COST PASS THROUGH APPLICATION

FINAL DETERMINATION

May 2013

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CHAPTER 1

Executive Summary

Background

1.1 Retail electricity prices paid by consumers are made up of a number of cost components:

- electricity generation costs;
- network (transmission and distribution) costs;
- system operation and control costs; and
- retail costs (including metering, billing and marketing).

1.2 For small and medium size customers (those consuming less than 750MWh of electricity per annum), retail tariffs are regulated by a Pricing Order which sets the maximum amount that the Power and Water Corporation (PWC) is able to charge these categories of customers. A change to the network price as a result of the cost pass through application that is the subject of this Final Determination will not impact the current Pricing Orders.

1.3 For customers on negotiated contracts for supply (eg large customers consuming more than 750MWh[1] of electricity per annum), the size and timing of the impact on retail tariffs will depend on individual contract terms and conditions with respective retailers.

1.4 Network costs are paid by electricity retailers and are essentially the costs associated with transporting the electricity through the poles and wires to the consumer.

1.5 Due to the natural monopoly characteristics of electricity networks, network charges are regulated in all Australian jurisdictions. In the Northern Territory, these charges are regulated by the Utilities Commission (Commission). The provider of network services in the Territory is PWC.

1.6 Nationally, network charges (transmission and distributions) account for some 45 per cent of total electricity charges.[2] In the Territory, network charges are a somewhat smaller component due to the higher costs of generation.

1.7 As part of its role in regulating network electricity tariffs, the Commission undertakes a major price review, in consultation with stakeholders, every five years to set the regulated network charges. The price review determines the revenue or price cap to be applied for the five year regulatory control period and the methodology by which prices may be escalated during that period.

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[1] For customers using between 750MWh and 2GWH per annum the rate at which PWC is permitted to increase their tariff may also be regulated. This will depend on individual circumstances.

[2] Australian Energy Market Commission, *Electricity Price Trends, Possible future electricity price movements: 1 July 2012 to 30 June 2015 Final Report*, 22 March 2013.

1.8 The last price review undertaken by the Commission was the 2009 Network Price Determination[3], which took effect from 1 July 2009 and will continue until 30 June 2014.

1.9 The 2009 Network Price Determination discussed what are typically referred to as 'cost pass through events', that is, events which give rise to additional costs which, if not passed through, could put at risk the efficiency of the network provider's decisions and actions.

1.10 In October 2008, the Northern Territory Government commissioned an independent, external inquiry into the September and October 2008 power outages in Darwin's northern suburbs.[4] The findings of the Independent Enquiry into Casuarina Substation Events and Substation Maintenance across Darwin (the Davies Review) was released in February 2009 and recommended improvements to PWC's operating and maintenance practices.

1.11 The Commission's 2009 Network Price Determination specifically excluded additional spending arising from implementing recommendations from the Davies Review, on the basis that it was too early to be certain about the amounts involved. Instead, the Commission indicated that, provided the requirements of clause 71 of the Electricity Networks (Third Party Access) Code[5] (NT Network Access Code) were satisfied, the Commission would consider a request from PWC for a 'pass through' of such costs.

PWC's cost pass through application

1.12 On 5 February 2013, PWC applied to the Commission for a cost pass through of expenditure that had exceeded that allowed for by the Commission in its 2009 Network Price Determination.

1.13 PWC submitted that this expenditure was a consequence of PWC's implementation of the Davies Review recommendations and the subsequent enhancement of the network asset management regime.

1.14 PWC submitted that the application is consistent with the requirements of clause 71(c) of the NT Network Access Code.

1.15 PWC identified incremental operating expenditure totalling $227.3 million[6] and incremental capital expenditure totalling $148.4 million[7], resulting in a proposed positive cost pass through amount totalling $325.8 million, which included an adjustment for the time cost of money.

1.16 The Commission sought further information from PWC on costs associated with specific projects directly related to the Davies Review.

1.17 PWC identified operating expenditure totalling $65.11 million and capital expenditure totalling $88.61 million as being directly attributable to implementation of the Davies Review recommendations. Based on these expenditures, PWC identified a cost pass

3 Utilities Commission, *Networks Pricing: 2009 Regulatory Reset – Final Determination*, March 2009

4 NTG Media Release, Rob Knight, Minister for Essential Services, Terms of Reference released for Power Outage Inquiry, 3 October 2008

5 Schedule of the *Electricity Networks (Third Party Access) Act*

6 Updated to $233.4 million in further information provided by PWC on 28 February 2013 to take account of latest 2013-14 operating expenditure forecasts.

7 Updated to $140.7 million in further information provided by PWC on 28 February 2013 to take account of latest 2013-14 capital expenditure forecasts.

through amount of $104.55 million which included an adjustment for the time cost of money.

1.18 However, PWC argued that the cost pass through should not be limited to this operating and capital expenditure, but should be the full amount of network expenditure that has exceeded that allowed for by the Commission in its 2009 Network Price Determination (ie $327.3 million based on updated forecasts).

Commission's Draft Determination

1.19 On 28 March 2013, the Commission released for public consultation its Draft Determination on PWC's cost pass through application.

1.20 The Commission's Draft Determination was that a cost pass through event had occurred, this event being the recommendations of the Davies Review.

1.21 However, the Commission was not convinced that all the expenditure identified by PWC was related to the Davies Review recommendations. The Commission had engaged Parsons Brinckerhoff (PB) to assess the expenditure identified by PWC and advise whether this expenditure was reasonably attributable to the Davies Review recommendations.

1.22 PB's report formed part of the Draft Determination and the Commission also sought comments on the report.

1.23 The Commission's Draft Determination was that the approved cost pass through amount was $65.26 million ($12/13)[8], which included an adjustment for the time cost of money to 2012-13.

1.24 The Commission's Draft Determination was that PWC should recover the approved cost pass through amount in two stages:

- $30 million in the 2013-14 regulatory year; and
- the remaining $35.26 million ($12/13) to be carried over to the next regulatory control period commencing 1 July 2014.

Submissions

1.25 The Commission received four submissions on the Draft Determination, from:

- Power and Water Corporation (PWC) (two submissions);
- QEnergy Limited (QEnergy); and
- Northern Territory Major Energy Users (NTMEU).

1.26 PB provided supplementary advice on issues raised in the submissions and this advice was considered by the Commission in making its Final Determination.

1.27 Copies of the submissions and PB's supplementary advice are available on the Commission's website.

1.28 The submissions from QEnergy and the NTMEU were predominantly concerned with whether or not the event met the requirement of being outside the control of PWC, and signals that would be sent to PWC and consumers on the extent to which the costs of allegedly poor management decisions would be passed on to customers in future.

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[8] Represents 2012-13 dollars ($).

Grounds for a cost pass through

1.29 The primary objective of the Commission is to promote fair and efficient market conduct within the regulated electricity industry for the long term benefit of consumers. In considering the application from PWC for a cost pass through, the Commission has been conscious of this objective and the need to ensure that the network provider is able to provide services in a financially sustainable manner.

1.30 The Commission considers that findings of the Davies Review and the implementation of its recommendations were extraordinary developments for the purposes of clause 71(c) of the NT Network Access Code because:

- the Davies Review was commissioned by the Northern Territory Government and PWC was directed by Government to implement the Davies Review recommendations as a matter of priority;
- the cost of implementing the Davies Review recommendations was explicitly excluded by the Commission from affecting the outcome of the 2009 Network Price Determination; and
- the findings of the Davies Review identified an unanticipated degradation of the network assets, resulting in the PWC Board having no other rational option but to take immediate remedial action to ensure the ongoing security of the network.

1.31 The Commission is satisfied that the extraordinary developments are with respect to the following key factors identified in clause 68 of the NT Network Access Code:

- the provision of a return on efficient capital investment undertaken by the network provider in order to maintain or extend network capacity that is commensurate with the commercial and regulatory risks involved; and
- the right of the network provider to recover reasonable costs incurred by the network provider in connection with the operation and maintenance of the network.

Cost pass through amount

1.32 The Commission considers that implementation of the recommendations arising from the Davies Review has materially increased PWC's costs in providing standard control services in the regulatory control period.

1.33 As previously noted, the Commission engaged Parsons Brinckerhoff (PB) to assess the expenditure identified by PWC and advise whether this expenditure was reasonably attributable to the Davies Review recommendations.

1.34 PB initially recommended adjustments reducing operating expenditure by a total of $21.91 million and reducing capital expenditure by a total of $26.83 million. After reviewing the submissions received on the Draft Determination and information provided by PWC in its application, PB identified additional adjustments reducing operating expenditure by a further $9.33 million.

1.35 The Commission has reduced PWC's proposed capital and operating expenditure by the amounts recommended by PB, including the further reductions recommended following the review of submissions. The Commission has used this adjusted capital and operating expenditure to calculate the building blocks costs.

1.36 The Commission has determined the total amount to pass through to network users to be $54.92 million ($12/13), which includes an adjustment for the time cost of money to 2012-13. This amount will be recovered in two stages, with $25 million to be recovered in 2013-14, the final year of the current regulatory control period, and the remaining $29.92 million ($12/13) to be recovered over the next regulatory control period.

CHAPTER 2

Final Determination

2.1 The Utilities Commission (Commission) considers that the Power and Water Corporation's (PWC) cost pass through application shows that a cost pass through event has occurred.

2.2 The Commission's Final Determination is that the approved cost pass through amount is $54.92 million ($12/13), which includes an adjustment for the time cost of money to 2012-13.

2.3 The Commission's Final Determination is that PWC should recover the approved cost pass through amount in two stages:

- $25 million in the 2013-14 regulatory year; and
- the remaining $29.92 million ($12/13) will be carried over to the next regulatory control period commencing 1 July 2014.

2.4 In accordance with clause 71 of the NT Network Access Code, the Commission's Final Determination is that it will reset the price cap with respect to the 2013-14 regulatory year.

2.5 For the 2013-14 regulatory year, the Commission's Final Determination is that PWC must develop network tariff schedules for standard control services that conform with the following constraint on weighted average tariffs (denoted as P):

$$P_{2013\text{-}14} \leq [\ P_{2012\text{-}13} * ({}^{CPI_{2012}}/{}_{CPI_{2011}}) * (1 - X) * (1 + C)]$$

where:

CPI = a 100 based index, being the all capital cities headline CPI index published by the Australian Bureau of Statistics ("ABS") measured in accordance with the Commission's 2009 Network Price Determination;

X = -0.85 per cent, in accordance with the Commission's 2009 Network Price Determination; and

C = 20.6 per cent, being the factor determined by the Commission to recover the approved cost pass through amount.

2.6 The manner in which the remaining amount of $29.92 million is recovered over the 2014-2019 regulatory control period will be determined as part of the 2014 Network Price Determination process.

CHAPTER 3

Requirements for the Commission to allow a 'cost pass through'

Background

3.1 Retail electricity prices paid by consumers are made up of a number of cost components:

- electricity generation costs;
- network (transmission and distribution) costs;
- system operation and control costs; and
- retail costs (including metering, billing and marketing).

3.2 For small and medium size customers (those consuming less than 750MWh of electricity per annum), retail tariffs are regulated by a Pricing Order which sets the maximum PWC is able to charge these categories of customers. A change to the network price as a result of the cost pass through will not impact the current Pricing Orders.

3.3 For customers on negotiated contracts for supply (eg large customers consuming more than 750MWh[9] of electricity per annum), the size and timing of the impact on retail tariffs will depend on individual contract terms and conditions with respective retailers.

3.4 Network costs are paid by electricity retailers and are essentially the costs associated with transporting the electricity through the poles and wires to the consumer.

3.5 Due to the nature of electricity networks and the uneconomic option of duplicating the infrastructure, network charges are regulated in all Australian jurisdictions. In the Territory, these charges are regulated by the Commission. The provider of network services in the Territory is PWC.

3.6 Nationally, network charges (transmission and distribution) account for some 45 per cent of total electricity charges.[10] In the Territory, network charges are a somewhat smaller component due to the higher costs of generation.

3.7 As part of its role in regulating network electricity tariffs, the Commission undertakes a major price review, in consultation with stakeholders, every five years to set the regulated network charges. The price review determines the revenue or price cap to be applied for the five year regulatory control period and the methodology by which prices may be escalated during that period.

3.8 The last price review undertaken by the Commission was the 2009 Network Price Determination, which took effect from 1 July 2009 and will continue until 30 June 2014.

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[9] For customers using between 750MWh and 2GWH per annum the rate at which PWC is permitted to increase their tariff may also be regulated. This will depend on individual circumstances.

[10] Australian Energy Market Commission, *Electricity Price Trends, Possible future electricity price movements: 1 July 2012 to 30 June 2015 Final Report*, 22 March 2013.

3.9 The 2009 Network Price Determination discussed what are typically referred to as 'cost pass through events', that is events which give rise to additional costs which, if not passed through, could put at risk the efficiency of the network provider's decisions and actions.

3.10 Permitting a cost pass through is consistent with generally accepted regulatory practice and provides a degree of protection for a service provider from the impact of unexpected changes in costs that are outside of its control, which arise during a regulatory period. It lowers the risks faced by the service provider, which would otherwise have to be compensated for in the calculation of the weighted average cost of capital (WACC) and allowed revenues.

3.11 Unlike the National Electricity Rules, the NT Network Access Code does not specifically address 'cost pass through' events. Rather, the Commission as regulator has the power under clause 71 of the NT Network Access Code, to allow a 'cost pass through' by exercising its discretion (in accordance with that clause) to revoke or reset the revenue or price cap for a particular financial year or years.

3.12 The Commission's 2009 Network Price Determination specifically excluded additional spending arising from implementing the recommendations from the Davies Review, on the basis that it was too early to be certain about the amounts involved. Instead, the Commission indicated that, provided the requirements of clause 71 of the NT Network Access Code were satisfied, the Commission would consider a request from PWC for a 'pass through' of such costs

Legislative requirements – NT Network Access Code

3.13 As noted above, the Commission as regulator has the power under clause 71 of the NT Network Access Code, to revoke or reset the revenue or price cap for a particular financial year or years.

3.14 Clause 71 of the NT Network Access Code provides that:

The regulator may only revoke or reset a revenue or price cap with respect to a particular financial year or years if it appears to the regulator that:

(a) the cap was set on the basis of false or materially misleading information provided to the regulator;

(b) there was a material error in the setting of the cap; or

(c) there were extraordinary developments with respect to any one of the key factors identified in clause 68 which, in the opinion of the regulator, were outside the network provider's control.

3.15 Clause 68 of the NT Network Access Code sets out the factors the Commission must take into account when determining a revenue or price cap. Those factors are:

(a) the demand growth that the network provider is expected to service using any appropriate measure including but not limited to:

(i) energy consumption by category of network users or other relevant groups of persons who consume energy;

(ii) demand by category of network users or other relevant groups of persons who consume energy;

(iii) numbers of network users or other relevant groups of persons who consume energy by category of network users; and

(iv) length of the electricity network;

(b) the service standards applicable to the network provider under this Code and any other standards imposed on the network provider by any regulatory regime administered by the regulator and by agreement with the relevant network users;

(c) the potential for efficiency gains to be realised by the network provider in expected operating, maintenance and capital costs, taking into account the expected demand growth and service standards referred to in paragraphs (a) and (b);

(d) the network provider's cost of capital applicable to the relevant network access service, having regard to the risk-adjusted rate of return required by investors in commercial enterprises facing similar business risks to those faced by the network provider in the provision of that service;

(e) the provision of a return on efficient capital investment undertaken by the network provider in order to maintain or extend network capacity that is commensurate with the commercial and regulatory risks involved;

(f) the right of the network provider to recover reasonable costs incurred by the network provider in connection with the operation and maintenance of the network, including those arising from but not limited to:

(i) any Territory and Commonwealth taxes or equivalent taxes paid in connection with the operation of its business as a provider of network access services; and

(ii) the tariffs and charges paid to other network providers irrespective of whether these tariffs and charges are regulated under this Code;

(g) any increase in the rate of a tax or any new tax, whether it is a tax or tax equivalent imposed by the Territory, a State or the Commonwealth that directly increases the cost of providing the access services that are directly attributable to the increase in the rate or to the new tax;

(h) any reduction or increase in network energy losses; and

(j) the on-going commercial viability of the network provider.

PWC's application for a cost pass through

3.16 PWC applied to the Commission for a pass through of expenditure that exceeded that allowed for by the Commission in its 2009 Network Price Determination.

3.17 PWC submitted that the excess expenditure was a consequence of PWC's implementation of the Davies Review recommendations and the subsequent enhancement of the network asset management regime.

3.18 The Davies Review was an independent inquiry headed by Mr Mervyn Davies and commissioned by the Northern Territory Government in response to concerns about the continued security of supply to the northern suburbs of Darwin, which arose following a series of equipment failures in late September and early October 2008 at the Casuarina Zone Substation and within its surrounding network. The scope of the enquiry was to undertake an assessment of the failure incidents, examine substation maintenance practices more generally across Darwin, and make recommendations accordingly.

3.19 The Davies Review Final Report[11] was delivered in February 2009. PWC published its final progress report on the implementation of the Davies Review recommendations in June 2011, with further monitoring of ongoing works forming part of PWC's five year Asset Maintenance Plan.

3.20 Amongst other things, PWC submitted that the release of the Davies Review Final Report and the need for consequent capital and operating expenditure by PWC that was explicitly not allowed for in the Commission's 2009 Network Price Determination, was an 'extraordinary development' as referred to in clause 71(c) of the NT Network Access Code.

3.21 PWC further submitted that this extraordinary development impacted on a number of factors set out in clause 68 of the NT Network Access Code which the Commission is required to take into account in setting the revenue or price cap, namely:

- the provision of a return on efficient capital investment undertaken by the network provider in order to maintain or extend network capacity that is commensurate with the commercial and regulatory risks involved [cl.68(e)];
- the right of the network provider to recover reasonable costs incurred by the network provider in connection with the operation and maintenance of the network [cl.68(f)]; and
- the on-going commercial viability of the network provider [cl.68(j)].

3.22 PWC further submitted that its implementation of the Davies Review recommendations was outside its control and that the implementation was directed by Government in its capacity as policy maker, rather than in its capacity as owner, shareholder or guarantor of PWC. PWC identified various statements by the Minister for Essential Services in Hansard and media releases to support its argument that implementation of the Davies Review recommendations was driven by considerations of public and staff safety and the restoration of a reliable essential service to Territory electricity consumers.

Legislative basis for decision

3.23 As noted above, under clause 71 of the NT Network Access Code, the Commission can only revoke or reset a revenue or price cap (ie electricity network pricing) if it appears to the Commission, as regulator, that either:

- the cap was based on false or materially misleading information provided to the Commission [cl. 71(a)];
- there was a material error in the setting of the cap [cl. 71(b)]; or
- there were extraordinary developments with respect to any of the key factors identified in clause 68 which, in the opinion of the Commission, were outside the network provider's control.

3.24 In making its application, PWC made specific reference to clause 71(c) of the NT Network Access Code.

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[11] Independent Enquiry into Casuarina Substation Events and Substation Management across Darwin – Final Report, February 2009.

3.25 There are three separate matters that must be assessed by the Commission in considering whether the requirements of clause 71(c) have been satisfied and, if so, whether to revoke or reset a revenue or price cap (or not):

- first, there must have been one or more extraordinary developments;
- second, the extraordinary development(s) must be with respect to one or more of the key factors set out in clause 68 of the NT Network Access Code; and
- third, the Commission must form the opinion that the extraordinary development(s) were outside PWC's control.

3.26 Each of those matters is discussed below.

Were there extraordinary developments?

3.27 The term 'extraordinary developments' is not defined in the *Electricity Networks (Third Party Access) Act* or in the NT Network Access Code. It is the Commission's view that, in the absence of a definition, the term is to be given its ordinary meaning having regard to the context in which it is used.

3.28 The Commission considers that an extraordinary development would be an exceptional, unusual or remarkable fact or circumstance which has occurred since the current network price determination was made in 2009.

3.29 The Commission's view is that this interpretation is consistent with the principle of revenue or price caps being set for a definite period with changes only being made in very limited circumstances, to ensure consistency and certainty for a set period of time.

3.30 The Davies Review identified a number of shortcomings of PWC's substation maintenance practices and risks posed by the uncertain condition of its substation assets at the time of the review, and made a number of recommendations. The recommendations encompassed changes to policies, systems and processes, new reporting systems, increased workforce levels and training, and equipment upgrades.

3.31 The Commission considers that:

- the issuing of the Davies Review Final Report; and
- the implementation of the recommendations of that Review, involving as it did a work program of significant magnitude and scope and initial large step changes and short timeframes for implementing the more urgent recommendations,

were exceptional, unusual or remarkable facts or circumstances and constituted extraordinary developments.

3.32 When determining the X value to apply for the purposes of the 2009 Network Price Determination, the Commission decided not to take account of increased capital and maintenance spending by PWC as a result of Government decisions responding to the findings and recommendations of the Davies Review[12], as it was too early at that time to be certain about the amounts involved.

Commission's draft decision

3.33 The Commission's draft decision was that it was satisfied that the Davies Review and the implementation of its recommendations was an extraordinary development for the purposes of clause 71(c) of the NT Network Access Code in that it identified general

[12] Utilities Commission, *Networks Pricing: 2009 Regulatory Reset – Final Determination*, March 2009, p.5.

unanticipated degradation of the network condition which PWC, as a prudent network operator, had no other rational option but to address.

Views in submissions

3.34 QEnergy agreed with the Commission that a cost pass through mechanism is a fair part of the regulatory bargain to compensate network providers for costs consequent to exogenous events outside the network provider's control.

3.35 However, QEnergy further noted that:

"Traditionally, pass through events have been held to have occurred where unexpected changes in Government policy, sudden environmental events or mid period changes in taxation arrangements have led to step changes in expenditure or obligations."

3.36 The NTMEU submitted that the Casuarina substation outages were the cost pass through event, rather than the implementation of the recommendations of the Davies Review.

3.37 Both submissions recognised that an event had occurred which gave rise to additional costs for PWC.

Commission's further analysis and response to submissions

3.38 The NT Network Access Code does not define 'extraordinary developments'.

3.39 While the Casuarina substation failures were the trigger for undertaking the Davies Review, it is the implementation of the recommendations of the Davies Review that has given rise to additional costs for PWC which were explicitly excluded from affecting the outcome of the 2009 Network Price Determination.

Commission's final decision

3.40 The Commission is satisfied that the issuing of the Davies Review Final Report and the implementation of the recommendations of the Davies Review were extraordinary developments for the purposes of clause 71(c) of the NT Network Access Code.

Were the extraordinary developments with respect to any of the key factors in clause 68 of the NT Network Access Code

3.41 The NT Network Access Code requires the Commission to administer network price regulation in a way that achieves, among other things, expected revenue for a regulated service or services that is at least sufficient to meet the long-run efficient costs of providing that regulated service or services [cl.63(aa)].

3.42 Additional capital expenditure undertaken to implement the Davies Review recommendations has increased the size of the regulated asset base. This in turn means that the return on capital investment allowed for in the 2009 Network Price Determination may no longer be commensurate with the commercial and regulatory risks faced by an efficient network provider. Likewise, the additional operating expenditure undertaken has also increased the costs of providing regulated services.

3.43 Given the magnitude of the costs involved, requiring PWC to absorb these additional costs may affect the ongoing commercial viability of PWC.

Commission's draft decision

3.44 The Commission's draft determination was that it was satisfied that costs incurred by PWC to implement the Davies Review recommendations, if not passed through, would affect the following key factors identified in clause 68 of the NT Network Access Code:

- the provision of a return on efficient capital investment undertaken by the network provider in order to maintain or extend network capacity that is commensurate with the commercial and regulatory risks involved [cl.68(e)];
- the right of the network provider to recover reasonable costs incurred by the network provider in connection with the operation and maintenance of the network [cl.68(f)]; and
- the on-going commercial viability of the network provider [cl.68(j)].

Views in submissions

3.45 The NTMEU did not address the effect on the key factors set out in clause 68 of the NT Network Access Code as identified by the Commission.

3.46 QEnergy submitted that the Commission should not have regard to the financial viability of PWC in considering whether an event has occurred. QEnergy argued that:

"..it is unprecedented for a regulator to take a decision to allow a pass-through event on the basis of the financial viability of the network service provider. It is doubtful that this decision would be taken if Power and Water were privately owned and unlikely it would be extended to a private sector industry participant in the future."

Commission's further analysis and response to submissions

3.47 While QEnergy may consider it as unprecedented, the NT Network Access Code expressly refers to the on-going commercial viability of the network provider as being a factor which might be impacted by extraordinary developments and therefore one to which the Commission must have regard. That is the case regardless of whether the network provider is privately, or government, owned.

3.48 That said, the Commission has not undertaken an in depth analysis of PWC's financial position, although it has had regard to the review of PWC's financial sustainability undertaken for the Government in March 2009 (the Reeves Review).

3.49 The Commission is however satisfied that there have been extraordinary developments with respect to key factors in clause 68 of the NT Network Access Code other than the on-going commercial viability of the network provider, and that this criterion in clause 71(c) has therefore been met.

Commission's final decision

3.50 The Commission is satisfied that the extraordinary developments are with respect to the following key factors identified in clause 68 of the NT Network Access Code:

- the provision of a return on efficient capital investment undertaken by the network provider in order to maintain or extend network capacity that is commensurate with the commercial and regulatory risks involved [cl.68(e)]; and
- the right of the network provider to recover reasonable costs incurred by the network provider in connection with the operation and maintenance of the network [cl.68(f)].

Were the extraordinary developments beyond the control of PWC?

3.51 The Commission had indicated in its 2009 Network Price Determination that, for it to form the view (for the purposes of clause 71(c) of the NT Network Access Code) that a 'government initiated' extraordinary development was beyond PWC's control, that development should be the result of a regulatory or public policy decision, as opposed to an ownership decision, by the Northern Territory Government.

3.52 PWC submitted that the implementation of the Davies Review recommendations was directed by Government in its capacity as policy maker, rather than in its capacity as owner, shareholder or guarantor of PWC.

3.53 In relation to that issue, whilst the *Government Owned Corporations Act* sets out a process by which Government may issue a direction to PWC, the Commission understands that, in practice, such a process has rarely been undertaken and that PWC has acted in accordance with Ministerial statements to the Legislative Assembly or the media which outline public policy matters that impact on the provision of essential services provided by PWC.

3.54 Statements were made by the (then) Minister for Essential Services in relation to the need, for safety and reliability reasons, for the Davies Review recommendations to be implemented.

3.55 The statements were made by the Portfolio Minister, who had responsibility for the provision of essential services.

3.56 The Commission considers that this is an instance of PWC implementing a public policy decision of the Northern Territory Government rather than complying with a direction from government as owner.

Commission's draft decision

3.57 The Commission's draft decision was that it was satisfied that the Davies Review and the implementation of its recommendations was beyond PWC's control.

Views in submissions

3.58 QEnergy agreed with the Commission that a cost pass through mechanism is a fair part of the regulatory bargain to compensate network providers for costs consequent to exogenous events outside the network provider's control.

3.59 However, QEnergy disagreed with the Commission's finding that these conditions had been met:

"While the findings of the Davies Review were unanticipated, the condition of the assets that led to the Review was within the control of Power and Water to detect. Any defects identified through condition based maintenance practices and procedures were therefore able to be included within the cost forecasts at the time of the 2009 regulatory proposal."

3.60 The NTMEU contended that:

"The NTMEU is now fully aware (as is the UC) that the failure of the substation was primarily the result of poor maintenance and poor operational practices (overloading of cables) by PWC.

…

This then raises the fundamental issue as to whether PWC should be recompensed at all for restitution works resulting from their poor maintenance and poor operational practices."

3.61 The NTMEU further argued that PWC's failure to appropriately maintain its assets is not the fault of consumers. Increasing charges to consumers is not equitable, nor does it send a message to PWC and its shareholder that proper maintenance and operation must be of the standard implied under the regulatory bargain.

Commission's further analysis and response to submissions

3.62 As discussed above, the Commission's assessment is that the issuing of the Davies Review Final Report and the implementation of the recommendations arising from the Davies Review were the factors that constituted the extraordinary developments for the purposes of clause 71(c) of the NT Network Access Code, and that these were matters that were beyond PWC's control. There is nothing in the submissions that leads the Commission to form a different opinion.

3.63 The Davies Review was commissioned by the Northern Territory Government[13] and clearly, that was a matter beyond the control of PWC.

3.64 As required by the Northern Territory Government's Terms of Reference, the Davies Review made a number of recommendations in relation to PWC's operating and maintenance practices relating to the network, including recommendations as to changes to policies, systems and processes, new reporting systems, increased workforce levels and training, and equipment upgrades. The making of those recommendations was a matter beyond the control of PWC.

3.65 The recommendations of the Davies Review were implemented by PWC. The Commission considers that the implementation of the recommendations of the Davies Review was the only rational response that could be expected of an operator of an electricity network given its responsibility to ensure the safety of persons and the reliability of electricity supply. In other words, the Commission considers that PWC had no choice but to implement the recommendations. Accordingly, the implementation was beyond its control.

3.66 However, for the sake of completeness, the Commission discusses below issues raised in the submissions.

3.67 The key factor in the arguments advanced by QEnergy and the NTMEU is the degree of knowledge PWC had, or should have had, regarding the condition of its assets and the maintenance and operation practices required.

3.68 The Davies Review noted that:

"Over a period of decades the approach to substation maintenance across Darwin has shifted from what was originally a very traditional approach involving routine preventative maintenance as the dominant task type, to one which is now a minimalist approach, dominated by corrective and breakdown tasks".

3.69 The Davies Review explicitly found that PWC was not provided with the resources required to maintain a traditional conservative maintenance regime (ie preventative and

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[13] NTG Media Release, Rob Knight, Minister for Essential Services, Terms of Reference released for Power Outage Inquiry, 3 October 2008

often overly intrusive and resource intensive maintenance) approach, nor was PWC supported with the systems and knowhow required to implement alternative better approaches being adopted throughout the industry. The Davies Review also found that the traditional conservative maintenance regime adopted by PWC, had been common industry practice a decade prior to the Review being undertaken.

3.70 The Davies Review found that PWC did not have in place the systems and processes to collect and analyse the necessary information to allow it to appropriately manage and maintain its network assets.

Commission's final decision

3.71 The Commission is satisfied that the extraordinary developments were beyond the control of PWC.

Were the extraordinary developments material?

3.72 In its 2009 Network Price Determination, the Commission indicated that it would, of course, only consider exercising its discretion to revoke or reset a revenue or price cap under clause 71(c) of the NT Network Access Code in order to effect a cost pass through as a result of extraordinary developments, if the impact of the extraordinary developments was material. In that context, the Commission indicated that a cost pass through would have to meet or exceed a threshold of 1 per cent of the annual revenue from standard control services in the financial year in which the event occurs before the Commission would consider exercising its discretion.

3.73 The Commission is satisfied that the materiality threshold has been met and relevant calculations are set out in Chapter 4.

Commission's final decision

3.74 In accordance with clause 71(c) of the NT Network Access Code, the Commission has formed the view that:

a) the issuing of the Davies Review Final Report and the implementation by PWC of the recommendations of the Davies Review were extraordinary developments;

b) the extraordinary developments were with respect to the following key factors identified in clause 68 of the NT Network Access Code:

- the provision of a return on efficient capital investment undertaken by the network provider in order to maintain or extend network capacity that is commensurate with the commercial and regulatory risks involved; and
- the right of the network provider to recover reasonable costs incurred by the network provider in connection with the operation and maintenance of the network; and

c) the extraordinary developments were outside PWC's control.

3.75 The Commission further considers that implementation of the recommendations of the Davies Review has materially increased PWC's costs in providing standard control services in the regulatory control period.

3.76 Given the above, the Commission has determined to allow a pass through of costs by resetting the price cap with respect to the 2013-14 financial year.

CHAPTER 4

Cost pass through amount

PWC's application – amount of cost pass through

Cost pass through application

4.1 In its application of 5 February 2013, PWC proposed a positive cost pass through amount totalling $325.8 million for the costs incurred in implementing the Davies Review recommendations, which included an adjustment for the time cost of money.

4.2 PWC's cost pass through application is available on the Commission's website.

4.3 PWC's application sought a cost pass through of all incremental operating and capital expenditure above that allowed for in the Commission's 2009 Network Price Determination. PWC submitted that this expenditure was a consequence of PWC's implementation of the Davies Review recommendations and the subsequent enhancement of the network asset management regime.

4.4 PWC proposed that this amount be recovered from network users in three stages:

- $40.4 million to be recovered through an increase to network prices in 2013-14 of 33 per cent;
- incremental capital expenditure be rolled forward in to the asset base in the fourth regulatory control period; and
- the shortfall in revenue in years prior to 2013-14 ($285.4 million indexed to 2014-15) to be recovered throughout the fourth regulatory control period, through the overs and unders provision associated with the revenue cap form of price control.

Commission request for additional information

4.5 Following a preliminary assessment of PWC's application, the Commission wrote to PWC on 14 February 2013 advising that the Commission would consider PWC's application to determine whether a cost pass through is warranted and, if so, the amount of the efficient costs involved and the extent to which existing (and future) end-users should bear these costs. The Commission also advised that a public consultation process would be undertaken prior to making a final determination.

4.6 The Commission further advised that it was not convinced that all operating and capital expenditure incurred (or forecast to be incurred) in the current regulatory control period above that allowed by the Commission in the 2009 Network Price Determination was directly related to the implementation of the Davies Review recommendations.

4.7 The Commission sought further information as follows:

- details of the projects initiated to implement the Davies Review recommendations, including relevant costs;
- details of any project that was re-scoped to implement the Davies Review recommendations, including original forecast costs and revised forecast costs for re-scoped project; and

- details of any step-change costs associated with changes to work procedures and/or staffing levels arising the Davies Review recommendations.

Submission of further information

4.8 PWC provided further information as requested by the Commission on 28 February 2013. PWC's response is available on the Commission's website.

4.9 PWC identified operating and capital expenditure directly attributable to implementation of the Davies Review recommendations as follows:

Table 4.1: Expenditure identified by PWC as directly attributable to Davies Review

$million (nominal)	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	TOTAL
Operating expenditure	15.30	6.39	9.99	9.77	14.33	9.34	65.11
Capital expenditure	3.07	7.93	18.62	27.87	31.13	0.00	88.61

4.10 PWC provided supporting documentation including business cases, reports and reviews commissioned from various consultants, internal memoranda documenting workplace requirements, planning and strategy documents and relevant internal progress reports.

4.11 Based on these expenditures, PWC identified a cost pass through amount of $104.55 million which included an adjustment for the time cost of money.

4.12 However, PWC requested that the Commission consider the full amount of network expenditure that has exceeded that allowed for by the Commission in its 2009 Network Price Determination (ie totalling $327.3 million updated from PWC's application of 5 February 2013 to take account of the latest 2013-14 operating and capital expenditure forecasts), and not limit the cost pass through amount to the operating and capital expenditure described above.

4.13 PWC argued that the operating and capital expenditure shortfall is reflective of the substantial enhancements made to the network asset management regime and the embedding of an improved maintenance cycle culture within PWC, as espoused in the Davies Review recommendations.

4.14 PWC proposed that, if the Commission only accepts the operating and capital expenditure projects and step changes that can be directly attributed to the Davies Review recommendations, then the full cost pass through amount of $104.55 million be recovered in 2013-14.

Commission's draft assessment of expenditure incurred

4.15 The Commission was not convinced that all operating and capital expenditure incurred (or forecast to be incurred) in the current regulatory control period above that allowed by the Commission in the 2009 Network Price Determination was directly related to the implementation of the Davies Review recommendations.

4.16 While noting PWC's advice that the full operating and capital expenditure shortfall was approved by the Northern Territory Government through the Statement of Corporate Intent (SCI) process, the Commission's view was that the process of negotiating its SCI with its shareholder is not relevant to the Commission's deliberations on what costs should be passed through to retailers.

4.17 The SCI is the mechanism by which the board and management of PWC inform the Government as shareholder of the financial position of the corporation, including financial forecasts, and provides information on the nature and scope of activities undertaken by PWC and its strategies, risks, investment plans and performance targets.

4.18 The considerations of Government as shareholder, as set out in the *Government Owned Corporations Act,* are to ensure that PWC operates at least as efficiently as any comparable business and maximises the sustainable return to the Territory on its investment in the corporation.

4.19 In contrast, the objectives of network pricing set out in the NT Network Access Code require the Commission to consider an acceptable balancing of the interests of the network provider, network users and the public interest [cl.63(f)].

4.20 The primary objective of the Commission is to promote fair and efficient market conduct within the regulated electricity industry for the long term benefit of consumers. In considering the application from PWC for a cost pass through, the Commission has been conscious of this objective and the need to ensure that the network provider is able to provide services in a financially sustainable manner.

4.21 The Commission considered that PWC provided no substantive justification as to why all capital and operating expenditure above that allowed should be recovered. Statements that the expenditure reflects requirements to improve security and reliability of supply and that substantial enhancements have been made to PWC's asset management regime, are of limited value if not supported by rigorous and detailed analysis of the actual activities undertaken, the issues these activities are meant to address and, where sufficient time has passed, an assessment as to whether the objectives have been, or are likely to be, achieved.

Consultant's advice

4.22 The Commission engaged Parsons Brinckerhoff (PB) to undertake a review of the documentation provided by PWC and advise on:

- overall reasonableness of projects and expenditure (operational and capital) identified by PWC and linked to the Davies Review;
- whether the projects and expenditure identified by PWC as being directly attributable to the Davies Review appeared reasonable (and if not, which projects should be excluded and why);
- for those projects and expenditure appropriately linked to the Davies Review, any areas of inconsistency with the Davies Review recommendations;
- for those projects and expenditure appropriately linked to the Davies Review, any areas where actual or forecast expenditure appeared unreasonable or inefficient for implementing specific recommendations and projects (operational and capital); and
- actual and forecast costs (operational and capital) which are directly attributable to the Davies Review recommendations.

4.23 PB's report to the Commission was released with the Draft Determination and is available on the Commission's website.

4.24 The Commission accepted PB's recommendations as summarised below.

Capital expenditure

4.25 PB assessed the capital operating expenditures claimed by PWC as expenditures related to the implementation of the Davies' Review recommendations on a capital project by project basis.

4.26 PB identified capital expenditure adjustments of $26.83 million consisting of:

- project level contingency;
- projects unrelated to Davies Review recommendations;
- project scope components unrelated to Davies Review recommendations;
- distribution system augmentation;
- purchase of spares above the levels required; and
- generation assets funded by a separate business unit.

4.27 PB recommended adjustments to the claimed capital expenditure, with the return on and return of capital components of the cost pass through based on the following capital expenditure amounts:

Table 4.2: PB recommended capital expenditure

$million (nominal)	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	TOTAL
Capital expenditure	3.07	5.53	15.22	24.44	13.53	0.00	61.78

Operating expenditure

4.28 PB undertook a review of the information provided by PWC to assess whether the identified operational costs are reasonably attributable to the Davies Review. In particular, this review focused on the cost build-up as set out in PWC's 'opex cost model' and the degree to which these costs could be explained by PWC's supporting documentation and the Davies Review.

4.29 PB identified operating expenditure adjustments of $21.91 million consisting of:

- labour unrelated to Davies Review recommendations;
- fleet and other costs unrelated to Davies Review recommendations; and
- hire of back-up generators sets during the restoration of Casuarina Zone Substation and prior to the completion of the Davies Report.

4.30 PB recommended that the Commission consider adjustments to the claimed operating expenditure, resulting in the following operating expenditure amounts:

Table 4.3: PB recommended operating expenditure

$million (nominal)	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	TOTAL
Operating expenditure	5.37	5.00	8.73	6.62	11.28	6.20	43.20

4.31 PB also noted that there is generally a trade-off between capital and operating expenditure. Where new assets are replacing old assets, there will be a corresponding reduction in the associated operating costs from the efficient base level of ongoing maintenance costs.

4.32 However, PB advised that, while PB would recommend that the value of the capex/opex trade-off be assessed and appropriately accounted for, PB was unable to reasonably assess an appropriate value of the aggregate capex/opex trade-off with the information currently available from PWC and the limited timeframes. The

Commission's view was that such an assessment would require significant resources and not result in a material change.

4.33 The Commission made no adjustment for the value of the capex/opex trade-off. However, the Commission intends to scrutinise PWC's operating expenditure proposal for the 2014 Network Price Determination with particular attention to the high levels of capital expenditure (both Davies Review related and other) that has been undertaken in recent years.

Views in submissions

4.34 PWC disagreed with two components of the reduction in operating expenditure recommended by PB:

- the rejection of a large amount of additional personnel as 'excessive for zone substation maintenance needs'; and
- rejection of the amount of $9.93 million for the provision of back-up generators.

4.35 PWC noted that the additional personnel, while not directly related to zone substation maintenance needs, were necessary to achieve a more strategic focus on the asset management function and essential related matters such as operating, safety and training. PWC also noted that the additional personnel were required to plan and deliver a robust condition based preventative maintenance program, consistent with the Davies Review recommendations.

4.36 In relation to the exclusion of costs associated with the back-up generators, PWC noted that the generators were deployed during the emergency restoration and reconstruction works (including those recommended by the Davies Review) to provide security against further unanticipated failure of assets and safeguard system security.

4.37 QEnergy noted that pass through amounts should be limited to those costs incremental to the amounts already allowed in the 2009 Network Price Determination. QEnergy raised concerns that some costs, such as corporate overhead allocations and some direct labour costs, may have been duplicated and these costs should be removed.

Consultant's further advice

4.38 The Commission sought PB's advice on whether the additional information provided in the submissions altered the opinion and findings of PB's report.

4.39 PB's supplementary report to the Commission has been released with this Final Determination and is available on the Commission's website.

4.40 PB did not recommend any further adjustments to capital expenditure, but recommended some further adjustments to operating expenditure.

4.41 In response to the additional information provided by PWC in support of the claim for additional staff for zone substation maintenance needs, PB's view was that only those resources reasonably necessary to implement the Davies Review recommendations should be included, and costs associated with additional resourcing to address PWC's long term action plan should continue to be excluded.

4.42 PB acknowledged that while some of the $9.93 million for the back-up generator sets could be directly attributed to the implementation of the recommendations, PWC had not clearly identified what costs were related the Davies Review recommendations.

4.43 In response to the concern raised by QEnergy with regard to duplication of corporate overhead costs, PB further examined the operational costs and identified corporate costs which could not be reasonably attributed to the modest increase in staffing as a result of the Davies Review recommendations. PB recommended that an adjustment be made to the operating costs to remove any duplication of corporate overhead costs.

4.44 PB also identified service level agreement costs which could not be directly related to the Davies Review recommendations and recommended that the costs be excluded.

Commission's final decision

4.45 The Commission has accepted PB's further recommendations as summarised below.

Table 4.4: PB final recommended capital and expenditure

$million (nominal)	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	TOTAL
Capital expenditure	3.07	5.53	15.22	24.44	13.53	0.00	61.78
Operating expenditure	5.11	4.52	6.36	3.63	8.06	6.20	33.88

Draft calculation of appropriate cost pass through amount

4.46 For the reasons discussed above, the Commission's Draft Determination reduced PWC's proposed capital and operating expenditure by the amounts recommended by PB. The Commission used this adjusted capital and operating expenditure to calculate the building blocks costs for the pass through of the extraordinary developments. The Commission also made some further adjustments to PWC's model.

4.47 PWC rolled forward the incremental capital expenditure consistent with the methodology determined by the Commission in setting the initial regulatory asset base in its Off-ramp Decision in April 2005.[14] Straight line depreciation with an assumed average asset life of 50 years was applied.

4.48 However, PWC's model applied indexation (adjustment for inflation) based on actual Consumer Price Index (CPI) data as applied annually in approving tariffs for standard network access services. Due to the timing of network tariff approvals, the CPI applied in assessing compliance with the price constraint is lagged (eg for approval of the 2012-13 network tariffs), the latest available CPI was for the December 2011 quarter.

4.49 The Commission considered that it was more appropriate to use the forecast CPI at the time of the 2009 Network Price Determination for the roll forward of the incremental asset base, as this is what would have been applied had an allowance for this capital expenditure been included at that time.

Table 4.5: Forecast annual increase in CPI (at time of 2009 Network Price Determination

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Forecast CPI	2.33	4.35	2.75	2.00	2.50	2.50

4.50 Substituting the Commission's assessment of incremental capital and operating expenditure costs for those proposed by PWC and using the forecast CPI at the time of the 2009 Network Price Determination, the Commission rolled forward the incremental asset base as set out below.

[14] Utilities Commission, *Networks Pricing: Asset Valuation Off-ramp Final Decision*, April 2005

Table 4.6: Incremental capital expenditure rollforward

$million (nominal)	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15
Opening incremental asset base	0.00	3.07	8.67	23.96	48.40	62.16	62.47
Capex	3.07	5.53	15.22	24.44	13.53	0.00	
Depreciation	0.00	-0.06	-0.17	-0.48	-0.97	-1.24	
Indexation	0.00	0.13	0.24	0.48	1.21	1.55	
Closing incremental asset base	3.07	8.67	23.96	48.40	62.16	62.47	

4.51 The 2009 Network Price Determination included a single-year ‘cost of service’ building blocks assessment to determine whether a Po adjustment was warranted in order that the weighted average of network access tariffs to apply at the commencement of the third regulatory period was sufficient to recover the efficient costs of supply of regulated network access services. To determine the return on assets for the single year, a pre-tax nominal WACC of 9.55 per cent was used.

4.52 However, for the purposes of this cost pass through application, the equivalent pre-tax real WACC of 6.82 per cent, as calculated by the Commission in its Po Adjustment Model[15] accompanying the 2009 Network Price Determination, was used as the asset base roll forward includes an allowance for indexation.

Table 4.7: Draft incremental revenue requirement

$million (nominal)	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	TOTAL
Return on capital	0.10	0.40	1.11	2.47	3.77	4.25	12.10
Return of capital (depreciation)	0.00	0.06	0.17	0.48	0.97	1.24	2.92
Return of costs	5.37	5.00	8.73	6.62	11.28	6.20	43.20
Total	**5.47**	**5.46**	**10.01**	**9.57**	**16.02**	**11.69**	**58.22**

4.53 Normally, when adjusting values for actual expenditure from one year to another, the value is adjusted for CPI. However, where expenditure represents a lost opportunity (ie where the money is no longer available for a different investment), the WACC can be applied to calculate the present value of that lost opportunity.

4.54 Indexation using the WACC requires inflation to be included. Accordingly, in adjusting for the time cost of money, the pre-tax nominal WACC of 9.55 per cent, as calculated by the Commission in its Po Adjustment Model accompanying the 2009 Network Price Determination, was applied.

15 The Po Adjustment Model (‘WACC’ worksheet) calculated the WACC on a numbers of bases – pre/post-tax, real/nominal. The Po Adjustment Model is available on the Commission’s website.

Table 4.8: Draft adjustment for time cost of money

$million	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	TOTAL
Incremental revenue requirement	5.47	5.46	10.01	9.57	16.02	11.69	58.22
Time cost of money adjustment factor	1.4403	1.3147	1.2001	1.0955	1.0000	0.0000	
Total	**7.88**	**7.18**	**12.01**	**10.48**	**16.02**	**11.69**	**65.26**

Views in submissions

4.55 No stakeholders provided comment on the methodology used by the Commission to calculate the cost pass through amount.

Commission's final decision

4.56 Incorporating the further adjustments to operating expenditure yields the following:

Table 4.9: Final incremental revenue requirement

$million (nominal)	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	TOTAL
Return on capital	0.10	0.40	1.11	2.47	3.77	4.25	12.10
Return of capital (depreciation)	0.00	0.06	0.17	0.48	0.97	1.24	2.92
Return of costs	5.11	4.52	6.36	3.63	8.06	6.20	33.88
Total	**5.21**	**4.98**	**7.64**	**6.58**	**12.80**	**11.69**	**48.90**

Table 4.10: Final adjustment for time cost of money

$million	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	TOTAL
Incremental revenue requirement	5.21	4.98	7.64	6.58	12.80	11.69	48.90
Time cost of money adjustment factor	1.4403	1.3147	1.2001	1.0955	1.0000	0.0000	
Total	**7.50**	**6.55**	**9.17**	**7.21**	**12.80**	**11.69**	**54.92**

Materiality

4.57 As noted above, the Commission's 2009 Network Price Determination indicated that the Commission would only consider exercising its discretion to revoke or reset a revenue or price cap under clause 71(c) of the NT Network Access Code in order to effect a cost pass through as a result of extraordinary developments, if the impact of the extraordinary developments was material. The Commission indicated that a cost pass through would have to meet a materiality threshold of at least 1 per cent of the annual revenue from standard control services in the financial year in which the event occurs.

4.58 Implementation of the Davies Review recommendations occurred over an extended period of time and a number of years. In assessing whether the materiality threshold has been met, the Commission has considered the incremental revenue requirement for each year against the expected revenue for that year.

4.59 The expected revenue requirement is based on parameters established in the 2009 Network Price Determination. The base year (2008-09) revenue of $79.994 million has been escalated by Po of 13.10 per cent, and then escalated by CPI-X each year. The estimated CPI is that set out in Table 4.6 above, and an X factor of -0.85 per cent was determined by the Commission. An estimated annual quantity growth of 2.50 per cent has been used, consistent with the estimated quantity growth used by the Commission in assessing financial viability in the 2009 Network Price Determination.

4.60 The Commission is satisfied that the materiality threshold has been met. The Commission's calculations are set out in below.

Table 4.11: Percentage of annual revenue

$million (nominal)	**2008-09**	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**	**TOTAL**
Incremental revenue requirement	5.47	5.46	10.01	9.57	16.02	11.69	58.22
Expected annual revenue	79.99	97.61	103.68	109.32	115.83	122.73	629.15
Percentage	**6.8%**	**5.6%**	**9.7%**	**8.8%**	**13.8%**	**9.5%**	**9.3%**

Views in submissions

4.61 No stakeholders provided comment on the materiality criteria.

Commission's final decision

4.62 The Commission is satisfied that the materiality threshold has been met.

Recovery of cost pass through amount

4.63 The Commission considered that the cost pass through amount should be recovered from network users in two stages:

- $30 million in the 2013-14 regulatory year; and
- the remaining $35.26 million ($12/13) will be carried over to the next regulatory control period commencing 1 July 2014. The manner in which this carried forward amount is recovered over the 2014-2019 regulatory control period will be determined as part of the 2014 Network Price Determination process.

4.64 The Commission proposed that the first stage be achieved through the inclusion of a (1 + C) term in the price constraint equation.

4.65 PWC's revenue for standard network access services is regulated through a weighted average price cap. Revenue rises in line with both price and quantity sold.

4.66 Expected revenue for 2013-14 can be derived as follows:

$$R_{2013\text{-}14} = [\, R_{2012\text{-}13} * (CPI_{2012}/CPI_{2011}) * (1 - X) * (1 + g) * (1 + C)]$$

where:

CPI = a 100 based index, being the all capital cities headline CPI index published by the Australian Bureau of Statistics (“ABS”) estimated at the time of the Commission’s 2009 Network Price Determination as 1.025;

X = -0.85 per cent, in accordance with the Commission’s 2009 Network Price Determination; and

g = expected growth in quantities sold.

C = the factor determined by the Commission to recover the approved cost pass through amount.

4.67 Recasting the equation with (1 + C) as the subject:

$$(1 + C) = R_{2013\text{-}14} / [\, R_{2012\text{-}13} * (CPI_{2012}/CPI_{2011}) * (1 - X) * (1 + g) \,]$$

4.68 Required revenue for 2013-14 including the approved cost pass through amount, is $152.725 million.

4.69 Based on the parameters set out above and an estimated average quantity growth of 2.50 per cent, the “C” factor required for PWC to recover the first stage of the approved cost pass through amount is 24.4 per cent.

4.70 The Commission acknowledged that applying a ’C’ factor based on incremental revenue to a weighted average price cap is not without drawbacks. Should the average growth in quantity of services provided fall below the Commission’s estimate of 2.50 per cent, PWC would not recover the full amount, whereas if growth should exceed the Commission’s estimate, then PWC would receive a windfall.

4.71 The Draft Determination sought comment on viable alternatives.

Commission’s draft decision

4.72 The Commission considered that the approved cost pass through amount should be $65.26 million ($12/13), which included an adjustment for the time cost of money.

4.73 The NT Network Access Code requires the Commission to achieve an acceptable balancing of the interests of the network provider, network users and the public interest [cl.63(f)]. To mitigate the price shock for network users, the Commission considered that PWC should recover approximately half (rounded down to the nearest $5 million) in 2013-14, with the balance to be carried over to the next regulatory control period.

4.74 The approved cost pass through amount should be recovered as follows:

- $30 million in the 2013-14 regulatory year; and
- the remaining $35.26 million ($12/13) will be carried over to the next regulatory control period commencing 1 July 2014.

4.75 The Commission considered that, for the 2013-14 regulatory year, PWC should develop network tariff schedules for standard control services that conform with the following constraint on weighted average tariffs (denoted as P):

$$P_{2013\text{-}14} \leq [\, P_{2012\text{-}13} * ({}^{CPI_{2012}}/{}_{CPI_{2011}}) * (1 - X) * (1 + C)]$$

where:

CPI = a 100 based index, being the all capital cities headline CPI index published by the Australian Bureau of Statistics (“ABS”) measured in accordance with the Commission’s 2009 Network Price Determination;

X = -0.85 per cent, in accordance with the Commission’s 2009 Network Price Determination; and

C = 24.4 per cent, being the factor determined by the Commission to recover the approved cost pass through amount.

4.76 The manner in which remaining amount of $35.26 million ($12/13) would be recovered over the 2014-2019 regulatory control period would be determined as part of the 2014 Network Price Determination process.

Views in submissions

4.77 PWC did not agree with the Commission’s use of expected revenue and forecast CPI from the 2009 Network Price Determination, arguing that more recent forecasts should be used.

4.78 PWC submitted that its most recent estimate of expected revenue for 2012-13 is $115.64 million (against the 2009 forecast of $115.83 million), and that the actual CPI that must be used by PWC for its 2013-14 tariff submission is 1.76 per cent (against the 2009 forecast of 2.50 per cent).

4.79 No stakeholders provided comment on the application of a ’C‘ factor based on incremental revenue to a weighted average price cap, or suggested possible alternative approaches.

Commission’s further analysis and response to submissions

4.80 The Commission accepts that, for the purposes of determining the ‘C’ factor required to recover the cost pass through amount, use of latest available estimates of current revenue and the CPI that will underlie PWC’s 2013-14 network tariff proposal is appropriate.

4.81 PWC’s current estimated revenue for 2012-13 is $115.64 million. Based on a CPI of 1.76 per cent, a total X factor of -0.85 per cent and an estimated average quantity growth of 2.50 per cent, the ’C‘ factor required for PWC to recover the first stage of the approved cost pass through amount is 24.7 per cent.

Commission’s final decision

4.82 The Commission considers that the approved cost pass through amount should be $54.92 million ($12/13), which includes an adjustment for the time cost of money.

4.83 The Commission considers that PWC should recover approximately half (rounded down to the nearest $5 million) of the approved cost pass through amount in 2013-14, with the balance to be carried over to the next regulatory control period.

4.84 The approved cost pass through amount should be recovered as follows:

- $25 million in the 2013-14 regulatory year; and

- the remaining \$29.92 million (\$12/13) will be carried over to the next regulatory control period commencing 1 July 2014.

4.85 The Commission considers that, for the 2013-14 regulatory year, PWC should develop network tariff schedules for standard control services that conform with the following constraint on weighted average tariffs (denoted as P):

$$P_{2013\text{-}14} \leq [\ P_{2012\text{-}13} * ({}^{CPI_{2012}}/{}_{CPI_{2011}}) * (1 - X) * (1 + C)]$$

where:

CPI = a 100 based index, being the all capital cities headline CPI index published by the Australian Bureau of Statistics (“ABS”) measured in accordance with the Commission’s 2009 Network Price Determination;

X = -0.85 per cent, in accordance with the Commission’s 2009 Network Price Determination; and

C = 20.6 per cent, being the factor determined by the Commission to recover the approved cost pass through amount.

4.86 The manner in which remaining amount of \$29.92 million (\$12/13) is recovered over the 2014-2019 regulatory control period will be determined as part of the 2014 Network Price Determination process.

CHAPTER 5

Other matters

Impact on end-use customers

5.1 Network prices are one component of total retail tariffs and are paid by electricity retailers.

5.2 The cost pass through approved by the Commission relates to the network component paid by electricity retailers. This component is incorporated into the bundled price offered to end-users by retailers.

5.3 For small and medium size customers (those consuming less than 750MWh of electricity per annum), retail tariffs are regulated by a Pricing Order which sets the maximum PWC is able to charge these categories of customers. The change to the network price as a result of the cost pass through will not impact the current Pricing Orders.

5.4 For customers on negotiated contracts for supply (eg large customers consuming more than 750MWh[16] of electricity per annum), the size and timing of the impact on retail tariffs will depend on individual contract terms and conditions with respective retailers.

Views in submissions

5.5 QEnergy noted that following the Commission's approval of a cost pass through amount, PWC will need to decide which network tariffs it intends to increase to the recover the increased amounts and that this decision will impact on the relative extent to which the increase is paid by large customers or by government through the CSO.

5.6 QEnergy argued that:

"It is imperative that the Commission consider the need for a real, cost reflective, basis for network tariff setting immediately and that it take a very active interest in the decisions that are taken by Power and Water in passing any amounts that are approved under this application."

Commission's response

5.7 The Commission has already foreshadowed that it intends to undertake a comprehensive review of network tariff classes and structures as part of the 2014 Network Price Determination.[17]

5.8 With respect to QEnergy's comment on the relative impacts on different customer classes, the Commission will review PWC's proposed reference tariffs for standard network access services as part of PWC's 2013-14 Network Tariffs Submission to

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[16] For customers using between 750MWh and 2GWH per annum the rate at which PWC is permitted to increase their tariff may also be regulated. This will depend on individual circumstances.

[17] Utilities Commission, *2014-19 Network Price Determination – Framework and Approach Decision Paper*, November 2012, p.87.

ensure that the proposed tariffs are not inconsistent with the principles or requirements of the NT Network Access Code.

Other matters raised by PWC

5.9 Two related matters have been raised by PWC in its cost pass through application.

5.10 First, as the third stage in its proposed three stage approach to recovering the cost pass through amount, PWC proposed that the Regulatory Asset Base (RAB) should be increased by the rolled forward value of capital overexpenditure at the commencement of the fourth regulatory control period.

5.11 The Commission addressed this matter in its Framework and Approach for the 2014 Network Price Determination[18].

5.12 The Commission noted that the network provider is undertaking a large capital expenditure program in the current regulatory control period and considered whether the full amount of this capital expenditure should be rolled into the RAB regardless of efficiency, or whether some level of optimisation should be undertaken.

5.13 The Commission’s preferred approach is that, consistent with the Commission’s Off Ramp Decision in 2005 and the National Electricity Rules, the Commission will roll the full amount of capital expenditure incurred in the third regulatory control period into the opening RAB for the fourth regulatory control period.

5.14 The Commission expects that PWC’s Regulatory Proposal will reflect this approach, and it will then be subject to the normal consultation that forms part of the determination process.

5.15 Secondly, PWC requested that a reconciliation of the actual expenditure incurred by the network provider during the third regulatory control period be undertaken as part of the 2014 Network Price Determination process, as it impact significantly on the network provider’s ongoing commercial viability.

5.16 Again, the Commission addressed this matter in its Framework and Approach for the 2014 Network Price Determination[19].

5.17 A network price determination provides sufficient revenue to meet the efficient long-run costs of providing regulated services, including a return on investment commensurate with the commercial and regulatory risks involved. Cost pass through arrangements deal with unexpected events, not allowed for at the time of the determination, for which the costs, if not passed through, could put at risk the efficiency of the service provider’s decisions and actions.

5.18 Where a service provider exceeds operating expenditure amounts allowed for in the determination (ie spends more than the regulator has determined is required for efficient service provision), the service provider is generally not permitted to recoup this over expenditure at a later date.

5.19 General regulatory practice to date[20] has been for a return on and return of (depreciation) assets resulting from capital expenditure over that allowed for in the

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[18] Utilities Commission, *2014-19 Network Price Determination Framework and Approach Decision Paper*, November 2012, pp.61-62

[19] Utilities Commission, *2014-19 Network Price Determination Framework and Approach Decision Paper*, November 2012, pp.18-19

determination, to be recovered from the commencement of the following regulatory control period, by rolling all actual expenditure into the RAB once incurred. However, a return on and return of assets from the time of purchase to the end of the regulatory control period in which the purchase occurred is foregone.

5.20 The 2009 Network Price Determination provided PWC with a return on and of assets based on an asset base expanding at the rate based on efficient industry standards rather than based on PWC's forecasts of firm-specific depreciation, indexation and capital expenditure

5.21 PWC may choose to make a submission as part of its Regulatory Proposal to explain why it should be permitted to recover the additional expenditure above that allowed for in the 2009 Network Price Determination and this cost pass through. However, the Commission would expect any such submission to include substantial and detailed analysis of the actual activities undertaken, the issues these activities are meant to address and, where sufficient time has passed, an assessment as to whether the objectives have or are likely to be achieved.

5.22 This will be subject to the normal consultation that forms part of the determination process.

5.23 PWC indicated in its submission on the Draft Determination that it intends to include in its initial regulatory proposal for the 2014 Network Price Determination, a submission explaining why it should be permitted to recover the additional expenditure above that allowed for in the 2009 Network Price Determination and this Cost Pass Through Final Determination.

[20] The Commission notes that recent changes to the National Electricity Rules allow the AER to exclude capital expenditure that it considers inefficient from the RAB's of service providers going forward.