



Submission to Utilities Commission

on

Networks Pricing: 2009 Regulatory Reset

December 2007

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EXECUTIVE SUMMARY

The Northern Territory Major Energy Users (NTMEU) welcomes the opportunity to provide its comments on behalf of the larger energy users in the Territory.

All forms of regulation have short-comings. The important issue is that the regulator recognises the deficiencies and takes the necessary remedial actions.

The NTMEU agrees, in the interests of certainty, that the price cap methodology applies to the 2009 Regulatory Reset. However, to avoid tariff manipulation common under this methodology, appropriate Pricing Rules and Principles need to be adopted at the outset to ensure that:-

- efficient use of electricity is encouraged
- efficient use of the networks is encouraged
- demand management options is encouraged

and to avoid over or under- investments in networks.

The Utilities Commission must take a close interest in pricing outcomes to ensure:

- cost reflectivity in tariffs
- non-discriminatory tariffs
- no cross subsidisation between customer classes

Comments are also provided in this submission on the key issues raised by the Commission.

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 Issues Paper, dated October 2007. Particularly pleasing is the Utilities Commission's (UC) invitation "to add to or modify that list (of issues) as well as to put forward preferred approaches" for the 2009 Regulatory Reset. That the UC has commenced the process at this time provides an appropriate timetable that should allow for a considered and consultative process for undertaking the 2009 Regulatory Reset.

The NTMEU comprises the larger end users of electricity in the Northern Territory and includes the following companies: Northern Cement Limited, Parmalat Australia, NT Airports, Darwin Central Hotel, Darwin Private Hospital, Natural Fuels, Compass Resources NL, and Yeperenye Pty. Ltd.

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 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 Issues Paper.

2. Price Cap Methodology

Issue:

(1) Is there any disagreement with the Commission's view that the principal focus of the 2009 Regulatory Reset should be on reviewing the operation of the 2004 methodology, rather than the form of regulation more broadly? If so, why?

In its decision¹ in 2003, the UC comments that it saw a revenue cap approach as less attractive than a price cap approach to a regulatory review for the following reasons

“3.9 The Commission considers the current revenue cap approach to be deficient in three key respects:

- the fixed revenue cap provides no incentives for efficient, cost-reflective pricing and output by the network service provider;
- the fixed revenue cap is inflexible with regard to volume changes; and
- the combination of a building blocks approach and the fixed revenue cap is costly and complex to apply and administer

3.10 Under a fixed revenue cap, the network service provider's income is fixed, regardless of how much electricity it distributes. This has a number of consequences. While the network service provider faces an incentive to reduce total costs since, with revenue fixed, lower total costs increases total profits, a primary means of achieving lower costs is to restrict output. There is the potential for a deterioration in the

¹ NETWORKS PRICING: 2004 REGULATORY RESET FINAL DECISION PAPER: PRICE REGULATION METHODOLOGY NOVEMBER 2003

provision of network access services, to both new and existing customers, resulting from an incentive to reduce units distributed.

3.11 This works against the efficient utilisation of the existing asset base. It also diminishes the role of prices in the management of profit risk arising from volume changes. The network service provider faces no clear incentive to align prices with costs, since cost reflectivity requires revenue flexibility.

3.12 In the face of a fixed revenue cap, variations in volumes from those forecast at the time that the cap was determined are accommodated by adjusting price. Greater-than-anticipated volumes lead to reduced prices and vice versa, potentially creating considerable price instability. Revenue inflexibility in the face of volume uncertainty adds to aggregate financial risk both for customers and the network service provider.”

The decision goes on to state support for a price cap approach

“3.25 The principal attractions of [a price cap] approach are that:

- it is light handed, with no reliance on forecast information and minimal withinperiod regulatory intervention or compliance activity;
- it greatly increases incentives on the network service provider to structure individual tariffs in line with costs (thereby managing the associated risks);

- it provides the network service provider with the flexibility necessary to deal with the network implications of offshore gas developments without regulatory adjustments, at the same time as ensuring that existing users are not expected to subsidise new users; and
- it provides a basis for price movements over time that is readily understandable to end users”

It is agreed that volume variation has the potential to create price movements in a year on year assessment, but it is pointed out that all transmission businesses operating in the NEM, all operate on a revenue cap approach, and are able to accommodate this volume variation issue. Equally, it is not a price cap approach that results in a lesser need to assess future volumes of demand. In fact, in a price cap environment, the forecasting of future demand is much more critical than under a revenue cap approach, where the actual demands are used to set prices, rather than having to forecast demand growth up to five years out, so that the basket of tariffs can be developed.

What the UC did not address is that a price cap approach is designed to actively encourage the network owner to seek greater use of electricity and to use the price cap approach to “game” the system. In this regard we would point out that:-

1. There is currently an identified shortage of power generation in the NT system, and augmentation of the generation sector is needed to meet the peak demands. With PWC being both generator, network owner and retailer, there is little need to incentivise the network tariffs to encourage greater use of electricity, as the PWC already has significant incentives.
2. Greater use of the network (particularly at peak times) results in the need for network augmentation, with its associated costs. Whilst the principle of encouraging greater use of the network during times when the network is underutilised is supported (as it can have the effect of reducing the cost sharing

overall), unconstrained encouragement can have the opposite effect by encouraging greater use at peak times, causing higher network charges and greater peaking generation investment. As the NT system is also dependent on gas as its primary source of generator fuel, short term peaks in generation can also require investment in the gas production and transport arrangements (particularly gas compression) to manage the short term high demands, further increasing costs to consumers.

3. Price caps are readily amenable to manipulation. It has already been seen in other jurisdictions that regulated businesses devote considerable attention to setting of prices with services, in order to maximise revenue without providing any additional service. For example, in Victoria it was identified that by this practice alone, the electricity distribution businesses gained up to 5% more revenue (effectively unearned) by adjusting tariffs. This 5% increase in revenue effectively added some 50% to the profit expected by the regulator.
4. The cost of providing a network is basically driven by demand, as it is demand that sets the size of the assets used in the network. Changes in volume might or might not cause an increase in investment, so that an increase in volume above the forecast used to set the target revenue might be paid for by consumers, but there might be no corresponding increase in costs to the businesses, resulting in unearned revenue. As this presents a risk to the business, it will endeavour to underestimate future consumption, in order to set higher starting unit prices. Thus, a revenue cap approach is likely to be more reflective of the costs incurred, than a price cap approach, and reduces risks to both the business and consumer. This reduction in risk (with its attendant costs) must be balanced by the potential for consumers to incur a greater expense by the regulated business being incentivised to game the system.
5. It would appear to be contra-indicated in the environment of today (with its pressure on carbon emissions) that there should be regulatory incentives provided to increase electricity consumption.

The NTMEU has some sympathy with the sentiments expressed in the following statements in support of the UC's proposed approach to continue with the use of the price cap methodology:-

“2.17 The Commission considers that both the factors that attracted it to the price cap methodology adopted in 2004 and the value of continuity and consistency across periods remain valid. Accordingly, it does not consider a repeat of the ‘zero-based’ examination of the form of regulation undertaken in 2004 to be justified.

*The Commission’s intention therefore is to place the principal focus of the 2009 Reset on the operation of the price cap methodology adopted in 2004, rather than on the choice of the form of regulation. Hence, the issues that are within the scope of this Reset are the fundamental operational features of the 2004 methodology (as outlined in **Box2**):*

- *use of weighted average price cap (tariff basket approach);*
- *cost-based adjustment of base year prices;*
- *escalation arrangements; and*
- *individual network access tariffs,”*

In the NTMEU’s view, however, a price cap regulatory approach may result in the following:-

- encourage greater use of the network by enabling a distribution network business to mask price signals to certain customers that cause peak demand through use of refrigerative air-conditioners and plasma televisions.
- encourage tariff manipulation to make and discourage embedded generation less financially attractive because this leads to reduced importation of power and therefore the revenue accruing to a network business.

Experience in some National Electricity Market jurisdictions shows that price cap regulation can discourage demand management options and can incentivise network investments (i.e. over-investments). In short, the NTMEU considers price cap regulation:-

- does not encourage more efficient use of electricity
- encourages greater use of networks and network options for augmentations
- increases the cost of network services to customers even if they are not responsible for causing peak demands or network congestion.

There are, of course, shortcomings in other forms of regulation, such as a revenue cap methodology which is used in some NEM jurisdictions. For instance, a revenue cap provides no incentive to get pricing correct, whilst **in theory** a price cap methodology is intended to achieve that (but does not due to tariff manipulation or rebalancing by distribution network businesses).

From the experience of NTMEU members that have operations in the NEM and are experienced with distribution regulatory reviews and resets, and from the advice received from our consultants, it is the attention provided to network pricing rather than the form of regulation that is critical. Thus the pricing rules setting out the appropriate pricing principles and the price guidelines setting out the pricing methodology that must be adopted by the distribution network business should be the main consideration in achieving through non-discriminatory cost reflective and economically efficient pricing:

- **more efficient investment in and provision and use of electricity services**
- **effective access to demand management options**
- **opportunity for networks to recover revenues based on the efficient cost of providing its services**
- **appropriate returns to the network business with the regulatory and commercial risks involved in providing the services**

- **and so on, in terms of clause 63 of the Electricity Networks (Third Party Access) Code (Box 1, Issues Paper).**

The NTMEU points to the new proposed National Electricity Rules in relation to distribution network pricing²

6.18.6 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.

Additionally, the NTMEU makes the following suggestions with respect to the 2004 methodology (Box 2).

² October 2007 draft of Chapter 6 National Electricity (economic regulation of distribution services) amendment Rules 2007

With regard to the **Weighted Average Price Cap** (Tariff Basket Approach) the NTMEU considers that great care needs to be taken by the regulator to ensure that the tariffs used in the basket are demonstrably reflective of the actual usage of each tariff class, and that when developed, the outcome of the tariffs in the basket totals the anticipated revenue that the regulator considers appropriate in the final determination. The NTMEU is of the very strong view that if cost reflectivity is achieved (or nearly so) then there is reduced potential for consumers to be disadvantaged by gaming.

Additionally the Electricity Code (clause 74(c)) requires the reference tariffs to be “transparent ... in order to provide pricing signals to network users”. If the tariffs are not accurate and demonstratively near cost reflective, they will send the wrong signal to consumers. Sending a wrong signal is worse than sending no signal.

Certainly the NTMEU strongly supports the UC’s intended approach for the 2009 Regulatory Reset, as expressed in its Networkings Pricing: 2004 Regulatory Reset Final Methodology Decision, November 2003 (Page 16):-

“...the Commission is seeking to build a foundation for an enduring, effective, low cost form of regulation tailored to the circumstances of the Northern Territory electricity market. By establishing a datum at the 2004 reset that includes a cost based review of opening prices and externally-benchmarked indexation combined with a tariff basket form of price control, further movement away from a cost-based approach and towards a pure price cap should be possible at future resets.”

It is of concern that there is an assumption that it is only the cost of regulation that needs to be minimised. Consumers in other jurisdictions have seen that the costs for the services provided have greatly increased as a result of reduced regulatory overview and involvement. As noted above, the costs to consumers in the Victorian electricity supply were significantly higher as a result of the regulator taking a light handed approach to network pricing – in fact the regulator did not carryout any assessment of the prices used in the basket of tariffs and as a result the regulated businesses were able to increase their revenue for no reason other than it was able to manage the development of the prices in such a way as to increase

revenue for the same consumption. This is a key aspect that needs to be addressed by the UC.

On this basis the NTMEU is of the view that:-

- the review must be non-discriminatory and fully transparent
- the use of a revenue cap should not necessarily be a foregone conclusion, and that there are good reasons why a change should not be made (i.e. the NTMEU’s concerns need to be addressed)
- it is essential that the setting of prices must be an issue for the regulator to have a deep involvement, to ensure that gaming is minimised, and that the tariff pricing approach of the revised NEM Rules be implemented.

3. Assessment Criteria for the Reset

The NTMEU agrees with the six objectives of the network price regulatory methodology to apply in the third regulatory period as stated in the Issues Paper (pg11), but with additional comments from the NTMEU against each objective. Additionally, we have added further objectives which we consider necessary:-

| Item | UC Objective for the review | NTMEU comment |
|------|--|---|
| 1 | <i>“be efficient and cost effective”</i> | We agree, but consider that it needs to be non-discriminatory, transparent, and cost reflective |
| 2 | <i>“ensure that Power and Water Networks does not exploit its position as a monopoly service provider”</i> | Pricing rules and pricing guidelines need to be developed to ensure there is minimal opportunity to set, manipulate or rebalance tariffs in order to maximise revenues or to strike tariffs that are inefficient and unrelated to efficient costs |

| | | |
|---|---|--|
| 3 | <i>“equitably distribute efficiency gains between stakeholders while providing sustainable commercial returns to Power and Water Networks”</i> | The NTMEU members require competitively-priced and sustainable energy over the long term. This means that it recognises the need to ensure that infrastructure network businesses receive sustainable commercial returns in order to invest and remain in business, whilst ensuring that end users receive competitively-priced network services and do not pay monopoly rents |
| 4 | <i>“foster competition in the provision of network services as a means of addressing concerns over monopoly pricing wherever economically efficient and practical to do so”</i> | This requires robust and effective economic regulation. The NTMEU will attempt to assist the regulator in this regard. |
| 5 | <i>“foster competition in upstream and downstream markets”</i> | Major end users require competitively-priced inputs in order to compete more effectively in overseas and domestic markets. |
| 6 | <i>“foster efficient use of, operation of and investment in, the network”</i> | Effective regulation should ensure there is no over or under investment in network infrastructure. The cost of over investment adversely affects upstream and downstream investments in the short term, and under investment adversely affects upstream and downstream investments in the long term. |
| 7 | Foster an ability for the demand side to be able to provide input on a “level | The NTMEU considers that the pricing mechanisms used by a distribution |

| | | |
|--|----------------|--|
| | playing” basis | network can minimise (even prevent) demand side responses to the market. Specifically the network must actively seek demand side responses as an alternative to augmentation. |
|--|----------------|--|

Overall, the NTMEU sees effective economic regulation as essential to achieving the right balance of interests between users and the network business. However, information asymmetry is a problem for the regulator as well as for users. In this regard, the UC must ensure that in the regulatory reset, adequate disclosures of information is not negotiable and that PWC is required to provide timely and accurate information so that the regulator and other Interested Parties have adequate time and information on which to provide comment and observations.

Users must be able to have sufficient information to ensure that:-

- (a) they are able to calculate the tariffs based on the information provided, and
- (b) they are able to establish that tariffs are fair and efficient.

4. Regulatory Certainty and Regulatory Risk

Issue:

(2) Is there any disagreement with the emphasis being on regulatory certainty and on the minimising of regulatory risk when the Commission is reviewing the 2004 methodology? If so, why?

The NTMEU supports the UC's emphasis on ensuring regulatory certainty and minimising regulatory risk, as they apply to end users as much as they apply to the network business. In this regard, not only is continuity important in say, the continued use of the 2004 methodology, but information disclosure is also important in ensuring regulatory certainty and minimising regulatory risk for both the business and customers.

Both upstream and downstream users of the networks have made investments based on the assumption that there will be regulatory certainty and that there is a low risk of the regulator changing its approach such that the outcomes will be significantly different from that used previously. This is not to say that there will not be significant changes in tariffs as a result of the regulatory review, but that the bases for developing these outcomes is clear and results in cost reflective prices.

The NTMEU does not consider that if there has been an error, or an approach that reduces risk that the desire for continuity should over-ride a proper cost reflective outcome. The NTMEU considers that it is essential that the correct outcomes are developed, even if this results in a significant change.

In the long term, regulatory certainty and consistency based on a correct regulatory approach reduces the risk of over or under investment for the regulated business and for those dependent on continued use of the network. Providing clear and unequivocal requirements for a consistent regulatory approach can reduce the overall transactions costs of economic regulation.

5. Weighted Average of Network Access Tariffs

Issue:

(3) Is there any disagreement with the Commission's proposal to continue with the tariff basket approach and the use of lagged quantity weights? If so, why?

The NTMEU has no reason not to support the approach of using a basket of tariffs as the primary mechanism for assessing the movement of tariffs to comply with the overall price control mechanism. However, the NTMEU does have a concern that this mechanism can be misused (and has been in other jurisdictions) and be the medium by which over recovery of revenue has been achieved.

Manipulation of tariffs is a well used technique to increase revenue under a price cap regime, and the effort made to achieve this outcome can be very rewarding to the regulated business. Whilst the outcome of such manipulation can be quite profitable for the regulated business, it is equally disastrous for upstream and downstream users, as the additional revenue increases their costs beyond those related to a cost reflect service.

If the UC considers that the basket of tariffs is the most economically efficient approach to tariff price movements, then it will be necessary to ensure that the initial tariffs are as close to cost reflectivity as possible. The UC should also put in place a mechanism to ensure that the price movements made after the initial setting are required to be made based on demonstrable changes impacting recovery of revenue. This can be by the regulator requiring PWC to provide a clear and unequivocal procedure for adjusting the basket and the elements within it combined with an audit approach such that the regulator can review at any time (but specifically including at the next reset) that PWC has complied with the required procedures. If PWC has over or under recovered target revenue by the application of the procedure, then this can be the basis for a revenue adjustment in the next period. This must be included in the UC's final determination.

Issue:

(4) Is the current range of excluded services still appropriate for the third regulatory period?

The NTMEU provides its comments on the defined excluded services as in the following table.

In other jurisdictions, excluded services include public lighting, visits by equipment or personnel, certain repair works, meter conversions, etc. It is presumed that these other activities are not included as excluded services.

| Item | Excluded service | NTMEU comment |
|-------|---|---|
| | For the purposes of clause 72(2) of the Code, excluded services not subject to any price regulation are the following services: | |
| 1 (a) | contestable engineering consulting services provided by Power and Water Networks | Agree |
| | For the purposes of clause 72(3) of the Code, excluded services which, in the regulator's opinion, do not lend themselves to being regulated by the price cap form of regulation applying in the second regulatory period are the following services: | |
| 2 (a) | <p>services (including metering, electric lines or electric plant) for the specific benefit of any third party (and requested by the third party) and not made available by Power and Water Networks as a normal part of standard services to all customers including –</p> <ul style="list-style-type: none"> i. charges for moving mains, services or meters forming part of Power Networks' system to accommodate extension, re-design or redevelopment of any premises; ii. the provision of electric plant for the specific purpose of enabling the provision of standby supplies or sales of electricity; and iii. provision of metering, or metering data, to a standard in excess of that required for billing | <p>Agree</p> <p>Agree</p> <p>Do not agree. If there is a meter provided which is capable of providing</p> |

| | | |
|------|--|---|
| | purposes; | additional data (eg ToU data) then this data should be provided at no additional cost |
| 2(b) | the provision of connection equipment to a standard in excess of a standard associated with the “least overall cost, technically acceptable” assets; | Partially agree. The standard of connection should be that consistent with the quality of connections provided to other users |
| 2(c) | Power system (but not network system) control costs directly associated with the activities of a system controller licensed under the Electricity Reform Act 2000 | It is presumed that the cost of power system control is recovered separately |

6. Allowing for New Tariffs and Encouraging Tariff Flexibility

Issue:

(5) Do the current new-tariff arrangements remain appropriate for the third regulatory period?

The principle of introducing new tariffs and dispensing with old “unused” tariffs is an extremely effective element of the tariff manipulation referred to in previous sections.

There is no doubt that there is an occasional need to introduce new tariffs, but the frequency of such introduction should be limited. A new tariff should only be introduced when there is a new service being provided, or that the basis for tariff setting has changed.

What the NTMEU suggests is that by and large new tariffs should be introduced only at the time of a reset. The NTMEU sees that the risks of allowing use of tariff changes is high for consumers, yet low for the regulated business. The tariffs that are needed at the start of the reset period should be clearly definable. There should be no reason for the introduction of a new tariff within the first 2-3 years of a period because if there is it implies that the business does not have a good understanding of the business it is in – and the NTMEU does not see that PWC is incompetent and lacking knowledge of its business. There maybe sufficient change in the market that might warrant a new tariff towards the end of a period, but even so, even if a less appropriate tariff continues beyond its use-by-date for 1-2 years the risk to the business is minimal,

If there is an absolute and over-riding need to change a tariff (eg as a result of a legislative change or a new and large class of user has entered the market) then the approach suggested by the UC could be used.

The Victorian regulator introduced the concept of a Tariff Strategy Report to be developed by the regulated business which is the basis of the tariffs deemed needed and why. Deviations from the tariff strategy are reported annually with detailed explanations and reasons for the changes together with a demonstration that the tariff change will not adversely affect the target revenue for the coming year.

Overall, the NTMEU sees that its concerns could be addressed by the UC requiring very stringent controls on the introduction of new tariffs and the demise of old tariffs. As a matter of principle the UC should make it very clear to PWC that tariff changes are not expected to be made as it implies that PWC has not devoted sufficient attention to the matter during the rest review. To justify the introduction of a new tariff PWC should be required to demonstrate why the existing tariff is no longer even remotely applicable and why it did not raise this as an issue during the time of reset review.

7. Base Year Adjustments

Issue:

(6) Is there evidence – involving financial data of a quality appropriate for regulatory analysis – that network access tariffs following the cost-based (Z factor) adjustments at the commencement of the second regulatory period under- or over-recovered forward-looking and efficient costs of supply of regulated network access services?

The NTMEU is aware of various approaches that might be used to reduce the regulatory burden of carrying out a full “building block” development of required revenue and the prices that result from that. The UC has suggested that as this is the third such review of the PWC network costs, there might be support for a Z-factor approach to minimise regulatory costs.

As an initial view, the NTMEU considers that the regulatory costs involved in a review are not outweighed by the potential costs that PWC could levy on users of the network in the absence of a review. There have been just as many reviews of networks in other jurisdictions as in the NT, yet no other jurisdiction has seriously proposed a move away from the building block approach. In fact, the recent review of Chapter 6 of the NER in relation to distribution networks has required the continued use of the building block approach. On this basis alone, the NTMEU would point out strongly that it is unlikely the PWC costs have reached a level of certainty for consumers to be certain that the benchmark cost levels have been reached to support the contention implicit in the use of a Z-factor, that the PWC costs have reached demonstrable maximum economic efficiency.

The NTMEU is aware that the Victorian regulator (Essential Services Commission of Victoria) has suggested that after three full periods of review the Victorian electricity networks might have reached maximum economic efficiency and that a process referred to as Total Factor Productivity might be introduced to minimise the cost of regulation. The ESCoV has a program running at this time to assess the effectiveness of TFP, but it has not reached any level of decision at this time.

The AEMC in its review of the transmission networks (Chapter 6A) noted the existence of TFP and commented³ (page 40 of its final determination)

“The Commission has also concluded that the building block approach remains preferable to alternative regulatory approaches which utilise industry-wide benchmarks (such as total factor productivity (TFP) based approaches) in view of the lumpiness and uniqueness of shared transmission network costs.”

The NTMEU considers that the AEMC and the other jurisdictional regulators are correct that regulation in Australia has not sufficiently mature to warrant a transition such as is contemplated by the Z-factor, and accordingly does not consider the UC should deviate from that. This view is supported by the most recent draft of the new Chapter 6 Rules of the NER (distribution network services) which state quite clearly in clause 6.3 that a building block approach is to be used for the development of revenue for an electricity distribution business.

Issue:

(7) Should a gains sharing approach be considered for adoption during the third regulatory period? If so, why and what form should it take?

The principle of an incentive regulatory arrangement is that the regulated business needs to be incentivised to reduce its opex and capex so that over time the base costs of the businesses will reach the point of maximum economic efficiency. Once this point is reached, then an approach along the lines of TFP or Z-factor might be appropriate to be used. At this stage of the regulatory cycle in Australia, it has been considered by AEMC, and MCE that this point has not been reached, and that the building block approach is still needed.

An essential element of the building block approach is that economically efficient opex and capex can be identified. This will not occur until the regulated business has developed its financial controls to a level that demonstrates economic efficiency. Whilst there is movement over time extant in the levels (adjusted for inflation) of opex and capex then this

³ AEMC National Electricity Amendment (Economic Regulation of Transmission Services Rule 2006 No 8

point of economic efficiency has not been reached. Thus there is a need to incentivise the regulated business to reach this base level of opex and capex.

The draft new Rules for distribution support the introduction of such an incentive scheme. Clause 6.5.5 (c) states this clearly:-

“In developing and implementing an *efficiency benefit sharing scheme*, the *AER* must have regard to:

- (1) the need to ensure that benefits to consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme for *Distribution Network Service Providers*; and
- (2) the need to provide *Distribution Network Service Providers* with a continuous incentive, so far as is consistent with economic efficiency, to reduce operating expenditure and, if the scheme extends to capital expenditure, capital expenditure;
- (3) the desirability of both rewarding *Distribution Network Service Providers* for efficiency gains and penalising *Distribution Network Service Providers* for efficiency losses; and
- (4) any incentives that *Distribution Network Service Providers* may have to capitalise expenditure; and
- (5) the possible effects of the scheme on incentives for the implementation of non-network alternatives.”

The NTMEU supports the approach of providing an incentive to PWC to reach this base level of opex and capex and accepts that this will require a two part approach, following the guidelines developed recently by the AER for transmission businesses and as used by a number of jurisdictional regulators.

Firstly, PWC should be permitted to retain any under-runs in opex and capex that it generates during a period, and secondly there be a method for providing some continuation of these savings into the next period.

8. Annual Escalation Arrangements

Issue:

(8) *Is any change warranted to the definition and measurement of the composite X factor as used in the 2004 methodology, notably involving the separate consideration of the X_1 and X_2 factors? If so, why?*

The concept of establishing a target revenue (in real terms) for each year of the reset period and applying a base starting value (P_0) and applying a smoothing factor and then an efficiency factor is well recognised.

The NTMEU considers that no change to this approach is warranted.

9. Service Performance Adjustment

Issue:

(9) Is there any disagreement with the Commission's intention to introduce an incentive mechanism into the price regulation methodology in support of the NT Electricity Standards of Service framework? If so, why?

The NTMEU strongly supports the use of a service performance adjustment for the 2009 Regulatory Reset. This is a common feature of incentive regulation and is universally supported in all regulatory regimes in the NEM and globally. The NTMEU would note that it is essential that high performance standards are introduced requiring effort by PWC to achieve them, otherwise, the process becomes essentially a cost-plus premium regulatory approach, which is inefficient regulation.

The service standard incentive scheme should require penalties for poor performance and the service standards should be extensive, covering a range of the services provided by PWC, including performance of the network and performance of the business in interfacing with its customers. Such service standards are now widely used by all jurisdictional regulators.

The NTMEU suggests that it is essential that performance standards are applied both in the average and in the particular. In this regard, averaging of service standards should not permit continued poor performance of specific elements of the network. Thus the service standard regime should include a set point for average performance (eg average minutes off supply) and a minimum standard to apply to the worst performing elements of the network. In this way all users of the networks are provided with similar standards regardless of location relating to the prices they pay.

10. Industrial Network Access Tariffs

Issue:

(10) Is there any disagreement with the Commission's intention to leave unchanged the side-constraint feature of the 2004 methodology? If so, why?

The concept of side constraints is to minimise tariff movements on a yearly basis. It is accepted that at a reset large tariff movements will occur replicating the change to P_0 .

What is of concern to NTMEU is the ability of PWC to set non-cost reflective tariffs at the start of a period and use the side constraint as an argument to not to provide appropriate adjustments during the period to reflect actual costs. This can be by way of providing cross subsidies.

If the tariff is demonstrably cost reflective at the reset, then the application of a side constraint should not be necessary, as the movement of any tariff as a result of network and/or customer changes is unlikely to exceed whatever side constraint might have been applied. Based on activities in other jurisdictions, the application of side constraints has been a result of poor tariff structure at the time of the reset. If the UC applies close control on the development of the tariffs as recommended by NTMEU in earlier sections, then the need for a side constraint becomes a non-issue.

The NTMEU does not agree in principle to a side constraint as the application of it has usually been that larger users have cross-subsidised residential customers. Having stated this, the NTMEU will examine its position again when the network business submits its access application.

11. Pricing Principles

Issue:

(11) Is there any disagreement with the Commission's intention to increase scrutiny of Power and Water Networks' proposed Pricing Principles Statement prior to the commencement of the third regulatory period and subsequently simplify the basis for approval of the proposed annual tariff schedules? If so, why?

The NTMEU supports the UC's intention to increase scrutiny of PWC's proposed Pricing Principles Statement prior to the commencement of the third regulatory period. In fact, the NTMEU itself would wish to examine the statement that is to apply to the Regulatory Reset.

The NT MEU considers that it is insufficient that the UC simply review the pricing principles statement, even with increased scrutiny. The NTMEU has seen that in other jurisdictions, the pricing principles statement has allowed the regulated business to set and manipulate tariffs to increase revenue above that expected by the regulator. The new NEM draft Rules chapter 6 specifically requires the regulator to assess the outcomes of the pricing approach used by a distribution business. It is now no longer sufficient for the regulator to have a cursory review of tariff outcomes – they are now required to be confident that they are cost reflective as near as is reasonable, and that the basket of tariffs used for managing tariff movements is demonstrably reflective of the costs to provide the various services included, and the weighting allocated to each service is demonstrably developed from actual experience.

Our interest is not so much to simplify the basis for approval of annual tariff schedules, but primarily to prevent tariff manipulation that:-

- Results in customer discrimination and cross-subsidies
- Discourages demand management options
- Inefficient regulation