Utilities Commission review

of

Power and Water Networks

INITIAL DRAFT DETERMINATION: 2009 REGULATORY RESET

NTMEU Response

November 2008

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EXECUTIVE SUMMARY

The Northern Territory Major Energy Users (NTMEU) welcomes the opportunity to provide its comments regarding the Initial Draft Determination on behalf of the larger energy users in the Territory. The outcome that NTMEU seeks from the Determination is that the cost to consumers is efficient, the reliability and quality of service is enhanced over time, and that the service is provided over the long term to match investments made by end users.

The NTMEU submission makes the following points

1. The lack of historical costs and data from PW has frustrated our ability to verify their proposed tariffs are efficient, fair and reasonable. This is inconsistent with the legislative framework underpinning this review
2. The move by PW to review and inflate its regulatory asset base using the DORC methodology is strongly opposed. It is inappropriate, inefficient and without merit to do so. Optimisation of asset values in the roll forward model will remove redundant and "gold plated" assets
3. The build up of the WACC parameters contains a cumulative conservatism that excessively over compensates the aggregate WACC outcome and this bias must be removed
4. The AER review on the WACC parameters should guide the UC in its WACC determination
5. The use of TFP by the UC is regrettable for many technical reasons, but it is currently quite uncommon, and unfair to consumers especially as there is not a strong incentive program to increase or at least maintain technical performance by PW
6. PW Po adjustment is opposed and it is clearly excessive, and a reality check is required by close examination of the opex and capex requirements

7. The proposed PW capex program appears excessive in comparison with a number of its peers and should not be automatically accepted. There should be a stipulation for achievement of certain service performance outcomes
8. The proposed PW opex program appears excessive compared to a number of its peers> A number of deficiencies are detailed, but they highlight the failure of UC and its consultants to examine whether the opex is efficient and allocated appropriately
9. Based on the information provided by the UC consultants for TFP (Meyrick) the NTMEU considers the X factors should be changed as follows
    a. X1 should be 0.4
    b. X2 should be considerably higher than 0.25
    c. X3 should be similar in value to the current period, ie X3 should be zero
    d. So that X should be 0.65, giving a real reduction over the regulatory period, rather than a real increase.
10. There must be a service target performance incentive scheme. This is an essential part of a TFP Based regulatory approach and the UC must insist that such a scheme is introduced.

Overall the third regulatory review of PW is disappointing, notwithstanding the preparations by the UC and the informed participation by NTMEU. The lack of verifiable cost information, the major increases sought by PW to garner excessive revenues from consumers, the absence of any service performance incentive scheme and the lack of detailed review by the UC and its consultant as the quantums for capex and opex (despite the acknowledged error by UC in the 2004 review) are very concerning to consumers in general and to the NTMEU in particular.

The NTMEU notes the recent attempt by PW to influence the UC by a press release[1]. This is clearly an attempt by PW to influence the UC determination; a determination that

[1] **PowerWater predicts $46 million black hole** November 3rd, 2008, - see attachment

is required to be an independent assessment of what revenue PW really needs to provide the services to consumers that it is required to do by government.

For PW to attempt to influence the UC so blatantly is concerning. The UC provided a view that the claimed PW revenue stream is grossly overstated, and the NTMEU assessment is that the UC has been over generous and should further reduce the PW revenue. On any comparative basis the electricity network operations as operated by PW are extraordinarily very inefficient. If PW cannot provide an efficient network service, then perhaps the time has come to find a way whereby the network service can be provided efficiently.

1. Introduction

The Northern Territory Major Energy Users (NTMEU) welcomes the opportunity to provide comments on the Utilities Commission's Network Pricing: 2009 Regulatory Reset Initial Draft Determination, dated October 2008.

The NTMEU comprises the larger end users of electricity in the Northern Territory and includes the following companies: Northern Cement Limited, Intercontinental Hotels Group, , NT Airports, Darwin Central Hotel, Darwin Private Hospital, , and Compass Resources NL.

The NTMEU has been established by the larger businesses operating in the Northern Territory. The members of NTMEU cover a range of industries: from manufacturing through mining to tourism. Member companies have identified that there are potentially more commercial options for providing essential services of electricity (and gas) than currently apply in the Territory, and are prepared to work with the Government and the Utilities Commission to improve the current energy supply arrangements. The NTMEU does recognise the unique nature of the NT (its relatively low population and population density, its large area, and its remoteness from other Australian markets) but it sees that large amounts of gas available nearby and the closeness of northern (overseas) markets can provide a basis for a more competitive Northern Territory energy market, which in turn drive additional downstream investment and expand employment opportunities in the Territory.

NTMEU member companies' main objective is to promote access to long term, sustainable and competitively-priced energy (electricity and gas) supplies in the Northern Territory. We have identified a key interest in the **cost** of energy supplies (commodity, network services and transactions costs) as this represents a significant cost element in each member's business operations.

Although electricity (and gas) is an essential source of energy required by each member company in order to maintain operations, a failure in the supply of electricity (and gas) will cause every business affected to cease production and/or suffer loss. Thus the **reliable supply** of electricity (and gas) is an essential requirement of each member's business operations.

With the introduction of highly sensitive equipment necessary to maintain operations at the highest level of productivity, the **quality** of energy supplies has become increasingly important, with the need for a focus on the performance of the distribution networks. Variation of electricity voltage, especially voltage sags, momentary interruptions and transients (and also of gas pressure) by even small amounts, now has the ability to shut down critical elements of many production and/or service processes.

Each of the businesses represented in the NTMEU has invested considerable capital in establishing their operations and in order that they can recover the capital costs invested, long-term **sustainability** of energy supplies is paramount. If sustainable supplies of energy are not available into the future, investments made by energy users quickly lose their value.

Accordingly, the NTMEU has a keen interest in addressing issues that impact on the **cost, reliability, quality,** and the long term **sustainability** of member companies' electricity (and gas) supplies.

NTMEU comments are provided below on the issues specifically raised by the UC in its Initial Draft Determination.

2. General observations

It is quite apparent to NTMEU that Power and Water Networks (PW) has shown a marked lack of cooperation with the Utilities Commission (UC) in the development of the third regulatory period permitted revenue. This observation is not intended to imply that PW has been deliberately obtuse, and it may be a direct outcome of the structure and re-structure that has been undergone within PW over the years.

It is noted that PW has either not been able, or refuses, to provide actual data to the UC to allow an equitable assessment of past performance. PW makes the observation that it has been beset by structural changes and internal transfers of activities. This issue highlights one of NTMEU`s major concerns: that Power and Water Cooperation (PWC) has the ability due to its corporate structure and lack of detailed and enforced ring fencing, to frustrate both the regulator and consumers from being able to transparently assess PW performance over the past period. The NTMEU has consistently sought for PWC to be segregated into its constituent elements of generation, retail networks and system operations on a detailed ring fenced basis or legal basis. Unless an approach such as this clearly defined elemental segregation is achieved, it will remain possible for PWC and PW to continue to frustrate the UC and consumers.

Notwithstanding that it may have been difficult for PW to provide accurate information to the UC for the purposes of the third determination, it is simply not acceptable from a consumer's viewpoint that costs claimed by PW to substantiate its tariffs, have little factual grounding. Consumers are required to pay the PW tariffs if they want access to electricity. Yet, electricity supply is an essential service. It is essential that monopoly service providers do have accurate data on which to develop their tariffs. The NTMEU is appreciative that the UC has gone to such lengths to provide a rational basis for developing the basis for the third regulatory period.

It is with concern that the NTMEU noted that PW had decided to have a new evaluation of the assets based on the depreciated optimised replacement cost (DORC) methodology. The issue of regular reviews of asset values using DORC has been debated extensively both in electricity and gas regulatory determinations. That the AEMC (and later the MCE SCO) was moved in the development of the National Electricity Rules (NER) to set a baseline for asset values, was a direct outcome of the concern that regular reviews of asset values was neither appropriate nor economically efficient. The concept of the roll forward model now used has much merit and certainly reduces the ability of regulated businesses to claim ever increasing regulated asset bases.

The NTMEU totally supports the UC approach in using the agreed 2002 regulated asset value as the basis and to roll forward the changes in this parameter based on actual depreciation and investment. It should be noted that the NTMEU has a residual concern that there is no optimisation of assets included in the roll forward model used by the UC, as it sees the need for optimisation provides a significant incentive for PW to be efficient in its use of capex. The NTMEU is aware that the approach in the NER does not permit ex post optimisation of actual capex, and this is a deficiency in the NER.

The NTMEU observes that both within the WACC parameters and used in various stages of the development of the X factors and P_0 calculation, there are a number of assessments made. As all assessments require some degree of estimation, there is a trend within the draft determination to bias all such estimates towards a conservative value. In principle NTMEU agrees that there should be a conservative bias as the loss of the network will cause greater harm to consumers (as seen with the failure of the Casuarina substation) than shorter term cost reductions. Equally, as was acknowledged at the recent AER forum of experts discussing elements of the WACC parameters, it is essential that such biases are not made cumulative. That is, every element value estimated should be set at the best estimate value, and then on completion of the calculation a determined bias value is incorporated. In this way there is a best estimate

provided for the “conservatism” required on the regulated business’s revenue rather than having an excessive conservatism built into the outturn which is unquantified.

3. Use of TFP

The NTMEU is not convinced that the UC approach of adjusting the allowed revenue based on TFP assessments is a sufficiently proven approach. TFP used when there are a large number of similar entities all operating at near steady state does have the advantage of a more simplistic method of setting revenues compared to the building block approach. To be most effective it requires a large number of entities on which the data is developed, and the smaller the number of source data entities, the more the data can be biased. It is noted that UC accessed input data from four other utilities (Ergon, Country Energy, Powercor and SP Ausnet). Despite all being predominantly rural DBs, there is still significant variation between each with regard to usage density and geography. That the UC had to admit that it had made an error in its 2004 determination in the application of TFP, does not provide a high level of confidence in the approach. In contrast, the building block approach is much more transparent and replicatable.

It is acknowledged that TFP does implicitly apply some incentive to achieve efficient levels of opex and capex, yet the use of actual opex and capex is needed to reset P_0. The NTMEU makes its observations on the opex and capex trends in a later section.

It is noted that an essential element of using TFP is that the technical performance of the network is assessed. Unless there is a formal assessment of technical performance the network service provider can make commercial decisions to deliberately underspend on opex and capex (and so make windfall gains) but allowing the system performance to fall. It has been recognised that in the proposals made to change the NER to allow the use of TFP, an integral element of the proposals is for there to be a strong incentive program to maintain or increase technical performance by the service provider of the network. The NTMEU notes that this essential element is absent from the PW proposal and NTMEU considers its absence to be a major concern.

All other things being equal (such as steady state on investment and the costs of acquiring capital being steady) there would be no requirement to adjust the TFP parameters and the current tariff regime would continue with effectively the same tariffs. However, parameters do change and if there are significant changes in the inputs then there is a need to reset the allowed revenue and its X factors. If there is a large enough change in WACC, opex and capex then there is a need to make a "one off" adjustment at each regulatory reset. This adjustment is P_0.

PW has sought an increase in the base value of the RAB, an increase in WACC due to the changes in the financial markets, and has indicated an increase in opex is also required.

As a result PW seeks a P_0 adjustment of some 60+%. Even with the adjustment in P_0 of the 20+% the UC seems to see is needed, there is a real concern that the TFP process has indicated that there is no steady state in the PW networks. A requirement for such a large change in P_0 is indicative that the TFP approach might not be appropriate at this time. Even if UC considers that the TFP approach will be applied for the third period, such a large movement in P_0 clearly requires more than a cursory review of the core elements making up the allowed revenue. In particular, it requires a close examination of opex and capex needs. The NTMEU is not convinced that such a review has been carried out to sustain the large increases in opex and capex implied by the P_0 adjustment.

The opex and capex claims are assessed in more detail in a later section.

4. RAB and WACC

Between them the product of RAB and WACC is the major source of revenue to a regulated business. It therefore requires careful attention. As part of the TFP approach the UC needs to assess the product of RAB*WACC to assist in setting P_0 for the third period.

RAB

PW considers that the initial valuation of its assets in 2002 was incorrect, and commissioned a new assessment by SKM for the new reset. As stated earlier the NTMEU considers that revaluing assets at each reset is inappropriate and that a roll forward methodology provides a better assessment of the capital base. At its most basic, the revaluation by PW, which has increased the asset base considerably, effectively becomes a tax on electricity consumers. PW did not outlay capital for the existing assets, except those which it invested in since 2002 under its capex program. The base assets were gifted to PW by its predecessor and were in fact paid for by the tax payers and electricity users in the NT prior to the creation of PW. For PW to claim they are entitled to a return on assets paid for by others is bad economics.

It is accepted that the value of the assets gifted to the network service provider should be based on some form of realism. Under the National Electricity Code (NEC) values for assets gifted to the newly created corporations were set by the jurisdictions. The jurisdictions had carried out a DORC valuation of the assets at the time and this was used as the initial asset base. Regulators used these values and revalued the assets over time based on the investments subsequently made by the corporate entities, a replacement cost based on inflation and economic depreciation based on straight line depreciation over the economic life of the asset. This is generally referred to as the roll forward methodology. To prevent exactly what PW has done (revalue the assets) the

NER has fixed the regulatory asset values at a point in time, and only allows regulatory roll forward.

There is considerable debate as to the methodology of developing a DORC valuation of an asset. The main drawback with DORC is that it is a notional estimate only, and different estimators will develop different values for the same assets. The DORC approach is often compared to the depreciated actual cost (DAC) basis for valuing assets. A DAC basis is based on actual payments and an agreed depreciation and as a result provides an exact and uncontestable value in a completely transparent manner.

At best, the concept behind a DORC valuation has some legitimacy in relation to assessing the value of assets which were developed within a vertically integrated supply authority and then hived off into a specific purpose corporate entity which will be regulated. The argument provided to support the use of DORC is that it provides the basis of equivalence for a new entity to enter the market and commence competition with the incumbent monopoly service provider. In practice there will never be competition for distribution services, so this argument has little validity.

At worst, DORC provides a value for assets which is considerably in excess of the actual cost to acquire and where consumers have been making a contribution over time. DORC is particularly attractive to governments seeking to sell the regulated assets and so reap the maximum cash benefit. Publicly listed companies operating in a competitive arena value their production assets on a DAC basis. Using DORC for regulatory purposes has resulted in consumers paying a premium for the services provided.

The UC has followed the principle of valuing assets on a DORC basis once and then rolling forward the asset base on an agreed set of principles. The UC has followed the NER approach and has not attempted to optimise previous investments even though the NEC did allow for this to occur.

PW has elected to attempt to force the UC into allowing its revised DORC valuation to be used by not providing UC with the necessary data to develop the full roll forward from the initial asset base set in 2002. The NTMEU considers that PW is completely in error in not only opposing the determination to use the 2002 asset value but also attempting to frustrate the UC in carrying out its proper assessments for setting regulatory values.

There is no doubt that the UC approach of assessing the asset value once and once only has the full support of past regulatory practices, and is the basis for asset valuation implicitly specified in the NER. The NTMEU fully supports the UC approach and agrees that the RAB value of $350 million set in 2002 should be the only estimate of the RAB.

WACC

The NTMEU notes the WACC input parameters used for the initial draft determination are those set in the NER chapter 6A for transmission regulation, and in the transitionary Rules to be used for regulation of the NSW distribution businesses.

The AER has been granted a Rule change which allows it to review the WACC parameters for both distribution and transmission jointly, and to release its views as to the WACC parameters to be used for the next five years. As the AER is to release these revised WACC parameters by 31 March 2009, it is appropriate that these new values be used in the WACC development for the UC rest of PW. The UC points out that there is sufficient time between the planned release of the AER settings for the WACC parameters and when PW must develop and release its proposed tariff schedules. On this basis the UC considers the best outcome for all is to wait for the AER to publish its final views.

The NTMEU strongly supports this approach.

The UC points out that PW accepts this approach but proposes two changes – one is to set the averaging period for the value of the risk free rate (ie the 10 year bond rate) and secondly to increase the debt premium (DRP) from 1.1% to 2%.

The NTMEU supports the first proposal but has concerns regarding the second, on two counts.

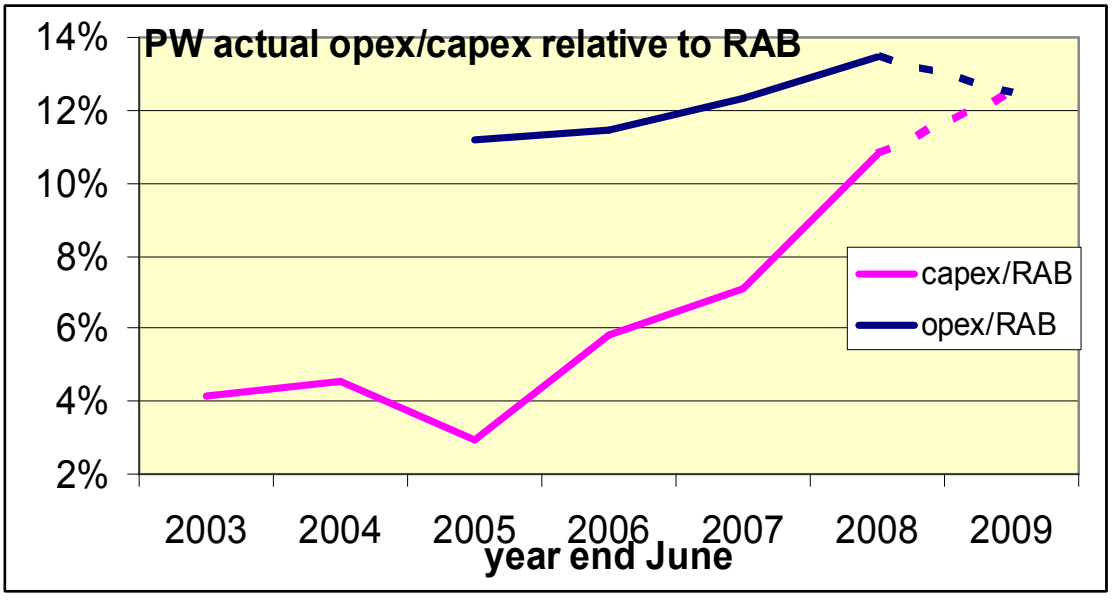
1. The debt premium is to a degree influenced by the credit rating of the entity. Currently, the base credit rating for the notional business is BBB+. From this has been calculated a DRP of 2%. It is possible that the AER might revert to its original credit rating of A for businesses such as PW. On this basis the DRP could well be a lesser amount.

2. There is currently significant concern as to what constitutes a DRP due to the market volatility and credit squeeze. Already some banks, after increasing their premium for debt, are already reducing this value. The NTMEU has a concern that the rise in DRP would appear to be a spike, and not long lived. On this basis it would be incorrect to base the DRP on a single point spike for a regulatory period extending for five years. It would appropriate for some degree of averaging to be applied as a result of this credit squeeze spike in the financial market, so that the DRP is more reflective of the longer term financial expectation over the period.

5. Opex and Capex

The TFP approach to regulatory rate setting provides much less control over actual capital and operating expenditure than is exhibited under the building block approach. One of the advantages of the TFP approach is that it incentivises the regulated business to operate at efficient levels. The down side is that it also incentivises the business not to expend if it can avoid doing so.

The following chart shows the actual and estimated opex and capex relative to RAB using data extracted from the UC initial draft determination. This shows that capex has risen dramatically relative to RAB whereas opex relative to RAB has been much more constant, but still showing an increase. For the purposes of comparison, the same values allowed in the 2004 regulatory decision for the Victorian distribution businesses in aggregate, the opex/RAB is about 7% and capex/RAB is about 10%. In the case of SA's ETSA, the comparable figures are 6% for capex and 5% for opex.



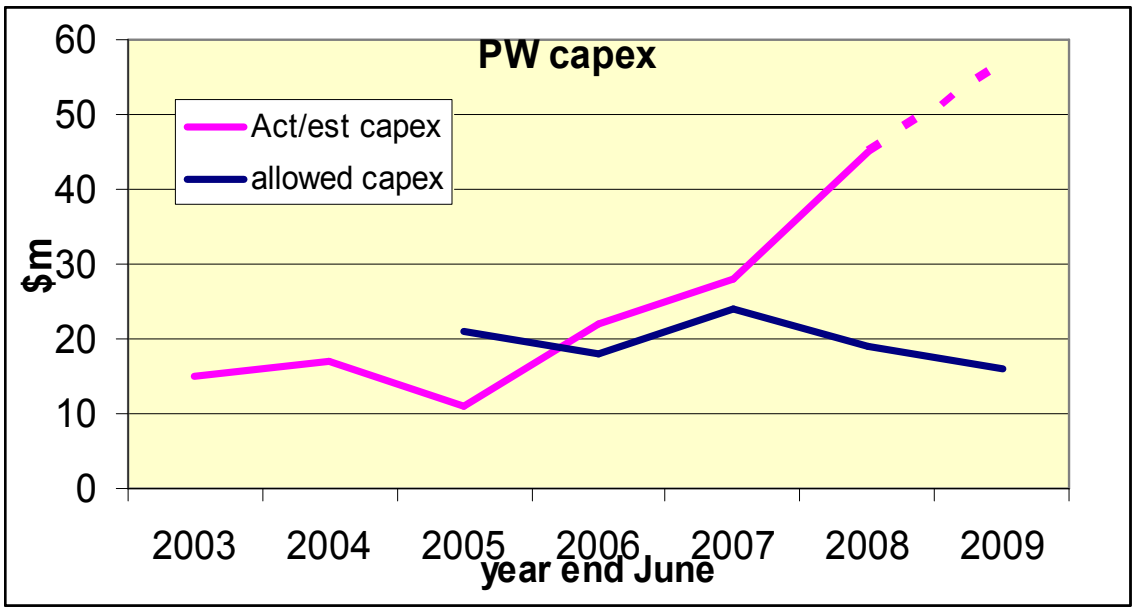
Thus on a comparable basis the actual capex used by PW over the past period is significantly lower and the opex significantly higher. That there are such divergent outcomes for both opex and capex compared to Victorian and SA DBs tends to confirm that the RAB value claimed by PW is incorrect.

PW makes the observation that they expect higher costs for both opex and capex as a result of the "boom" times. This same observation was made by other regulated businesses in other jurisdictions. Unfortunately there is a clear indication that the world economy is now heading for much lower growth for the next few years. As a result we can expect that many factories, rather than increasing prices, will be seeking new clients to fill "holes" in their production schedules caused by projects being deferred or cancelled. As a result we can expect a significant softening of the forward prices for materials and even labour. This effect must be addressed by the UC in its review of the PW forward capex and opex programs.

5.1 Capex

What the comparison with other DBs does, is to imply that PW capex has been too low over the early years and the recent trend by PW to catch up on its capex would appear to support the view that PW has grossly underspent on capex in the current period. Of course by doing so it has garnered significant commercial benefit as it was not until year 07/08 that the actual capex exceeded the cumulative capex allowed in the 2004 determination. It should be recognised that the last year capex is still an estimate and needs to be treated with a degree of caution.

The following chart depicts the actual and estimated capex by PW over the past 5-6 years. Also tracked is the intended capex as implied by the last reset of PW revenue.



What the chart shows is that the expected capex for the first year of the current period (a value set as a result of the capex program of the first period, there was an expectation of an increase. In fact, PW spent less than it had in the previous year. That this occurred at the last reset only increases the concern that PW may do exactly the same for the next period – claim it needs more capex and then spend considerably less. At the same time, the PW underspend which lasted over three years provided PW with a significant windfall in that the underspend allowed PW to retain the return on the unspent capex and so accrue a significant windfall in revenue.

With a TFP approach there is no clear and identifiable program of capital spend. What is important (especially since the failure of Casuarina substation and the major adverse impact that has had on many electricity consumers) is that a capex program must be provided so that consumers can see that PW is addressing the supply concerns of consumers. In addition, consumers need to see that for the additional capex they effectively fund, they will receive equivalent if not better service performance.

On the basis of comparison and based on the recent PW actual expenditure the capex implied by the Po adjustment is based on the recent capex caused by a need to catch up. If PW had spent wisely and consistently over the current period, and assuming its 08/09 capex is indeed achieved, then an appropriate level of capex to set the new Po would be an average over the entire period since 2003, adjusted for inflation. Such an average is similar to the actual spend incurred in 06/07 year, and after adjustment for inflation delivers a capex of some $33m pa as being the efficient level for PW. On this basis the NTMEU would consider that a capex allowance of some $30-40m pa is probably in the range of efficiency. What is totally unacceptable is the implied claimed allowance of PW of nearly $60m pa.

The review of capex by ACIL Tasman makes a very clear statement – that it has not undertaken an efficiency audit of the past and current capex, and has not examined the sorts of projects that might be undertaken by PW in the next period. ACIL comments that this is beyond its scope of their study. ACIL also observes that they have concerns about PW ability to undertake such a large capex program in a single year and that the planned capex could well not be achieved within the timeframe planned. NTMEU supports this view and adds that experience of members in other jurisdictions indicates that a number of regulated businesses have proposed large capex programs in the past and there have been concerns that the capex has in fact been inefficient as a result of an inability to adequately manage too many projects at the one time. It has also been observed that the prices for capital projects have exceeded budgets as a result of too little competition. This effect would be greater in the small NT market.

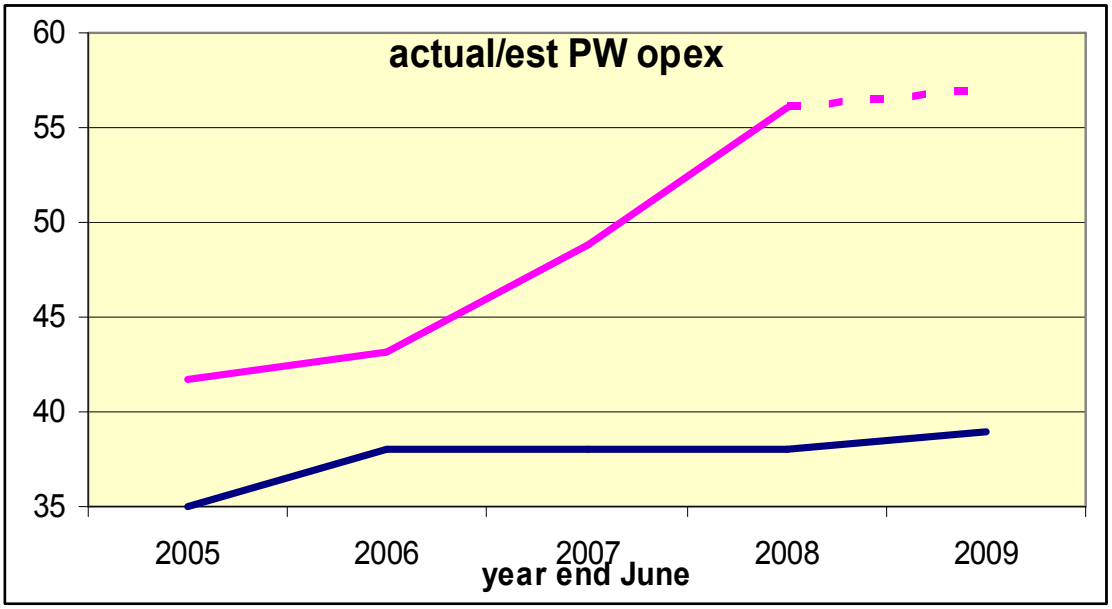
When this observation by ACIL is applied to the implied forward capex program resulting from the reset of Po, this raises serious concerns as to the longer term effect of such a large capital program. That PW early in the current period did not use all of its allowed capex and so achieved a considerable windfall profit and there are fears that this may again apply.

The UC draft determination appears to support PW in such a high but apparently non-efficient capex program. What is most concerning is that for such a high capex program, the UC does not stipulate that PW must achieve certain service performance outcomes, and that a failure to do so will result in some form of penalty – after all, consumers are paying for performance but if that performance is not delivered it is the consumers themselves which bear the brunt of the lack of service provision, as consumers attached to Casuarina substation have found out.

An efficient capex program must have some identifiable and measurable outcomes, but the approach by UC does not require PW to achieve any measurables at all. This issue is addressed later in this submission.

5.2 Opex

The comparison of opex to RAB for the SA and Victorian DBs shows that PW has been provided with a significant premium for its opex. The following chart shows the actual and estimated opex for the current period, using data from the UC draft determination.



It is quite apparent that the opex allowance in the current period was well under what PW actually spent, but even so the actual would appear to be well above the benchmark in other jurisdictions. The issue for the UC is to identify what the efficient level of opex is, and this is made more difficult as the allowed opex was what PW saw as being appropriate in 2004. That PW has been so far out with its own opex estimates, does not fill consumers with a great deal of confidence that the next period opex is correct either.

For years ending 2005 and 2006, the PW opex appears to be some 15-20% higher than the allowed opex. Then PW opex appeared to lose any sense of reality compared to PW previous actuals. PW has attributed this step change to a number of factors including reallocation of overheads and Tech Services costs.

This issue of internal transfers and overhead allocation is a vexed one for consumers, and typifies the ability PWC has to internally transfer pricing at will due to the corporate structure. It is because of this that NTMEU considers that the current approach to ring fencing is totally inadequate and allows PWC free rein to use its internal processes to confound the regulator. More importantly it allows PWC to transfer costs to sectors where it has no competition and away from aspects where competition might occur. This licence has been part of the reasons why there is no competition to PWC in those aspects where the government had expected competition to occur.

In section 5.73 of the UC draft determination, in addition to the overhead and Tech services cost reallocation, PWC provides another 12 aspects where it considers there has been a step change (see table 2).

Table 2: **PWPN quantified opex due to operating environment conditions, 2008–09**

Factors causing extraordinary opex	*PWPN claim*	*GHD Meyrick acceptance*
1. Materials and spare parts costs	$0	$0
2. Unplanned outages due to wet season weather conditions	$282,350	$86,481
3. Equipment wear and tear due to climatic conditions	$2,034,085	$403,267
4. Vegetation trimming	$2,928,571	$2,928,571
5. Termites	$1,148,552	$1,100,195
6. Bats and Birds	$770,909	$513,939
7. Cyclones and flooding	$1,063,053	$1,063,053
8. Reduction in labour productivity	$1,052,785	$350,928
9. High earth resistivity	$632,411	$632,411
10. Higher costs resulting from inability to recruit staff in some locations	$2,508,000	$342,836
11. Higher labour costs in the Northern Territory	$0	$0
12. Differences in overhead capitalisation	$7,966,200	$6,638,500
Total quantified extraordinary opex	$20,386,916	$14,060,182

It is accepted that the UC consultant has already addressed some of these issues and has discounted some aspects. What NTMEU finds difficult to accept is that most are not step changes to the operating environment that have occurred since the last review. If as is implied these are legitimate costs that need to be included in the allowed opex, then it raises some very serious concerns as to what the consultants consider occurs in the other regions used to benchmark performance.

For example, vegetation trimming is an issue for every DB. It is accepted that in parts of the PW network vegetation growth rates are very high, but so are they in parts of the benchmark DBs, and there are parts of the PW network that are not exposed to high vegetation growth rates at all. For example, parts of Ergon and Country Energy have excessively high growth rates of vegetation, probably exceeding those faced by PW. The same issue applies in the case of termite attacks.

Bats, birds, cyclones and flooding are not unique to PW and occurred recently in large parts of SP Ausnet area as well as in Ergon and Country Energy areas. Loss of productivity and labour recruitment are universal issues quoted by all DBs and transmission businesses, and are not unique to PW.

Wear and tear due to climatic conditions is prevalent in all DB areas, including humidity and dust. NTMEU members also operate in the PW area and they advise that such costs have applied consistently in the NT. They also advise that the conditions in NT do have some unique features but these are offset by other negative features common in the other regions used as the benchmarks.

The implication of the ACIL Tasman assessment is that PW is entitled to a premium of 50% in costs due to the unique nature of the PW region. The outworkings of the assessment are excessive and fail to take account of the premiums other DBs require which are unique to their regions. This assessment is totally one dimensional and is biased as it fails to recognise that PW has some advantages compared to the benchmark DBs and that other DBs not only suffer from many of the same issues but also have their unique issues causing premiums too. NTMEU recognises that the regulatory process does allow the regulated DB to highlight aspects where the benchmarks do not fully recognise the unique features of the DB under review. The NTMEU affiliates in other regions, see exactly the same argument applied in other regions, with the local DBS making much of the differences (all negative of course) between them and the other DBs. In every case the local DB fails to provide any of the aspects where its performance should be better than the benchmark DBs[2].

The assessment of opex implies that PW is entitled to a premium on its opex because it has to operate some transmission assets. This is totally unreasonable. Assessment of the costs attributable to transmission businesses show that opex in relation to RAB is

[2] For example SP Ausnet never comments that its issues with dust ingress is less than that of ETSA, yet ETSA operates in a much more dusty environment than many other DBs.

lower for transmission than for distribution. For example, ElectraNet which has the highest opex/RAB of the large transmission businesses has an opex/RAB of less than 5%, lower than the opex/RAB of the distribution business ETSA which operates in the same region. For Meyrick and ACIL to make a statement without verifying the facts is simply not good enough.

On this basis alone the opex should reduce due to the presence of transmission assets. In fact, many DBs have transmission assets within their asset base including 66 and 132 kV assets frequently ranked in transmission. In SA for example, a large part of the opex for the transmission business is carried out by the distribution business under contract!

After analysing the reports of ACIL Tasman and GHD Meyrick, the UC considers that the efficient equivalent opex should be discounted from the expected level of $57,570 for 2008/09 to $47,365, an overall reduction of 18%. This lesser reduction allows for some transitioning costs over time.

Using opex/RAB as an indicator for prudent and efficient opex, analysis shows that Victoria has an aggregate value of 7%, Ergon 6% and ETSA 5%. There is considerable consistency in this value between these values, implying that this is approximately where the indicator should be. The value sought by PW based on the UC revised RAB shows a value of 12.5%. The adjusted opex assumed by UC to be prudent and efficient gives an opex/RAB of over 10%, still well above the average benchmark of the other DBs

Based on equivalent opex benchmarks in these other jurisdictions, the opex allowance for PW allowed by UC would appear to be excessive and should be further reduced. As a start NTMEU would suggest that the premiums supposedly applying to PW compared to the benchmark DBs used for the TFP analysis should be more closely and reasonably assessed. The NTMEU considers that the premiums allowed do not relate reasonably to the disparity that is alleged between PW and the benchmark DBs.

NTMEU accepts that opex/RAB is not the only benchmark that should or could be used, but has used this as it highlights that the opex allowance for PW is so far away from the equivalent benchmark in other regions, that it shows there is a real issue to be further examined. This view is supported by the outworkings of Meyrick in its assessment of the TFP X factors, which opines that PW has an opex 27% higher than the benchmark DBs. NTMEU considers that in this assessment Meyrick is excessively conservative in that it has allowed PW significant additional opex "…after allowing for PWPN's adverse operating conditions and transmission equivalent operations… ". As noted above NTMEU is not convinced that PW operational conditions are significantly worse that the other DBs when the unique features of each are accommodated. Further, the assumption that providing transmission services is more arduous than providing distributions services, is not supported by the facts and has not been demonstrated to be so.

It could be alleged that if the RAB was increased to that sought by PW then the opex/RAB would be lower, and NTMEU acknowledges this is an issue when using such benchmarks. However, NTMEU would point out that the capex/RAB for PW is so low compared to the other DBs, then this argument is unlikely to be sustainable – after all the RAB can't be wrong in both directions at the same time.

Overall the increase in opex implied by the Po adjustment proposed by PW would appear to be grossly excessive, and the UC assessment seems to concur with the NTMEU assessment.

What concerns the NTMEU is that there has been no assessment of the Po increases in opex other than a detailed examination of the transfer of the Tech Services cost, and even there, there was no assessment whether these cost are, in themselves, efficient, and whether all of the costs are attributable to network operation. In this regard, NTMEU is concerned that there has been an internal transfer of costs into the regulated business which gives the PWC "competitive" business units an unfair advantage.

The NTMEU does not consider that there has been adequate benchmarking of the actual costs which have effectively been extrapolated into the Po adjustment. The NTMEU notes that UC has discounted the opex adjustment claimed by PW but this has been carried out without any serious assessment as to what efficient costs might be.

5.3 Meyrick assessment of opex premiums

Meyrick devotes considerable effort in supporting the PW claims that it is more difficult to operate in the NT than in other regions. In principle NTMEU supports that some of this has validity, but does question the extent of the allowances given by Meyrick.

For example:

- PW claims that its vegetation trimming is much more than other DBs face. What has not been assessed is a realistic view on the vegetation clearing required in other regions. Both Powercor and SP Ausnet have massive clearing problems in the state forests, as do Ergon and Country Energy. In particular, Ergon faces probably a greater challenge than does PW, as significant areas of PW power lines are in rain shadow areas whereas both Ergon and Country Energy face large tracts in high growth tropical rain forest areas. Whilst not disagreeing that PW does have a vegetation clearance problem, it is disputed that this is excessively greater than for the benchmark businesses.

- The incidence of bats and birds is similar to that in northern Queensland and even into northeastern NSW. Whilst bats and birds do impact the NT, in the southern states a similar degree of shorts occurs due to possums. Thus while the issue id legitimate, it needs to be balanced by realism that similar outcomes do occur in other regions but perhaps from other causes.

- Cyclones do impact Queensland to a similar extent as in the NT and even northern NSW suffers perhaps as much. Therefore the issue is not unique to the NT. In the southern states the EDBs suffer from snow falls which have a considerable impact.

- It is noted that there are high travel costs to service Tennant Creek and Alice Springs. In fact, the PW staff are not faced with the extraordinary travel requirements experienced by Country Energy and Ergon staff. These staff would also point out that their productivity was just as severely impacted by adverse weather as PW staff. It is acknowledged that this is not a feature for Powercor and SP Ausnet, although SP Ausnet would contend that the time lost in the Latrobe Valley would equate to that in the NT

- Meyrick refers to the corporate cost allocation impact on PW. It is immaterial how corporate costs are allocated, if these costs are reasonable. To allege that overheads in other regions are allocated to capital is not correct – these costs can only be allocated to capital if they are related to actual capital projects, and it has been noted that the ATO has queried this practice. If some overheads are dedicated to capital projects then this increases the capex, and therefore a careful analysis is required to ensure that the PWC practice is not just an excuse to increase opex and recover additional costs in capex. But it is the quantum of the claim that astounds NTMEU. PW alleges that $8m of overheads are transferred from capex to opex – this is 14% of the total opex budget! Yet the capex budget is ~$50m pa implying that there has been a 16% transfer of overhead costs from capex to opex. It is most unlikely that an amount anything approaching this share is uniquely transferred from the capex budget to the opex budget as a result of overhead costs, as overheads for capital works generally do not exceed ~8%.

Overall PW has claimed an opex cost of $57m for 08/09.

Meyrick has assessed the special features for PW as follows:-

Table 2: **PWPN quantified opex due to operating environment conditions, 2008–09**

Factors causing extraordinary opex	*PWPN claim*	*GHD Meyrick acceptance*
1. Materials and spare parts costs	$0	$0
2. Unplanned outages due to wet season weather conditions	$282,350	$86,481
3. Equipment wear and tear due to climatic conditions	$2,034,085	$403,267
4. Vegetation trimming	$2,928,571	$2,928,571
5. Termites	$1,148,552	$1,100,195
6. Bats and Birds	$770,909	$513,939
7. Cyclones and flooding	$1,063,053	$1,063,053
8. Reduction in labour productivity	$1,052,785	$350,928
9. High earth resistivity	$632,411	$632,411
10. Higher costs resulting from inability to recruit staff in some locations	$2,508,000	$342,836
11. Higher labour costs in the Northern Territory	$0	$0
12. Differences in overhead capitalisation	$7,966,200	$6,638,500
Total quantified extraordinary opex	$20,386,916	$14,060,182

Effectively, of its 08/09 claim for opex of $57m for 08/09, PW is claiming a premium of $20m for its adverse operating conditions. Thus if PW was operating in the southern states, it would need an opex allowance of $37m. Thus the premium sought is 55% above benchmark. This would result in an opex/RAB outcome of 8%, still above the opex/RAB for other EDBs.

Meyrick has discounted the premium from $20m to $14m

5.4 Conclusions

The principle behind using TFP as a tool to adjust regulatory revenues, is that there is unlikely to be a Po adjustment at each revenue assessment. If the business is operating at efficient levels, as are all the benchmark businesses, then a Po adjustment should not be necessary. The fact that UC is proposing a Po adjustment implies that PW is not operating at efficient levels. This could be the result of an incorrect setting of Po at previous resets, or that PW is not efficient or that PW has suffered some identifiable step change.

NTMEU cannot comment on whether the Po set previously was inaccurate, but as it was set using PW input at the time, would seem to indicate that the original Po reflected PW operations as they were. In fact in the 2004 reset, UC allowed significant increases in both opex and capex, giving some support to the view that the amount set in 2004 was possibly greater than the most efficient costs.

PW has not provided any step changes which would justify a step change in the operating constraints that it must work within. In other jurisdictions, such step changes include changes in Laws, enhanced safety requirements, increased compensation claims, increased system requirements, etc. Under a TFP control mechanism, these are the only changes that should be included in a Po adjustment. In fact, there is proposed a step increase in opex of some $14m pa of which nearly 50% is attributable to an overhead transfer from capex to opex. This then leads to the question as to whether the capex allowance which has increased from $30m pa to over $50m pa should be assessed as including these overheads, or whether they are excluded.

Of the balance of $7m pa this is alleged to be a step change due to greater difficulty in operating in the NT. However, Meyrick states that in its 2003 assessment it provided for many of these issues. This then leads to the following questions – has it become harder to operate in the NT or has PW asked for more opex without justification, or did Meyrick underestimate the allowances in 2003? Neither UC not Meyrick make any comment to provide justification for this step change.

After assessing that these other options are not applicable, it leads to the conclusion that the UC proposes to increase Po without justification other than PW want to increase its opex and capex above the levels allowed in the initial setting of Po in 2004.

The NTMEU considers that increasing opex without this being supported by identifiable step changes is not appropriate. Further increasing the capex without identifying what the step increase in capex is to achieve is equally inappropriate.

As noted earlier, a good TFP control mechanism without setting acceptable standards of performance and identifying what any increased opex and capex is to achieve, is not what is intended by the TFP approach to regulatory control.

If the UC desires to use TFP then it must apply more rigour to the PW claims for increases. This it has not been done in the draft determination. Alternatively,, the UC should revert to a building block approach.

On the basis of the information provided by PW, ACIL and UC, the NTMEU does not consider there is a reasonable basis to increase the opex allowance, especially when the benchmarking (albeit quite simplistic) carried out by NTMEU and by Meyrick clearly shows that PW opex is considerably higher than equivalent distribution businesses in other jurisdictions. Both Meyrick and ACIL opine that the unique features of PW operating regime support increased opex is not supported by clear analysis proving that this is so. In particular the unsupported opinion that opex for transmission is higher than for distribution (thereby increasing opex needs) is not tested against the actuality of other transmission businesses.

With regard to capex, the NTMEU is not necessarily opposed to the level of capex implied by the UC draft determination. However, it does have a clear concern that:-

- such capex allowances claimed do not have a specific outcome clearly stipulated (what PW states in its application about capex is all high level “warm and fuzzies”),

- past capex has not been assessed for efficiency (raising the concern that future capex might not be efficient)

- there is no measurable outcome in terms of performance standards

6. The X factors

The UC has introduced the concept of TFP to adjust the tariffs used by PW for its network charges. The concept is that each tariff will be changed using a CPI –X approach where X comprises three elements.

As a first step as noted earlier NTMEU considers that a TFP approach must be accompanied by a performance and service standard program which defines the expected performance of the utility, and provides a penalty/bonus arrangement for achieving these standards. If there are no such standards with an appropriate penalty for non achievement, then there is an incentive on the NSP to not spend the opex and capex embedded in the revenue allowed. Unless such is implemented then the X factor elements lose much of their impact.

Meyrick addresses three different X factors – X1 addresses electricity DBs against the Australian economy, X2 addresses opex for comparable businesses, and X3 the price growth of PW against the national economy.

The NTMEU does not have access to the data used by Meyrick to develop the differences and therefore only comments as an overview.

6.1 X1 factor

Meyrick identifies that there is a differential between the growths of EDBs and the national economy. Meyrick uses data from the US, NZ and Victoria's ESC review of Victorian EDBs. From this data it has identified that X1 should be 0.2, yet decides, on the basis of conservatism to reduce this to zero.

It is not the province of Meyrick to decide if conservatism is warranted, but to provide the outworkings of the TFP analysis, although it is noted the UC accepts this conservatism. The NTMEU is concerned that if there is to be a trend based approach to revenue setting (such as using TFP), then the actual outworkings as they stand must be used. To deliberately impose conservatism onto the calculations will distort the entire concept of using TFP. Just imagine if every analysis undertaken used the same conservative approach, then the UC decision on PW would be used for other DBs and so skew those decisions. Ultimately TFP is a circular approach – what is used for one decision flows onto others and ultimately back to the source. Such an approach requires the regulators using the approach to use the actual outworkings as they are calculated and not to impose their own biases.

For the UC to allow a discount to the actual values (ie a conservative approach) defeats the whole concept of benchmarking and distorts not only the decision under review, but all subsequent decisions made elsewhere using the data for the specific decision.

Deeper analysis of the Meyrick report shows that the very amount it determined for X1 is distorted. It observed that the PEG report on the TFP growth in Victoria averaged 1.7 pa for the decade to 2006. Meyrick considered that the large changes in 2006 and immediately after privatization should be discounted. TFP is meant to be a longitudinal assessment and not to be interpreted too closely and adjusted because the figures seemed inconsistent. If there is a view that data can be excluded then this creates distortions which undermine the concept of TFP. An analogy is the assessment of (say) market risk premium used in the WACC calculation. There is no doubt that MRP demonstrates large swings on a yearly basis. If the calculators of MRP decided to exclude large swings, then this would undermine the principle of using a long term average. The regulators have decided to use the long term average without excluding data. The same concept applies to TFP inputs. To use selective data undermines the the validity of the data.

The Victorian DBs have the closest relationship to PW, in fact two (SP Ausnet and Powercor) are used as the basis of the X2 calculation along with Ergon and Country Energy. The longitudinal data shows that for a decade the average X1 value for SP Ausnet and Powercor has been 1.7; the same data shows that since 2000, the average X1 is 1.3. Meyrick then removes the 2006 data and determines that X1 is now 0.4. In the final recommendation it effectively then averages and then discounts these amounts further to be 0.7.

Meyrick's analysis of NZ EDBs shows that X1 was 2.1 in the early years after disaggregation, falling to a lower figure in later years as the effects of the regulation had delivered their benefit. PW is still in the early years and therefore there is an expectation that it still has not achieved the efficient level that is being seen in NZ and in the US.

The NTMEU considers that if there is available data for Australian businesses then this should be preferred to international data, especially if the international data has been prepared on a basis reflecting extended periods of consistency and regulation. The longer businesses have been operating in a regulated environment the greater the expectation that the pressures driving towards efficiency have been successful. Australian distribution businesses are still in the early phases of regulation and are still well away from efficient operation. It should be remembered that one of the main reasons for moving to a regulated basis was to drive the incumbent government owned vertically integrated power businesses to greater efficiency. To use data from overseas where businesses are already efficient will not cause the outcomes expected of regulation.

The NTMEU does not consider that if the UC is going to use TFP as the basis for revenue setting, that the UC is correct in including a conservative discount, that data should be selectively used or discarded and that the actual data developed should stand. Further the most appropriate data to use is that closest in similarity to PW and this

is the Victorian experience where Meyrick has identified that its opex benchmarking uses two of the Victorian businesses.

On this basis there is strong evidence that X1 should be +1.7 based on the decade of Victorian business performance, and on the outcomes in NZ in the early years after disaggregation. At the very least, the average of the Victorian businesses for the period since 2000 should be used without selective exclusion of some data, implying an X1 of 0.4 as a minimum.

The NTMEU does not consider that any data developed should be further discounted because of a need for conservatism.

6.2 X2 factor

Meyrick devotes considerable effort in supporting the PW claims that it is more difficult to operate in the NT than in other regions and allows a premium of $14m pa for this feature. Of this amount nearly 50% is supposedly attributable to corporate overhead transfers from capex to opex, but as noted earlier NTMEU does not see that this amount is at all reasonable and needs much deeper analysis and ensuring there is no double counting for it within capex and opex.

Based on their assessment, Meyrick discounts $6m from the opex budget and then assesses the X2 productivity.

In its detailed assessment Meyrick again repeats its approach to discounting actual data. On page 28 it observes

> "While GHD Meyrick believes the bulk of available evidence points to opex partial productivity increases for EDBs between 2003 and 2009, in this case we have made the conservative assessment (in favour of PWPN) that the opex partial productivity of

> the interstate EDBs in Meyrick (2005a) remains unchanged. We thus make no adjustments for interstate productivity growth when comparing PWPN's 2009 adjusted opex (in 2003 prices) with the other EDBs' actual 2003 opex."

As noted earlier, when assessing TFP inputs it is not for Meyrick to make conservative judgments as to what data to use – it should use actual data and not discount the impacts as by doing so it distorts the outcomes for both the review being carried out and for subsequent analyses.

Meyrick then added a further discount, even though PW had not requested it

> "While PWPN did not quantify an adjustment for its 'transmission equivalent' operations, in the interests of being conservative in favour of PWPN, GHD Meyrick has adjusted PWPN's opex downwards by 5 per cent in recognition of the extra functions PWPN performs relative to interstate EDBs."

What is even more intriguing is that whilst Meyrick only adjusted its 2003 estimates for the net opex (ie absent the operating environment premium of ~50%) it has added this adjustment on the <u>whole</u> of the opex claim further increasing the bias towards PW, and Meyrick quite openly states that this adjustment is conservative in favour of PW.

After making all for these conservative adjustments Meyrick still identifies that of the four operational measures used (opex/km, opex/GWh, opex/customer and multilateral unit opex) PW is the worst performing EDB in three of the four measures by a factor of over 50%, and is in the higher end in the other measure.

In 2003 Meyrick recommended that a 10 year period was appropriate for PW to reach the target performance, ie by 2013. Unfortunately it has decided that this is not long enough and another 10 years is required to reach target performance ie to 2018. At this

rate PW will never have to reach target performance and Meyrick has introduced another level of conservatism.

There has been no assessment as to the impact of this cumulative conservatism upon conservatism, but there is no doubt that it is excessive. What is required is an assessment which excludes any conservatism so that the UC can decide if it should introduce a level of conservatism which applies now. Thus level of conservatism should be targeted to reduce in firm and known steps over an agreed time at which point it should cease or remain constant at an agreed level in to the future.

It is totally unreasonable for consumers to have to pay for cumulative but unknown levels of conservatism without being defined and transparent.

Based on its cumulative conservatism, Meyrick recommends (and UC accepts) holding the X2 value at 0.25%, which is considered to be conservative relative to the actuality of the value which should be used. As there is so much unquantified conservatism used in reaching this value for X2, it is impossible for NTMEU to recommend an X2 value at this stage.

6.3 X3 factor

X3 is to allow for the impact of costs to the industry relative to the national economy. Meyrick refers to data which applied to regulatory decisions made in 2007 and 2008. There is considerable doubt that as a result of the 2008 financial crisis and the resultant massive changing of international and national growth forecasts that the Meyrick assessment remains valid. Already there are signs that major cost inputs for materials have fallen massively in recent months.

Since the middle of 2008 to the current time copper and steel prices have fallen by 60%[3] and the forecast Australian economic growth has halved. On this basis the data provided by Meyrick is totally misleading and must be reassessed in light of the real forecast of costs.

The NTMEU is of the view that the cost pressures that PW will face in the next five years are likely to be less than those faced by PW in the current period.

On this basis, it is probable that X3 should be zero.

6.4 Conclusions

Meyrick has clearly stated that it has deliberately discounted the actual data provided in TFP assessments to provide a conservative view of the X factor inputs. This conservatism has been cumulative and provides a clear distortion of the outputs derived. This conservatism should be quantified so that UC and consumers can see what the impact of this conservatism is.

The calculation of X3 is clearly wrong as a result of the recent changes in world growth, and must be done again using current data and forecasts.

The NTMEU is of the view that based on the information provided by Meyrick in its assessments,

- X1 should at least be 0.4, and there is evidence to indicate it should be higher
- X2 should be considerably higher than the value of 0.25 allocated by Meyrick

[3] See London metals exchange data

Based on the recent forecasting showing the "first" world as a whole is heading towards recession and Australia to half of its forecast growth, and that the major economies of China and India are forecast to have a significant (at least 30%) reduction in growth forecasts, there is a need to revalue X3. In particular the prices of materials used by PW have already shown massive reductions (>50%) and these prices are likely to remain for much of the next regulatory period.

On this basis the NTMEU considers that X3 is likely to be the same as for the current period and should be set at zero.

The implications of these assessments is that X should be at least

X = 0.4 + 0.25 +zero = 0.65, ie showing a real reduction over the regulatory period

7. Service performance standards

PW has not proposed a service target incentive scheme (STPIS). The AER has implemented such for DBs under its control and the NER clearly considers that such a scheme is to be mandated. The NTMEU accepts that the regulatory regime in NT does not mandate such a scheme, allowing the regulated business to decide if one will be implemented.

The NTMEU is aware that an essential part of a TFP regulatory approach must have a requirement for minimum service standards. The absence of such standards does not allow the regulator to identify if the allowances within the TFP base program are achieving any measurable outcome. In the absence of such measurables it allows the service provider the very real potential to maximise its revenue, “run the network into the ground” and walk away. It was because of this concern that proponents of TFP based regulation require a clear statement of performance and service standards. The best way to achieve this outcome is an incentive scheme that provides sufficient commercial pressure on the service provider to be active in enhancing service performance.

What the UC draft determination does is to provide a one-legged regulatory regime. It allows the regulated business to use its revenue in anyway it wants, and imposes no controls on how it uses the funds – and incentive scheme clearly achieves this outcome. Achievement of performance standards is essential, especially in an environment like the NT.

NTMEU does recognise that PW (being a government owned corporation) is unlikely to actively underperform to return enhanced dividends to its shareholder because of the political implications of such an action. That being said, NTMEU affiliates in NSW have seen, at times, the government owner require its distribution businesses to provide

additional special dividends. Such special dividends could only come from a reduction in capex and opex to provide the funds required.

The NTMEU considers that as it is ultimately consumers that underwrite the ability of PW to raise funds for capex and to remain financially viable, it is only reasonable that there be very clear explanations of what funds are required, what they are to achieve, and to have the performance measured in appropriate ways. Already some consumers have been significantly disadvantaged by the failure of the Casuarina substation. If an incentive scheme had been in place, it is possible that the failure might not have occurred.

Consumers need to see that performance improves over time and certainly that it does not deteriorate. A STPIS provides consumers with the confidence that their issues are being addressed. What is more, consumers are prepared to pay for enhanced performance.

NTMEU considers that the UC is not addressing the needs of consumers by allowing PW not to provide a STPIS as part of this reset.

8. Tariff development

As a result of significant work by consumers in the development of the new Electricity Rules for transmission and distribution, regulators are now required to ensure that the tariffs developed by both TNSPs and DNSPs are to be more reflective of the costs related to the provision of the service. This is clearly stated in the NER at clause 6.18.5, and UC draft determination seeks to have PW develop its tariffs in accord with this clause.

6.18.5 Pricing principles

(a) For each *tariff class*, the revenue expected to be recovered should lie on or between:

(1) an upper bound representing the stand alone cost of serving the customers who belong to that class; and

(2) a lower bound representing the avoidable cost of not serving those customers.

(b) A tariff, and if it consists of 2 or more *charging parameters*, each *charging parameter* for a *tariff class*:

(1) must take into account the long run marginal cost for the service or, in the case of a *charging parameter*, for the element of the service to which the *charging parameter* relates; and

(2) must be determined having regard to:

(i) transaction costs associated with the tariff or each *charging parameter*; and

(ii) whether customers of the relevant *tariff class* are able or likely to respond to price signals.

(c) If, however, as a result of the operation of paragraph (b), the *Distribution Network Service Provider* may not recover the expected revenue, the provider must adjust its tariffs so as to ensure recovery of expected revenue with minimum distortion to efficient patterns of consumption.

It is now no longer simply a matter for NSPs to decide in isolation that they will set the tariffs to suit themselves. The reason for the change to much greater regulatory oversight of tariffs, comes from the outcomes of the Victorian DBs being given essentially free rein to set tariffs. It was identified that they had used the ability to set and change tariffs so that they were able to increase their revenues by between 5-10% by careful tariff structuring. That is the enhanced revenue received above the allowed revenue could not be explained by increases in the volume which allow increased revenue due to the price cap approach. The conclusions drawn were that the excess revenue resulted from tariff manipulation.

This phenomenon has bee seen in other price cap regimes and was the primary cause for the increased involvement in the regulatory process into tariff setting in both transmission and distribution.

Another feature of tariff setting by NSPs is that there is a tendency to bias tariffs to deliver unearned income. One of the ways that this is achieved is by the closure of some tariffs and the opening of new tariffs. The NTMEU strongly suggests that the UC provide some control over PW from making many adjustments to, retirements of, and opening new tariffs. This can be readily achieved by ensuring that PW must justify in

detail a change in the tariff structure, and that PW can demonstrate that the change will not result in unearned revenue.

The UC has insisted that PW provide a draft of its Network Pricing Principles and methods Statement. This is essential first step in ensuring the tariffs are as close to possible to cost reflective and do not significantly over or under recover from any specific customer class.

However, the UC has a responsibility to ensure that PW not only produces a Statement that is expected to provide the targeted outcomes for tariff setting, but that the proposed methodology actual does achieve the expected outcomes. This requires the UC to undertake some additional testing to be satisfied that the PW approach does result in appropriate tariffs.

Attachment

PowerWater predicts $46 million black hole

MATT CUNNINGHAM, November 3rd, 2008

ELECTRICITY costs could rise sharply for big business and government after Power and Water predicted a $46 million revenue shortfall this financial year.

Any increases will not automatically be passed on to householders and small business.

Power and Water has told the Utilities Commission it will need to lift its network tariffs by 61.4 per cent to cover the shortfall.

The submission was made as part of the initial draft determination of the Commission's 2009 Regulatory Reset - a five yearly review of the prices paid by electricity network users - and was submitted before the recent failures at the Casuarina substation.

But the Commission has rejected PowerWater's proposal, arguing the shortfall will be only $20 million and the increase need be only by a factor of 24.4 per cent.

Power and Water has until January to resubmit its figures before the Commission signs off on a final decision.

Power and Water general manager of strategy and corporate affairs Alistair Parker said it was likely the price rise would be passed on to the corporation's "contestable customers" - large businesses and Government organisations that use more than 750 megawatts of power each year.

Mr Parker said the increase had been caused by rising capital expenditure, repairs and maintenance costs and an underestimation of costs when the last reset was conducted in 2004.

PowerWater cannot routinely pass the increases on to domestic customers.

They are protected under the Electricity Reform Act because the corporation has a monopoly over their business.

It will be up to the Northern Territory Government to decide if these customers will see any price increase.