

SUBMISSION FROM THE ESSENTIAL SERVICES COMMISSION OF VICTORIA TO THE DRAFT NATIONAL ELECTRICITY RULES

The Essential Services Commission of Victoria (the Commission) welcomes the opportunity to comment on the draft National Electricity Rules (NERs). It should be noted that the views expressed in this submission are the views of the staff of the Commission only and do not represent a position taken by the Commission.

As the Ministerial Council on Energy is aware, the Commission has over 10 years of experience in the regulation of the privately-owned electricity distribution networks in Victoria.

The regulatory framework established by the Commission has aimed to achieve a balance between providing sufficient incentives to the distributors to invest efficiently in their networks and over time returning a share of the efficiency gains to customers in the form of lower prices. At the same time, the Commission has aimed to increase the accountability of the distributors for the service levels that they provide to their customers.

Under this framework, the Victorian distributors have achieved a marked improvement in service performance for virtually all Victorian customers. Services have not only improved in terms of average network performance, but they have also improved for customers located in those parts of the distribution network that have historically experienced poor performance.

At the same time as improving service performance, the Victorian distributors have also improved the efficiency of their operations. This has resulted in substantial declines in real distribution network prices since the Commission's first review in 2000. Distributors have also consistently exceeded the benchmark returns on assets since economic regulation was first introduced in 1995.

With this experience in mind, the Commission has reviewed the draft NERs and given consideration to whether they can be practically implemented, the incentives that they create on the electricity distributors, and how well they address the issues that the AER will face in transitioning electricity distributors from different jurisdictional regulatory frameworks to uniform national arrangements. The Commission also gave consideration to the extent to which the draft NERs build upon the experiences of jurisdictional regulators.

The Commission commends the MCE on the progress that has been made on developing the draft NERs. It is a complex and difficult task, yet much of what is contained in the current draft is of a high quality and will provide a solid basis for the regulation of distribution services into the future.

However, the Commission is concerned that the draft NERs have the potential to limit regulatory innovation due to the level of prescription and limited flexibility that

they provide to the AER. It also appears that the draft NERs are requiring the development of procedures and guidelines that might discard rather than build upon existing procedures and guidelines at the jurisdictional level that incorporate numerous years of experience. This may create discontinuities and thus create uncertainty for the regulated businesses as well as increase the possibility of gaming the transition to the national framework.

The submission provides comments on two high level issues — the focus of the draft NERs on the building blocks approach and the processes and procedures that the AER must follow. The submission then provides comments against specific clauses of the draft NERs.

Predominance of the building blocks method

The Commission notes that the draft NERs are heavily founded in the building blocks approach and are highly prescriptive in the way in which the AER must implement the building blocks approach. The prescription contained within the draft NERs suggests that the AER will have little flexibility to make modifications to the building blocks approach without going through a Rule change process with the AEMC.

The MCE should note that the building blocks approach itself has evolved over time as experiences with the building blocks framework have identified ways to improve upon that framework. Regulators have modified the ‘pure form’ of the building blocks method to increase the power of the incentives under the framework and thus improve the effectiveness of the regulatory approach.

For example, to maintain the strength of the incentive to achieve efficiencies throughout a regulatory period, regulators introduced the efficiency carryover mechanism (or efficiency benefits sharing scheme) into the building blocks framework. Regulators also offset the power of incentives to reduce costs created by the efficiency carryover mechanism by introducing service incentive arrangements that financially reward or penalise distributors for their performance against a set of service standard targets. Thus, the two mechanisms complement each other to balance the incentives for efficiency with the incentives to achieve certain performance outcomes.

Neither the efficiency carryover mechanism nor the service incentive schemes were a feature of the ‘pure form’ of the building blocks method originally used to regulate distribution services. Rather they were introduced after reviewing the outcomes achieved under the ‘pure form’ of the building blocks method and identifying that modifications to its features were required.

The jurisdictional regulators have continued to examine the outcomes achieved under the applied regulatory framework to identify further improvements and refinements to that framework.

In its last electricity distribution price review, the Commission further improved upon the building block approach through application of the ‘inferential approach’¹

¹ The inferential approach was adopted by the Commission in the 2006-10 price review to determine the distributors’ future expenditure requirements relied on the strength of the incentives inherent in the approach as enhanced by the efficiency carryover mechanism to

to forecasting expenditure and the 'rate of change'² approach to forecasting likely changes in operating and maintenance expenditure over time. The 'rate of change' approach was initially proposed by one of the Victorian distribution businesses and its benefit rests in the fact that it reduces the focus in price reviews of undertaking a bottom-up line-by-line assessment of expenditure.

The 'rate of change' approach is a productivity-based approach as it relies on historical industry-wide movements in productivity and the cost of growth rather than forecasts of business-specific cost movements, reducing administrative costs. The index utilised for the rate of change in operating and maintenance expenditure in the 2006-10 price review was based upon the partial factor productivity (PFP) trend calculated by PEG for the five Victorian electricity distributors.³

The inferential and rate of change approaches were adopted to improve upon the processes used in price reviews to determine expenditure forecasts.

The prescriptive nature of the draft NERs does not appear to provide similar scope to the AER to improve upon the current form of the building blocks approach implemented in the jurisdictions. Rather, it appears to take one form of the building blocks as the definitive approach to regulation. Had the current draft of the NERs been in place 10-15 years ago, innovations such as the efficiency carryover mechanism or service incentive schemes may not have occurred.

The prescriptive nature of the draft NERs also means that extensive Rule changes will be required if further advances in regulatory approaches are to be made, for example the implementation of TFP-based approaches to regulation.

TFP is not a substitute for the building blocks approach but is an evolution of the building blocks approach and is most likely to be used in conjunction with the building blocks approach. Under TFP, a regulator will be able to establish longer regulatory periods with less intensive periodic reviews resulting in significant and administrative efficiencies.

TFP-based approaches share the benefits of efficiency gains achieved by updating the value of the TFP trend whilst providing distributors with a longer pay off period for efficiency initiatives. In this way, they are a better and more sophisticated efficiency benefits sharing scheme than the efficiency carryover mechanism operating in Victoria as they provide a stronger incentive to deliver other broader market objectives such as demand management and efficient tariff structures.

TFP-based approaches better simulate the disciplines of a competitive market as businesses are rewarded or penalised on how well they perform against their

infer that a distributor's revealed cost information was representative of efficient costs. Where the scope of activities is unchanged, the inferential approach narrows the scope of review to changes in costs driven by changes in the scope of the activities undertaken by the distributor.

² For operating expenditure, once the base level of expenditure was established using the inferential approach, changes in operating expenditure over the period were estimated using the 'rate of change'. The 'rate of change' is defined as the year to year change in operating and maintenance expenditure for a number of factors such as expected productivity improvements, changes in the price of distributors' inputs and an allowance for the cost of growth.

³ Kaufman et al 2004 TFP Research for Victoria's Power Distribution Industry 2004.

peers. They also provide a more immediate reflection of changes in demand and industry costs and thus overcome the key information asymmetries issues associated with developing forecasts.

The pre-conditions necessary for using TFP to establish a price path are present in Victoria. However, the ability to introduce TFP through changing either the laws or rules is unlikely prior to the next Victorian electricity price review. As a result, the draft NERs effectively prevent Victorian customers from realising the benefits of a more effective and efficient form of independent economic regulation.

The Utility Regulators' Forum identified TFP as an approach to regulation worth investigating. In 2002, Farrier Swier, in a report to the URF, found that TFP-based approaches to regulation are likely to be conceptually superior to other approaches to regulation, including the building blocks. Farrier Swier noted that:

... TFP-based approaches inherently have lower regulatory costs than other approaches: they avoid the need for detailed analysis of projected costs and efficiency gains over the regulatory period and potentially increase the period between review ...⁴

Despite making this finding back in 2002, jurisdictional regulators have not introduced TFP-based approaches even though they have had the scope to do so. Regulators realise that any changes to a regulatory framework have implications for the incentives under which regulated businesses operate and thus the outcomes experienced by their customers.

Hence, providing scope within the NELs and NERs for the introduction of TFP-based approaches does not mean that the AER will introduce such approaches without undertaking extensive consultation and careful consideration of the effects of such a change. However, it will allow the AER to continually improve upon existing regulatory approaches as data availability and the regulatory experience of regulated businesses increases.

The legislative framework should allow for appropriate testing and consultation on changes to the regulatory framework rather than prevent further refinements to existing approaches.

The Commission notes that the following clauses will make it difficult for the AER to introduce TFP-based approaches:

- Clause 6.2.6(b)(2) requires that the revenue to be earned be set equal in NPV terms to the revenue requirement. This clause explicitly prevents the application of TFP as it is this requirement that is broken when applying TFP indices to price movements.
- Clause 6.3 requires a revenue determination to be based on the post-tax revenue model and specify annual amounts for indexation of the regulatory asset base, performance incentive scheme and efficiency benefit scheme. It would be difficult to adopt a TFP approach and still meet these requirements.
- Clause 6.5.5 requires the application of an efficiency benefits sharing scheme. The requirement to have an explicit scheme would increase the difficulty of

⁴ Farrier Swier Consulting 2002 Comparison of Building Blocks and Index-based approaches, Utility Regulators Forum, June, p. 84.

applying a TFP approach to price movements. TFP resolves revenue recovery and efficiency sharing simultaneously and as such more faithfully replicates the normal outcomes of competitive markets.

Consultation procedures

There are a number of guidelines and models that the AER is required to establish 6 months after the Rules are established. These guidelines and models include the:

- service incentive performance target scheme
- efficiency benefits sharing scheme
- cost allocation guideline
- post-tax revenue model, and
- roll-forward model.

Any amendments to these guidelines and models can not be applied to a particular determination less than 15 months prior to a determination.

The requirement to establish these guidelines and models within 6 months of the Rules coming into effect means that the AER must establish the guidelines and models without the experience necessary in regulating distribution services. Given the short timelines provided to the AER, it is likely that the existing approaches used in regulation of transmission will be the initial start point for the AER.

There are marked differences in the way that transmission and distribution services are regulated and there are fundamental reasons for why these differences exist. Thus, the experiences of regulating transmission services cannot be immediately translated to the distribution level without a knowledge of the circumstances of the distribution businesses in each jurisdiction and an understanding of why distribution should be regulated the same or differently from transmission. An understanding of the various approaches and implications of changes is critical in developing national guidelines, schemes or models.

Six months is insufficient time for the AER to gain this understanding. It is also unlikely that the AER will have resources with sufficient experience in these areas within 6 months of the NERs being finalised and will not yet have undertaken an entire distribution price review.

It should be noted, for example, that the current transmission cost allocation guidelines being consulted on by the AER are largely an amendment to the cost allocation requirements already contained in its Information Requirements Guidelines.⁵ The Information Requirements Guidelines have evolved over time as the AER has gained experience in regulating transmission entities. Similarly, the Commission's Regulatory Accounting Guideline has evolved as its experience in regulating the distribution businesses has grown and the circumstances of the Victorian distribution sector have changed.

⁵ Australian Energy Regulator 2007 First Proposed Transmission Network Service Provider Cost Allocation Guidelines — Issues Paper, January, p. 4.

The AER's transmission cost allocation guidelines are also refining an approach that is already applied nationally whereas the approach to distribution has varied significantly across jurisdictions. Unlike transmission, the distribution sectors have been subject to different governance arrangements (some are private, others remain publicly owned) and differing regulatory arrangements. As a result, the distribution sectors across the jurisdictions are at different stages of development.

The requirement to develop guidelines and models within 6 months would lead to the development of these procedures in the absence of experience or an understanding of how they interact. Further, the regulated businesses have made investments in their networks in the knowledge that there is some level of predictability and certainty in the way the regulatory regime works.

Developing a nationally consistent approach should be achieved over time once experience and implications of variations have been taken into account.

If developed at the outset, the guidelines and models established by the AER will need to be very high level to accommodate the differing circumstances of the distribution sector in each of the jurisdictions.

Further, even if the AER had the appropriate experience and a reasonably consistent start point, 6 months is not sufficient time to undertake a sufficiently robust process to establish new procedures and guidelines that build upon existing experiences at the jurisdictional level.

Another concern that the Commission has with the requirements being placed upon the AER is that any amendments made to a guideline or model cannot apply within 15 months of a determination. This requirement limits the flexibility of these instruments and therefore restricts the ability of the AER to respond to the changing circumstances of industry or introduce refinements and improvements.

The AER will be undertaking distribution price reviews on an almost annual basis once it assumes responsibility for this function. However, the experiences of one price review cannot be factored into the AER's guidelines and models before conducting the next price review. Thus, continual improvement in the way price reviews are conducted is potentially constrained.

The AER may be required to establish a rule change team to keep on top of the rule changes that may be required to build on the experiences of each price review — an inefficient outcome reflecting an inappropriate balance between prescription and discretion.

It is important that the MCE be aware that there is a distinction between guidelines and models developed for the purposes of one particular price review and guidelines and models that have a life after a particular price review has concluded.

The cost allocation guideline has a life beyond any particular price review as the AER will need to assess the distributors' regulatory accounts against this guideline on an annual basis. The other guidelines and, in particular, the models are all instruments that are specific to particular price reviews and will vary depending upon the circumstances of the distribution sector within the jurisdiction under review.

The Commission would suggest that the draft NERs reflect the two stage process to a price review that is currently used in the jurisdictions. Under the processes used by the jurisdictions, the first stage of a price review has typically comprised of a framework and approach stage with the second stage being the decision stage.

The framework and approach stage aims to establish the methodology that a regulator will use to make a decision regarding the regulation of distribution prices and the information the distributors are to provide to assist the regulator to make its decision. For example, it will establish the form of regulation, the services to be regulated, the method by which the regulator will determine the forecasts for the next period and the processes the regulator will follow during the price review.

The decision stage of a price review is where the information contained in the distributors' price-service proposals is reviewed and a decision made on the price controls to apply in the next regulatory period.

The Commission would suggest that, for distribution, the AER be given the flexibility to consult on and establish guidelines and models during the framework and approach stage of a price review. This approach would have significant benefits as it would:

- provide the AER with time to familiarise itself with the circumstances of the distribution sector within a jurisdiction prior to establishing a guideline or model for that jurisdiction
- allow the AER to tailor guidelines and models to the recognises circumstances of the distribution sector within a jurisdiction
- allow sufficient time for the AER to consult with stakeholders and sufficient time for stakeholders to participate in the development of the guidelines and models.

Part B — Classification of Distribution Services and Distribution Determinations

Division 1: Classification of distribution services

Clauses 6.2.2 and 6.2.3 require the AER to classify direct control services as a standard control service or an alternative control service, and that it must review this classification in the course of a price review.

Alternative control services are distribution services not included in the DUoS price control because the supply of those services is competitive or potentially competitive. Alternative control services that are potentially competitive are normally subject to some form of price control because the level of competition in the market is not sufficient to prevent monopoly pricing.

The draft NERs recognise this distinguishing feature of alternative control services by requiring the AER to have regard to the potential for the development of competition in the relevant market when classifying services.

In the Commission's view, the other distinguishing feature of alternative control services is that the cost of providing the service can be reasonably attributed to a customer provided with the service and thus the cost does not need to be recovered through DUoS system charges. Being able to attribute the cost of a service to a customer is important to be able to determine the price of that service.

Where the cost is smeared across customers, then a separate charge for that service cannot be established and its costs would be better recovered through the DUoS price control.

From the criteria set out in clause 6.2.2(b), it does not appear that the AER must give consideration to whether the cost of a service can be reasonably attributed to a customer. The Commission strongly recommends that such a requirement be inserted into clause 6.2.2(b) and suggests the following wording:

whether the cost of providing the service or kind of service can be reasonably attributed to a customer provided, or to be provided, with the service or kind of service, and that the cost need not be recovered through use of system charges.

Clause 6.2.3 requires that the AER undertake a review of the classification of services at each price review. Given the criteria set out in 6.2.2(b), clause 6.2.3 is requiring the AER to undertake a review of the effectiveness of competition in relation to every service provided by a distributor. Such a review would be time consuming and resource intensive and, given the maturity of the distribution market, would most likely result in no change to the classification of services. In other words, the AER would undertake a costly review with no change in outcome.

The Commission agrees that there should be a facility to re-classify services. However, requiring such a review of every service at every price review seems unnecessary and pointless.

Changing the wording of clause 6.2.3(b) from “The classification is to be reviewed in the course ...” to “The classification may be reviewed in the course ...” would enable either the AER or the distributors to propose a change in classification to a particular service without the AER having to review all distribution services.

If the two stage price review process suggested above is incorporated into the NERs, then any changes to the classification of services could be considered in the first stage.

It is also unclear how the potential for reclassifying services at a price review corresponds with the 15 month implementation timeframe applying to the cost allocation guideline. If services are reclassified then it is presumed that the distributors’ cost allocation methodology would also need to change to reflect the reclassification. However, it does not appear that the AER would be able to amend the cost allocation guideline to reflect any change in reclassification that occurred as part of a price review.

Division 2: Distribution determinations

The Commission has no comments in relation to clauses 6.2.4 to 6.2.7.

Division 3: Guidelines

The Commission has no comments in relation to Division 3.

Part C — Revenue Determinations for Standard Control Services

Clause 6.3: Revenue determinations

The Commission has no comments on clause 6.3.

Clause 6.4: Post-tax revenue model

Clause 6.4 requires that the AER to develop and publish a post-tax revenue model within 6 months of the clause coming into effect.

As has been the experience in the jurisdictions, the framework and approach established at a price review will vary depending upon the circumstances of the businesses involved in the price review. While these circumstances can be many and varied, they include such things as:

- how much and what quality of historical data is available
- what the past investment profile of the businesses has been and thus what investment will be required going forward, and/or
- the incentive framework that has applied in the past, the outcomes that have been achieved under this framework and thus what should apply going forward.

The regulatory frameworks used by the jurisdictions in regulating electricity distribution services have varied between those jurisdictions. However, there have often been sound reasons for why this variation has occurred.

The differing circumstances of the businesses in each of the jurisdictions means the framework and approach used in each price review will vary across the jurisdictions. As a result, the post-tax revenue model will also necessarily vary from one price review to the next.

While the Commission can appreciate the desire toward national consistency underlying the move to the national framework, the differing experiences and circumstances of the distribution industry in each of the jurisdictions will necessarily mean that the framework and approach and thus the post-tax revenue model used to calculate the price path will not be consistent across jurisdictions from the outset. The objective of national consistency should be achieved over time with the benefit of experience and understanding of the jurisdictional approaches and the implications of change.

In this context, it is unclear why the draft NERs are requiring the AER to establish within 6 months a post-tax revenue model that will apply to all distributors and which cannot be varied without undertaking the extensive distribution consultation procedures set out in the draft NERs. The requirement means that the AER will be forced into the position of creating a 'one-size-fits-all' model that does not fit any one well without having full knowledge of the framework and approach that it might apply in each of the jurisdictions in the future.

The Commission strongly recommends that the requirement for the AER to develop and publish a post-tax revenue model within 6 months be reviewed and substitute it with a two stage approach to price reviews.

Clause 6.5: Matters relevant to the making of revenue determinations

Clause 6.5.1: Regulatory asset base

The Commission is generally supportive of the provisions under clause 6.5.1 in relation to the determination of the regulatory asset base, particularly the use of the roll forward method for updating and forecasting asset values.

The roll forward method is non-contentious and is easily understood by all stakeholders. It also avoids the need for costly asset value determinations at each price review which reduces certainty for distributors because of the potential for asset stranding and the uncertainty over the regulatory treatment of long-term capital investments.

However, the Commission has concerns with some of the provisions set out in schedule 6.2.

S6.2.1(e)(5) requires that the regulatory asset base be reduced by actual depreciation rather than the amount of estimated 'regulatory depreciation' determined at the previous price review.

The Commission has a number of comments in relation to this clause. First, there is some potential ambiguity as to how 'actual depreciation' is interpreted as 'actual depreciation' is not a defined term. The concept of depreciation is capable of being interpreted in both financial and physical terms.

On face value, the term 'actual depreciation' might reasonably be interpreted as referring to the physical degradation of the service capability of a particular asset. However, in the context of the draft NERs, the intent appears to be for the term 'actual depreciation' to refer to a financial or accounting allowance that is set by reference to out-turn expenditure on new as well as existing assets.

Second, the Commission assumes that the intent of this clause is to replicate the arrangements applying in the revised transmission Rules. The various discussions of this issue by the AEMC in the context of the transmission Rule determination process⁶ indicate that the intent is to adjust the *ex ante* depreciation allowance established at the beginning of a regulatory period upwards or downwards according to the extent of any over- or under-spend of outturn capital expenditure (relative to forecast) that arose within the period.

The AEMC's stated rationale for its 'actual depreciation' proposal was:

... to strengthen the incentive in relation to capital expenditure by including depreciation as part of the incentive approach.⁷

⁶ See: Australian Energy Market Commission, Rule Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No.18, 16 November 2006, page 81; and, Australian Energy Market Commission, Draft Rule Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, 26 July 2006, page 100.

⁷ Draft Rule proposal, July 2006, page 100.

The use of actual depreciation to roll forward the asset base is a complex issue. As a result, it has not been previously clearly articulated by the Commission why it has used regulatory depreciation to determine the value of the asset base and not actual depreciation.

However, the Commission has attempted to set out below why it believes that rolling forward the value of the asset base using actual depreciation is not an optimal approach.

The MCE should give further and closer consideration to this issue to ensure that it fully understands the implications of its draft Rule. The Commission would be pleased to discuss this issue further with the MCE's representatives if further clarification is required.

The actual depreciation approach (determining revenue based on forecast depreciation and adjusting the asset base based on the actual) increases the penalty to the distribution business where they spend more on capital than forecast regardless of whether the expenditure undertaken was prudent. It also increases the costs to customers where the distributor spends less on capital regardless of whether the savings were efficient.

One view of this outcome would be that it increases the power of the incentive to spend efficiently. However, the link between the cost of the efficiency incentive and the benefit of the efficiency incentive is not maintained.

An important design feature of an efficiency incentive is that the cost of the incentive should not outweigh the potential benefit of that incentive. The use of actual rather than the regulatory depreciation to adjust the regulatory asset base upsets the balance between the cost and benefits of the incentives. If the goal is to achieve a higher powered incentive, using depreciation is likely to be an ineffective and potentially distortionary approach to achieving this.

Further, as was recognised during the last Victorian electricity price review, there is an unclear relationship between capital expenditure and the outcomes experienced by customers. Reductions in capital expenditure below forecast can be the result of any or any combination of the following reasons: efficiency gains; deferral of capital expenditure projects between periods; changes in external expenditure drivers (eg, lower than anticipated peak demand); or overstatement of expenditure requirements during the price review. This differs from operating and maintenance expenditure where there is a clear translation of revealed costs into the next period's forecasts which ensures that customers only reward sustained efficiencies and that customers share in efficiency benefits via lower prices.

The unclear relationship between capital expenditure underspends and the transfer of those benefits to customers applies equally, if not more so, to depreciation.

Further, administratively, the costs of considering, determining and ensuring compliance with this approach are considerable. The regulatory depreciation approach enables a 'hands off' approach by the regulator because, except for some high level review of consistency over time and linkages with capital expenditure, the rate of depreciation only affects the timing of recovery through prices. The actual depreciation approach would require ongoing and intrusive review of assumptions, parameters, application and calculation and it would be

possible that depreciation is recovered more than once or not at all regardless of whether this was the result of efficiency or misreporting.

There are three main problems with the actual depreciation proposal:

- Rolling into the regulatory asset base new capital expenditure that is net of accumulated depreciation will, in circumstances where a distributor has exceeded its total allowance for the regulatory period, prevent it from recovering the cost of capital expenditure that may well be prudent. This is unlikely to be consistent with the national electricity market objective.
- Although the arrangement clearly increases the reward and the penalty arising from under- or over-spending on capital (relative to that forecast for the regulatory period), adjusting depreciation does not achieve this in a manner that gives a continuous incentive throughout the regulatory period.
- By including depreciation as part of the capital expenditure incentive arrangements, network businesses will have an incentive to manipulate their expenditure priorities and the classification of capital assets because the strength of the incentive will depend significantly on whether the over- or under-spending occurs in relation to long-lived or short-lived assets.

On the first point, although there is merit in designing efficiency benefit sharing schemes that are symmetric in terms of their incentive for under- and over-spending, there is always a degree of tension between this goal and the broader regulatory principle that a service provider should have a reasonable prospect of recovering the cost of prudent investment.

By sharpening the incentives to spend within a five year forecast allowance, the possibility arises where capital expenditure that may well have been prudently made is disallowed from inclusion in the regulatory asset base, thereby breaching a fundamental principle of regulatory design. Consistent with this, the proposed arrangement may well not be consistent with the national electricity market objective, because of its potential discouragement of investment that is both efficient and in the long term interests of consumers.

In relation to the second point, the accumulated depreciation on an item of capital (and so the amount of the adjustment under the actual depreciation rule) is heavily dependent on the timing of any over- or under-spend within a regulatory period. Over-spending on an asset with a ten year life in the first year of a regulatory period would result up to 50 per cent of its cost being netted out of the regulatory asset base, whereas the same over-spend in the final year would attract an actual depreciation adjustment of just 10 per cent. This clearly gives rise to an incentive to:

- ensure that over-spending takes place late in the regulatory period, while under-spending occurs in the early years; and
- to the extent feasible, alter the reported timing of expenditure, for example, by 'delaying' the commissioning date of new assets from one regulatory year to the next.

In relation to the third point, the fact that different types of capital expenditure involve different amounts of within-period depreciation — depending on the life of the asset. For example, information technology assets (such a network control infrastructure) might have a useful life as short as five years, while some network

assets (poles, wires) may well have regulatory asset lives as long as forty years. Such differences in asset life will have a profound effect on the strength of the incentive for under-spending.

Such incentives are likely to affect both the incentives on distributors as follows:

- all else equal, it would be preferable for forecast capital expenditure to be weighted towards short-lived assets (since these will attract a higher depreciation allowance); and
- conversely, there will be much greater penalties for over-spending on short-lived assets, thereby encouraging network businesses to delay their replacement until later in the regulatory period and, to the extent possible, to classify installed assets as being relatively long lived.

This range of potential distortions to the forecasting, reporting and execution of capital expenditure programs are all inconsistent with the principles for efficiency benefits sharing schemes cited elsewhere in the Rules.⁸ These require the AER to have regard to the need to provide continuous incentives throughout the regulatory period, and to avoid inefficient capital expenditure.

The AEMC has stated explicitly that its intention in introducing the actual depreciation regime was to strengthen the incentives in relation to capital expenditure. The above analysis suggests that the actual depreciation regime is a poor mechanism for achieving this objective, and may well do more harm than good.

A much preferable approach to sharpening such incentives would be to alter the design parameters of any efficiency benefit sharing mechanism.

Using actual depreciation also requires the regulator to closely review the assumptions regarding depreciation and potentially determine appropriate depreciation parameters. These parameters and approach would also need to be reviewed for consistency and accuracy from one period to the next. This would increase the level of intrusion and the range of issues to be determined by the regulator whereas regulators have traditionally taken a 'hands-off' approach to depreciation.

The Commission strongly recommends that the asset base be rolled forward by deducting the same allowance for depreciation that was established at the beginning of the regulatory period (that is 'regulatory depreciation'). The regulatory depreciation approach simplifies the process of review and the information required.

S6.2.1(e)(8)(ii) permits the rolling in of past capital expenditure that has not been included in the value of the asset base.

It is unclear what past capital expenditure would not have been included that could be 'added' in the future. Only capital expenditure that has been previously audited should be included. If capital expenditure previously undertaken has been audited, then it is unclear why it would not have been included when it was incurred.

⁸ National Electricity (Economic Regulation of Distribution Services) Amendment Rule 2007, clause 6.5.5(c)(1)

This clause would appear to provide an opening for distributors to 'find' expenditure that has not previously been included in the regulatory asset base. This is also inconsistent with the concept of a financial (rather than physical) regulatory asset base.

Given the information asymmetries that exist between a regulator and a regulated business, it would be extremely difficult for the AER to determine that this capital expenditure had occurred. It would involve the AER auditing all the capital expenditure that a distributor has incurred throughout history in order to ensure that the capital works 'found' by the distributor had not already been rolled into the asset base.

Nevertheless, the exclusion of the 'found' capital expenditure is unlikely to have impacted on the viability of the business if the business had been previously determined to have an appropriate revenue requirement to provide the required services.

Clause 6.5.2: Return on capital

While the Commission broadly supports the provisions of clause 6.5.2, it notes a couple of issues with this provision.

Clause 6.5.2(c)(iii) requires that the start date and end date for the agreed period for measuring the risk free rate be kept confidential until the expiration of the agreed period.

It is assumed that confidentiality is required to minimise the potential for any manipulation of the bond rates in the market. However, in the Commission's view, none of the regulated businesses would have sufficient scale within this market to influence the bond price. Even if this were so, it would be easy for the AER to discern significant movements in bond price and could investigate the reasons why.

The risk with making the period confidential is that stakeholders may not be able to draw the AER's attention to changes that may be occurring in the bond market during the measurement period. For example, some stakeholders may be aware of a significant number of bonds reaching their call date during the measurement period which could influence the determination of the risk free rate. However, stakeholders may not immediately think to alert the AER if they are not aware of the measurement period being used.

Clause 6.5.2(d) requires the use of two Commonwealth Government bonds closest to the 10 year term and which also straddle the 10 year expiry date.

The risk with including a requirement that bonds straddle a 10 year expiry date is that the AER may find itself in a position of having no bond rate to use. With the Commonwealth Government currently running large budget surpluses, there may be no bonds straddling a 10 year expiry date. For example, there are currently no bonds with an expiry date over 15 years.

The Commission recommends removing the words 'and which also straddle the 10 year expiry date'.

Clause 6.5.2(e) requires the use of Standard and Poors credit rating. It is unclear why the use of a Standard and Poors credit rating is required and not some other

credit rating. The requirement to use Standard and Poors appears overly prescriptive and relies on Standard and Poors having a credit rating for the bonds that the AER intends using.

The Commission recommends the removal of the words 'Standard and Poors'. If reference must be made to a brand of credit rating, then the Commission suggests using the words 'credit rating from a recognised credit agency'.

The Commission notes that the national framework applying to electricity distribution requires that the parameter values determined in a five yearly review apply at each price determination.

The Commission recognises that determining the parameters of the cost of capital every five years simplifies the process. However, it does mean that a regulated business undergoing a price determination in year five will have its cost of capital based upon parameter values that are ten years old by the final year of a five year period. This issue is exacerbated if regulatory periods begin to exceed 5 years.

Clause 6.5.3: Depreciation

The Commission has no comments on the provisions of clause 6.5.3.

Clause 6.5.4: Estimated cost of corporate income tax

The Commission has no comments on the provisions of clause 6.5.4.

Clause 6.5.5: Efficiency benefits sharing scheme

The Commission supports many of the provisions under clause 6.5.5, in particular, that the efficiency sharing scheme is not required to be applied to capital expenditure and that it should apply equally to efficiency gains and losses.

In the 2006-10 price review, the Commission noted that the distributors' submitted capital expenditure forecasts were 54 per cent higher than reported expenditure during the 2001-05 period (during which the efficiency carryover mechanism applied to capital expenditure). This suggested to the Commission that the capital expenditure underspends may not have been the result of sustained efficiencies but rather the result (at least in part) of capital investment deferral. It also appeared to the Commission that these deferrals may not have been efficient as the distributors appeared not to have assumed that similar deferrals would occur on an ongoing basis.

As a result, the Commission discontinued the application of the efficiency carryover mechanism to capital expenditure in the 2006-10 regulatory period. A regulator would need to be certain that the application of an efficiency benefits sharing scheme would result in future benefits to customers sufficient to warrant the payment of the efficiency reward in the first place. Where this cannot be determined, a regulator should have the discretion not to apply one.

It is also important that the efficiency benefits sharing scheme apply to both efficiency gains and efficiency losses as this ensures that only sustainable efficiencies are rewarded under the scheme.

An asymmetric scheme that only rewards efficiency gains undermines one of the key objectives of an efficiency sharing mechanism — that distributors are encouraged to pursue efficiency gains throughout the regulatory period. Where the

mechanism is not symmetric, distributors have a strong incentive to defer potential efficiency gains or even increase their rate of expenditure in the latter years to ensure a higher cost is visible when submitting their proposals to the regulator. Regardless of whether a regulator relies on the final year or all years of a regulatory period, the incentive for distributors to increase their rate of expenditure could misrepresent the ongoing efficient costs of providing the services.

Clause 6.5.6: Forecast operating and maintenance expenditure

The Commission has no comments on the provision in clause 6.5.6.

Clause 6.5.7: Forecast capital expenditure

While broadly supportive of clause 6.5.7, the Commission is concerned that the forecasts of capital expenditure must be set so as to meet expected demand over the period.

The Commission agrees that the forecast levels of capital expenditure incorporated in revenue requirements should be sufficient to ensure that distributors are able to undertake necessary reinforcement expenditure. However, distributors should also be encouraged to manage coincident and non-coincident peak demand through price signals and to seek efficient solutions to addressing the impact of peak demand on network costs.

The building blocks approach as outlined in the draft NERs provides distributors with sufficient revenue to address system constraints associated with an increasing rate of growth in peak demand. However, where a network constraint exists, the building blocks approach provides stronger incentives to distributors to build network rather than identify non-network solutions or other pricing options to relieve constraints because they are provided with a return on the estimated capital expenditure associated with meeting increasing peak demand.

With the roll out of interval meters in Victoria, distributors will have greater flexibility over the types and structure of their tariffs. Thus, they will have greater flexibility to signal to customers that they should either reduce demand or expect to pay more to cover the cost of the expenditure necessary to supply the network capacity they demand.

As a result, the Commission signalled that in future price reviews it would be appropriate to consider forecast growth in peak demand to be consistent with the forecast growth rate in energy consumption. The exception that the Commission highlighted was where the costs associated with a higher rate of growth in peak demand are recovered from the customers who are contributing to the higher rate of growth.

The Commission is concerned that the prescription set out in the draft NERs will limit the flexibility the AER has to respond to issues identified in the course of undertaking a price review. For example, the prescription set out in clause 6.5.7(a) may limit the scope that the AER has to introduce or signal changes to the framework such as those considered by the Commission at the last price review.

Clause 6.6: Revenue adjustments after making of revenue determination

Clause 6.6.1: Cost pass through

Clause 6.6.1(e) appears to imply that the regulator would only have 60 business days to consider a cost pass through proposal whereas the distributor has 90 business days to prepare it. It is not clear why the regulator should have less time, particularly when the regulator is required or needs to consult with other stakeholders to clarify the need for a pass through.

Clause 6.6.2: Service target performance incentive scheme

Victoria's service incentive schemes are the most sophisticated of the NEM jurisdictions. It combines an S-factor scheme and GSL payment scheme, with both schemes applying to a range of service reliability and customer service parameters. It is intended that the next Victorian electricity distribution price review give consideration to including quality of supply parameters into the S-factor and/or GSL payment schemes.

As noted at the outset of this submission, the Victorian service incentive schemes have been successful in improving service levels to all Victorian customers, particularly those living in areas of the state that have traditionally had poor service levels.

The incentive (or payment) rates underlying both schemes reflect customers' willingness to pay for services. Thus, the incentives created by the schemes encourage the distributors to trade-off the cost of improving services with their customers' willingness to pay for those services. As a result, distributors will only undertake continued improvements in the provision of a service where customers' willingness to pay is equal to or exceeds the cost of undertaking the improvement.

It is important to note that the S-factor scheme and GSL payment scheme complement each other. The S-factor scheme measures the actual average performance on a particular feeder against the targeted average performance for that feeder. The fact that the S-factor applies to averages means that some customers will experience performance that is better or worse than the average. The GSL scheme complements the S-factor scheme by providing incentives to a distributor to avoid letting its actual performance fall below a certain threshold. In this way, distributors are encouraged to provide a minimum level of service to customers who are receiving the worst performance on a feeder.

Changes to either scheme have implications for the level of service provided to customers and the incentives under which the Victorian distributors operate.

For this reason, the Commission is concerned that the AER must prepare and publish a service incentive performance target scheme within 6 months of clause 6.2.2 coming into effect. The published scheme would need to be at such a high level to accommodate the transition of the different arrangements in each jurisdiction to the national level that it would be of dubious value. Alternatively, where more detail was required, the AER may be forced into the position of developing a scheme that was insufficient to accommodate the arrangements in Victoria.

The development of the service incentive schemes in the Victorian price review of 2001-05 and their modification and refinement during the 2006-10 price review took the entire length of the price review to consult on and come to a decision. Also, elements of the scheme cannot be finalised without consideration of the way the scheme interacts and impacts on other features of the regulatory determination and thus can only be done simultaneously with a price review.

The Commission notes that the terms 'distribution service standards' and 'service incentive performance target scheme' do not appear to be defined. It has been unable to locate a definition of either term in either the NELs or NERs.

Both terms need a sufficiently broad definition to accommodate the existing arrangements in Victoria. In Victoria, distribution service standards have been set for reliability measures, quality of supply measures and customer service measures. Reliability targets and customer service targets have been included in the S-factor scheme. The GSL payment scheme applies to reliability measures, quality of supply measures and customer service measures.

Thus, if the term 'distribution service standards' defines the range of parameters included in a 'service incentive performance target scheme', then it must be defined to include reliability measures, quality of supply measures and customer service measures to accommodate the arrangements in place in Victoria.

Similarly, the term 'service incentive performance target scheme' must be defined sufficiently broadly to accommodate the application of both an S-factor scheme and a GSL payment scheme to the three types of distribution service standards.

Another issue noted by the Commission is that clause 6.2.2 appears to allow the AER to apply service incentive mechanisms to minimum standards determined in a Ministerial derogation. It should be noted that applying the S-factor to minimum standards implies that distributors will be penalised for not supplying a minimum level of service. In other words, rather than achieving the minimum, distributors may prefer to incur the penalty under the S-factor scheme. If this was not the case then the scheme would have to be asymmetric.

While it is not stated that this is the intention of this clause, the Commission wishes to note that, in the case of minimum standards, only the GSL payment scheme can be used.

Part D — Negotiated distribution services

The Commission has no comments in relation to Part D.

Part E — Regulatory proposal

Clause 6.13 permits the AER to revoke a determination for a clerical mistake or an accidental slip or omission, or a miscalculation or misdescription, if it is material. There is no guidance on materiality.

The Commission is concerned that this clause could result in numerous applications for revocation and removes the onus on the distributors to address errors. Any material errors of the regulator can be appealed so allowing a process to fix an error made by the business would seem to provide a perverse incentive not to ensure the accuracy of information in the first place.

Part G — Cost allocation

Clause 6.15: Cost allocation

Clause 6.15 requires the development of cost allocation principles by the regulator and the application of a cost allocation method by the distributors to be approved by the regulator.

The approach taken by the Commission is to allow distributors to determine how costs are allocated but to require them to disclose the allocations and reasons for the allocations and provide previous year comparisons. This allows the regulator to make adjustments for the purposes of measuring efficiencies and estimating future requirements where allocations result in a misrepresentation of the costs of providing distribution services.

To approve a method reduces the flexibility and ability for a regulator or regulated business to make adjustments to improve the cost-reflectivity of the information provided. It also prevents a consistent data set to be established as the data may change to reflect a change in an approved method with no corresponding understanding of the adjustment, a comparison against a previous allocation method or implications of the change. The Commission would leave the allocation method up to the distributors as long as it was consistent with the high level principles in the NEL and accompanied by a requirement to provide appropriate disclosure, transparency and comparative information.

Part I — Ring-fencing arrangements for distribution network service providers

Clause 6.17: Distribution ring-fencing guidelines

The Commission supports the provisions of clause 6.17.

Part J – Distribution pricing rules

Clause 6.18.3: Pricing proposals

Clause 6.18.3(a)(5) suggests that a tariff may be varied during the course of the regulatory year. Allowing tariff variations outside the annual network tariff approval process increases the administrative burden on the regulator and reduces the effectiveness of compliance enforcement due to the inability to look at all of a distributors' tariffs when assessing one tariff.

The Commission suggests changing the wording to "...variation or adjustment in a regulatory year ...".

It is unclear what the purpose of clause 6.18.6(c)(3) is. It appears that this clause allows the distributor to recover more than the revenue requirement to recover the cost of installing meters. The cost of meters of any type should be dealt with during the process to establish the revenue requirement.

Clause 6.18.6(d) establishes a side-constraint of CPI+2 per cent. The Commission is of the view that placing this explicit requirement in the NERs could be inconsistent with the national electricity market objective because it prevents the distributors from introducing efficient tariffs.

The Commission recommends that clause 6.16.6 be deleted as it is much too prescriptive.

Parts K to M

The Commission has no comments in the relation to the provisions set out Parts K to M.