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25 May 2007

The Manager  
MCE Secretariat  
Department of Industry, Tourism and Resources  
GPO Box 9839  
CANBERRA ACT 2601

Dear Sir/Madam

**ECONOMIC REGULATORY PACKAGE - NATIONAL ELECTRICITY RULES  
DISTRIBUTION REVENUE AND PRICING RULES**

Country Energy appreciates the opportunity to comment on the economic regulatory package of draft National Electricity Rules and related explanatory material. The National Electricity Rules represent a crucial element in the new economic regulatory framework for Distribution Network Service Providers.

Country Energy's response will seek to address issues of importance from the draft National Electricity Rules, and provisions that are believed to be in need of further consideration prior to the release of the final National Electricity Rules. The submission will then address the proposed transitional provisions discussed in the explanatory material for the upcoming NSW and ACT distribution network determinations.

Country Energy would be pleased to discuss the matters raised in this submission with the Ministerial Council on Energy. If you require further information or clarification in relation to this submission please feel free to contact Jason Cooke on 02 6338 3685 or myself on 02 6589 8419.

Yours sincerely

Natalie Banicevic  
**General Manager Regulatory Affairs**

Att. 1.



**Response to Economic Regulatory  
Package – National Electricity Rules**

**DISTRIBUTION REVENUE AND PRICING  
RULES**

**25 May 2007**



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## Overview

The draft National Electricity Rules (NER) represent a crucial element in the new economic regulatory framework for Distribution Network Service Providers (DNSPs). The NER represent major progress in the national market reform process by seeking to establish clear, consistent and transparent economic regulatory arrangements to guide efficient investment in network infrastructure.

Country Energy's response addresses issues of importance from the draft NER, and provisions that are believed to be in need of further consideration prior to the release of the final NER. The main issues addressed in Country Energy's submission are:

- The need for a two step process to determine classification of services and related form of price control at least two years prior to the commencement of a regulatory period.
- The potential confusion and complexity created by numerous and overlapping regulatory instruments.
- The approach to determining the appropriate return on capital, which in Country Energy's view is flawed.
- The appropriateness of a service standard incentive scheme.
- A lack of detail around determining X factors and cost pass through arrangements.
- The need for further clarity around negotiated distribution services.
- Requirements of the regulatory proposal under Part E of the draft NER.
- Concerns regarding pricing proposal requirements and the need for side constraints.
- Further detail is required regarding contents of revenue proposals and the regulatory asset base.
- Related comments regarding the outline of NSW/ACT transitional arrangements.

## Part B – Classification of Distribution Services and Distribution Determinations

### *Classification of Distribution Services and Distribution Determinations*

Country Energy believes that Part B of the NER needs to be a separate process that is completed well before a DNSP submits its revenue proposal 13 months out from the expiry of the relevant regulatory period.

Under the current NER, DNSP's have to be informed of a change in the form of regulation two years from the beginning of the next regulatory period. Country Energy believes two years would be the minimum amount of time necessary for the classification of services and form of price control to be finalised, in order for DNSPs to be able to prepare a comprehensive and complete revenue proposal for submission eleven months later.

The development of the classification and form of price control for services can be a lengthy and involved consultative process. Therefore, Country Energy believes that the Australian Energy Regulator (AER) would need to begin consultation at least five months ahead of the two year deadline in order to ensure the process can be completed on time. This process would be triggered by submission of a proposal from a DNSP, noting that if the DNSP believes no change is warranted, then no proposal will be submitted.

An indicative timetable for the process could be as follows:

DNSP submits proposal	1 February
Submissions on DNSP proposal	15 March
AER releases draft decision	30 April
Submissions on draft decision	31 May
AER releases final decision	30 June

Given the dependency of the entire revenue proposal on the above decision, Country Energy believes that the final decision must be subject to merits review provisions at the time it was made, and not at the end of the complete revenue reset process two years later.

As the economic regulatory framework develops and consolidates over time, Country Energy sees scope to better define the boundaries of direct control services in the Rules, and decrease reliance on the process outlined above.

### **Guidelines**

Country Energy is concerned with the number of regulatory instruments established in the draft NER due to the confusion and uncertainty created. The NER should clearly elucidate whether each instrument is binding or non-binding and on whom this status applies. Country Energy maintains that any substantive obligations envisioned for these regulatory instruments should be contained in the NER rather than delegating rule making functions to the AER. Guidelines are appropriate as a safe harbour, whereby compliance with the guideline is automatically accepted, but a DNSP should be free to propose alternative approaches that the AER then assesses against the principles listed in the rules.

## Part C – Revenue Determinations for Standard Control Services

### *Return on Capital*

In its submission to the Australian Energy Market Commission's (AEMC's) review of transmission revenue rules, Country Energy supported the inclusion of the Weighted Average Cost of Capital (WACC) methodology and key parameters in the rules, as it provides greater certainty and transparency in regulatory decision making.

In some respects, the draft NER seek to retain consistency with the transmission rules, however they do diverge from this approach in several important areas. Country Energy believes the result provides an unbalanced approach to determining the return on capital.

First, the AER has the choice to determine the WACC parameters at each individual DNSP regulatory reset or by adopting fixed values based on a five yearly review from 2009. This approach creates a level of uncertainty for DNSP's.

Second, the Ministerial Council on Energy (MCE) has indicated that merits review provisions would not be available on the AER's five yearly review of WACC parameters, but would be available if the parameters were left to be determined as part of each DNSPs individual regulatory resets. Given that the return on capital is a major component of a DNSPs annual revenue requirement, Country Energy is concerned that any decision on the value of the return on capital would not be subject to merits review provisions. Therefore, Country Energy cannot support the concept of optional five yearly reviews being undertaken by the AER with little or no accountability. Furthermore, the AER can also conduct a review but can choose not to use the outcomes of that review. In our view this reduces predictability and transparency for all stakeholders.

Finally; the draft NER allow the AER a high degree of flexibility and choice in making a decision on how it will regulate the most critical element of the revenue building blocks. The AER can choose to adopt individually determined WACC parameters balanced by merits review of the decision, or it can conduct a potentially less rigorous industry wide five yearly review of parameters with no merits review provisions available to DNSPs. The draft NER places the AER in an undesirable situation, and is inconsistent with the stated aims of transparency, guided discretion and accountability in regulatory decision making.

Country Energy welcomes the insertion of guiding principles and criteria in the draft NER that must be taken into account when reviewing the WACC methodology and parameters every five years. Regardless of whether a five yearly review is retained in the rules, Country Energy believes these guiding principles and criteria must also apply to individual AER WACC decisions for DNSPs.

Country Energy also believes that if the five yearly review of WACC methodology and parameters remains in the rules and is not subject to merits review provisions, it should be subject to a rule change process carried out by the AEMC. Country Energy believes that it is inappropriate for the AER to be completing the review outside of a rule change process without appropriate accountability or oversight.

## ***Service Target Performance Incentive Scheme***

Country Energy firmly believes that the NER should not impose a service standards incentive mechanism where there is already a comprehensive service standards regime established by jurisdictions. It would be inappropriate for the draft NER to allow for the introduction of a second service standards incentive mechanism that could potentially negate the benefits and intent of existing jurisdictionally set service standards. DNSPs would be effectively penalised twice for not meeting the same single target, making it even more difficult in upcoming years for the DNSP to achieve service standard targets. The flow on effect of such duplication may be a degradation in the security and reliability of supply, with long term negative impacts for consumers, undermining the National Electricity Market (NEM) objective.

### ***X Factor***

Country Energy notes that clause 6.5.8 relating to the X factor has significantly less detail than is present in the equivalent transmission provision within clause 6A.6.8. In the explanatory material, the MCE states that this is because of the different control mechanisms available. Country Energy believes that regardless of this point, more guidance is necessary for setting of the X factor for DNSPs.

Specifically, the essential guiding principle that is absent and should be inserted into the NER, is that the AER must accept X factors nominated by the DNSP as long as the Net Present Value (NPV) of the expected revenues over the regulatory period equal the calculated building block revenue requirements for the regulatory period.

Similar provisions may also be needed within clause 6.4.2 so that it is clear the post tax revenue model must calculate the smoothed revenue building blocks and related X factors.

### ***Pass Through***

In its submission to the AEMC's review of transmission revenue rules, Country Energy stated that a 60 business day timeframe for lodgement of a pass through application was inadequate due to the often complex nature and amount of information required for such events. The AEMC agreed with this view and extended the timeframe to 90 business days for positive pass through applications but the timeframe remained at 60 business days for a negative pass through application. While Country Energy has no insight into the reasons for different timeframes for positive and negative change events, we note the draft NER has maintained the same difference in approach. Country Energy believes that the timeframe for negative pass through applications should also be increased to 90 business days, as such an event could potentially be as difficult and complex a task to evaluate as a positive pass through event.

Country Energy notes that there is no definition of the term materially in regard to the definitions for a negative or positive change event. For certainty and transparency, Country Energy firmly believes that the definition for materially in Chapter 10 of the NER must be extended to cover a DNSP under clause 6.6.1 along the same lines as a transmission network service provider (TNSP) is covered under clause 6A.7.3. Country Energy could not find a reason in the explanatory material as to why the term materially is clear and defined for the AER in relation to TNSPs, but no such guidance was deemed necessary for DNSPs.

## Part D – Negotiated Distribution Services

Country Energy seeks clarification on negotiated distribution services. In our view, it is unclear if under the draft NER a DNSP would be required to prepare a negotiating framework if it has no services classified as negotiated distribution services, given that services cannot transfer between classifications during a regulatory period. Country Energy proposes that a negotiating framework is unnecessary in this instance. Country Energy believes clauses 6.7.5(a) and 6.8.2(c)(5) imply that a negotiating framework must only be prepared in conjunction with a revenue proposal if a negotiated distribution service exists at that time, although this it is not entirely clear.

## Part E – Regulatory Proposal

Country Energy believes that the timeframe provided for DNSPs to submit a revised regulatory proposal after the draft decision requires extension. Country Energy is of the view that the most appropriate due date for a revised proposal would be at the same time as written submissions are due. Country Energy believes our view is practical, as a DNSP would most likely be preparing a written submission and revised proposal in unison, not as a separate exercise. A timeframe of thirty business days to digest, consider and respond to a complex and lengthy draft decision will not allow for a comprehensive revised proposal to be adequately prepared.

If the NER were to adopt the same timeframe for both written submissions and revised regulatory proposals, then the words '*or on any revised regulatory proposal submitted to it under clause 6.10.3,*' would need to be removed from clause 6.11.1(a).

In Country Energy's opinion, timing constraints assist the AER in its aim of delivering efficient and effective regulatory decisions. Country Energy requests that the NER specify the latest day that a predetermination conference can be held – no later than ten business days after the draft decision is published seems appropriate. Certainty around the predetermination conference is critical, as the timeframe for written submissions is dependant on this. If the disconnect in due dates between the revised regulatory proposal and written submissions remains in the NER, then it may be conceivable that an undesirable situation could develop where a revised regulatory proposal would be due before the AER has had the chance to explain its draft decision and receive oral feedback from interested parties.

Country Energy notes the omission from the draft NER of a clause equivalent to clause 6A.14.3 contained in the transmission rules, and can find no reasons for this in the explanatory material. The clause is an important link in implementing the MCE's fit for purpose approach to economic regulation. Clause 6A.14.3 achieves this aim by clearly setting out decision making criteria and guidance for the AER for circumstances in which certain matters must be approved. Country Energy therefore strongly supports inclusion of an equivalent clause for distribution in the draft NER at 6.12.3 that could also cover additional decision making points unique to distribution, including service classification and form of price control decisions.

Country Energy believes that the NER should also offer guidance to the AER on the level of materiality that would trigger revocation and substitution of a distribution determination under clause 6.13(a)(2). The AER and DNSPs require clear and explicit guidance when a potential revocation decision is being contemplated.

Country Energy would prefer inclusion of provisions in the NER that clarify the actions that would be taken in the event that the deadline for the final decision is missed, resulting in a delay of the start date of the new regulatory period. If a final decision is delayed by any party other than the DNSP, then Country Energy believes that the DNSP should be entitled to recover revenue foregone between the original projected commencement date of the new regulatory period and the actual later commencement date resulting from the delay. Regardless of the cause of the delay, arrangements that are triggered by such an event must be clear and unambiguous for all stakeholders.

## Part J – Distribution Pricing Rules

### *Pricing Proposal Provisions*

Country Energy believes the pricing proposal provisions in the draft NER require further refinement. The requirement in clause 6.18.3(a)(1) for a DNSP to submit a pricing proposal as part of its regulatory proposal is unwarranted at that stage of the regulatory reset process. Country Energy believes this clause should be deleted and clause 6.18.3(a)(2) amended to read:

- (2) submit to the AER, at least 2 months before the commencement of each *regulatory year* of the *regulatory control period*, a *pricing proposal* (an “annual pricing proposal”) for the relevant *regulatory year*.

A requirement to submit prices for the first regulatory year of the regulatory control period thirteen months ahead of the effective implementation date, while at the same time preparing and communicating pricing proposals for the final regulatory year of the preceding regulatory control period will be extremely confusing for stakeholders. This is compounded when considering that the revenue proposal would not have been subject to any preliminary examination under clause 6.9.1 of the draft NER. Furthermore, the revenue proposal may or may not be adopted in its entirety by the AER in its final decision some eleven months later. A pricing proposal should only be required after the revenue requirement that pricing proposals will be based on has been determined as part of the AER's final decision.

If the rules were to retain a requirement for submission of an initial pricing proposal with the regulatory proposal, Country Energy believes that clause 6.18.7(a) should not apply. The work and complexity in preparing an annual pricing proposal can be extensive, and the requirement to resubmit an amended pricing proposal each time the AER makes a determination seems to be an unintended outcome. For example, this could involve revising the initial pricing proposal after the AER makes a preliminary examination under clause 6.9, a draft decision under clause 6.10, and a final decision under clause 6.11. This requirement would be on top of also preparing revised revenue proposals at the same time.

Country Energy also questions the need to prepare pricing proposals for services classified as alternative control services. Alternative control services may contain services that are subject to some level of competition or have prospects of competition developing, in which case it would not be appropriate to detail competitive pricing arrangements in a public pricing proposal.

### *Side Constraints*

Country Energy believes that constraints on annual price changes should not exist as it inhibits a DNSP's ability to manage prices in a way which is both efficient and equitable.

The implementation of inflexible price constraints severely:

- restricts the development and implementation of innovative network price structures;
- limits the rationalisation of prices; and
- compromises the ability to recover efficient costs.

Country Energy currently has many obsolete network tariffs. Constraints on pricing limit the ability to equalise obsolete network prices and structures to non obsolete network prices in a time period where Country Energy is able to create any significant incentive for customers to move to new prices. The establishment of price constraints also inhibits Country Energy's ability to introduce innovative products that provide price signals to customers. To encourage change in a customer's energy consumption, price signals from cost reflective pricing levels are required in order to promote a shift in behaviour.

Country Energy proposes that if constraints for pricing regulation are to be implemented they should be of a more light handed form, where a high level target is set based essentially around the CPI-X mechanism, but does not intervene beyond that point. Before introducing pricing constraints, consideration should be given to the principles to be applied in determining the need for, and the magnitude of, the constraints to be applied. The presence of pre-determined and inflexible constraints limits the ability to restructure and implement new prices.

## Schedule 6.1 – Contents of Revenue Proposals

Clause S6.1.1(1) states that proposed material assets contained in a revenue proposal should be identified by location, cost and services provided by the asset. Country Energy would like to see the NER contain a definition of material asset in this context, so that the AER and DNSPs have certainty and transparency in the requirements for a revenue proposal.

Country Energy also seeks further information in the NER on what is meant by the reference to location in clause S6.1.3(11) in regards to depreciation schedules. A depreciation schedule for distribution assets based on well accepted categories as suggested by the clause will contain many assets found in many different locations within each category. It would not be practical or achievable to list assets for each category by location, which is how Country Energy interprets the requirements of this clause.

## Schedule 6.2 – Regulatory Asset Base

From Country Energy's understanding of clause S6.2.1(e) of the draft NER, it is not clear that the methodology described for adjusting the value of the RAB at the beginning of a regulatory control period allows for an inflation adjustment in order to maintain the real value of the RAB. Country Energy requests that this be made explicit by adding in a similar clause to that found at clause S6.2.4(c)(4).

The draft NER prevent a reopening of the entire regulatory asset base for revaluation purposes. However, Country Energy would like to point out that underlying values need to be analysed and understood before being used in benchmark comparisons under the rules, as historical differences in approaches need to be recognised before any effective benchmarking can take place.

## **Transitional Arrangements for ACT and NSW 2009 Distribution Determinations**

Country Energy appreciates the effort that the MCE has dedicated to preparing transitional arrangements for the upcoming ACT and NSW distribution determinations in such timely fashion. The transitional arrangements are vital to all stakeholders in order to ensure that the AER's first distribution determination process can be completed in an efficient, effective and practical manner.

Country Energy is generally supportive of the MCE approach to transitional arrangements outlined in the explanatory material. Many of the points raised above in discussions on the draft NER are equally applicable to the transitional arrangements, and therefore, comments on these issues will be brief. Country Energy looks forward to reviewing the detailed version of the transitional arrangement provisions in the near future.

### ***Form of Regulation and Form of Price Control***

Country Energy agrees that the majority of the MCE's suggested approach is most appropriate given the circumstances. Country Energy concurs with current prescribed services being subject to a building block methodology and a weighted average price cap form of price control, except in the case of miscellaneous and monopoly services which may be better suited to an alternative form of price control.

Country Energy also agrees that current excluded services should be subject to an alternative form of price control setting method and different form of price control. However, Country Energy believes that the most appropriate and transparent approach would be to adopt the current excluded services rule contained in the Independent Pricing and Regulatory Tribunal's (IPART's) final determination on NSW Electricity Distribution Pricing 2004/05 to 2008/09. In Country Energy's opinion, the excluded services rule could be accommodated under the proposed alternative control services definition as it would meet the criteria for control setting and price control listed in the explanatory material. While Country Energy believes that going forward under the new NER there may be scope for some of the current excluded services to fall outside of the direct control service classification, for transitional purposes, a continuation of the excluded services rule would be the most practical and efficient solution.

### ***Revenue and Pricing Proposal***

Country Energy agrees with adopting the draft NER for submitting the revenue and pricing proposal, subject to the amendments suggested in the relevant sections above being adopted.

### ***Weighted Average Cost of Capital***

Country Energy agrees that due to time constraints, the uncertainty of WACC provisions in the draft NER, and the transmission and potential distribution review of WACC methodology and parameters in 2009, adoption of the transmission WACC parameters is the most practical transitional option.

Country Energy would like to reinforce that agreeing to adopt the suggested transitional approach to WACC does not mean we agree that transmission and distribution businesses are the same in practice, nor does it mean we believe the transmission WACC parameters are most appropriate for use in distribution. Country Energy recognises this is a practical way forward and does not bind future distribution regulatory submissions.

### ***X Factor***

Clause 6.5.8 of the draft NER needs to be amended to reflect the arrangements from clause 6A.6.8 as discussed above.

### ***Cost Pass Through***

As discussed above, Country Energy believes the issues around timeframes and definitions need further consideration by the MCE.

### ***Incentive Schemes***

Country Energy reiterates that it is inappropriate for the rules to allow the AER to impose a service standard incentive scheme over the top of existing jurisdictionally based regimes. Country Energy is subject to strict network performance standards as part of its distribution licence, and sets rigorous expenditure programs to achieve these targets.

In any case, if the NER retain provision for a service standard incentive scheme, it would be premature for it to apply to Country Energy in the transitional arrangements. As stated in the explanatory material, Country Energy has not been subject to a service standard incentive scheme during the current regulatory period, and the foreshadowed paper trial of such a scheme has not taken place. Country Energy believes that time constraints will inhibit the AER's ability to fully develop an appropriate incentive scheme and accompanying parameters for NSW distributors, given the lack of historical data and standard data collection protocols.

### ***Cost Allocation Guidelines***

Country Energy agrees with the transitional approach suggested by the MCE in the explanatory material to continue the use of IPART's current approved cost allocation methodology. Country Energy notes that its current cost allocation methodology is consistent with the cost allocation principles in clause 6.15.2 of the draft NER.