark forecasts, for the distribution business, for that year.

The Panel found that the rule of thumb resulted in a measure that did not reflect efficiency as normally understood as the comparison entailed in that rule of thumb did not make any allowance for changes in the size of scope of the business from those which were assumed in the benchmark forecasts.

In result, the Panel decided that this application of the rule of thumb constituted an error of fact in a material respect and decided to set aside the determination and remit it to the Office for amendment.

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AGL estimated that this error would have deprived it of \$6.44m over the regulatory period.

### **Example 5**

#### *2005 Electricity Distribution Price Determination (South Australia) - Error in determination of equity beta used in calculating the WACC*

ETSA Utilities sought review of the final determination of the Essential Services Commission of South Australia (**ESCOSA**) on the ground that ESCOSA had incorrectly determined that ETSA Utilities' equity beta for the purposes of calculating its WACC was 0.8.

In its review of the final price determination, ESCOSA accepted that it did not give due weight to the need to provide reasonable certainty and consistency over time in the outcomes of regulatory processes.

Upon giving due weight to this factor, ESCOSA determined that an equity beta of 0.9, and not 0.8, should be used for the purposes of determining the WACC under the 2005-2010 price determination.