Mr Alan Tregilgas
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Your ref

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Contact

2 February 2000

Dear Mr Tregilgas

"Calculating PAWA's initial network revenue caps" - NT Power's response

Introduction

NT Power is pleased to respond to the Office of the Interim Utilities Commissioner's (IUC) request for public comments on its discussion paper on the calculation of PAWA Networks's (PAWA) initial network revenue caps, dated 17 January 2000. As requested, we have also provided an electronic copy of this letter.

Please note that where reference is made throughout this response to the IUC, it is intended that the comments equally apply to its successor body.

We present an executive summary followed by our responses to the issues specified for comment by the IUC, in accordance with the order and headings stated in sections 4 to 9 of its paper. We have also identified a number of other matters that we consider are relevant to the determination of PAWA's future revenues, which we have addressed in a separate section. In making this response, we note that the National Competition Council (NCC) is currently considering the NT Government's electricity access arrangements. We would welcome the opportunity to make further comments on the revenue determination process following the outcome of the NCC's deliberations.

There are a number of important issues relating to the development of PAWA's future revenue that are not fully addressed by the current discussion paper, in particular the determination of appropriate X factors, an explanation of the form of price control and the nature of PAWA's reference network tariffs. NT Power looks forward to commenting on these significant matters in accordance with the timetable detailed in Chapter 2 of the discussion paper.

Executive Summary

NT Power believes that the IUC's discussion paper generally provides a sound basis for the determination of PAWA's future revenues. There are, however, a number of areas where we believe specific changes, or further explanation, are required. In particular, we consider:

- specific changes are needed to the proposed mechanism for calculating the capital base, including working capital; and

- PAWA should only be allowed to recover efficient operating and maintenance costs from 1 April 2000, rather than moving towards this standard over a three-year period.

In addition, it is considered vital that the IUC clarifies the practical workings of the proposed revenue cap and in particular the nature of the incentive arrangements and mechanisms for avoiding price volatility and rate shocks.

Chapter 3, "Role of Commission in Setting Revenue Caps", section 3.5, page 6

It is noted that clause 7(2)(h) of the Utilities Commission Bill referred to in this section currently requires the Commission "to ensure an appropriate rate of return on government assets".

Our view is that this clause should be amended to reflect the fact that the IUC has the capacity to regulate revenues and prices for privately owned, as well as Government owned, network services and that it should have regard for the need to ensure appropriate returns on these privately owned assets.

Chapter 4, "Special Requirements for the Initial Year", clause 4.19, page 9-10

A. No comments at this stage.

B. NT Power seeks the IUC's explanation of the reasons for the proposed use of different inflation rates for different purposes in determining the revenue cap. In particular, it is noted that:

   - it is proposed that the lower of Westpac's and NAB's inflation forecasts be used to determine:

     - the first full year price cap, as per section 4.7;

     - the price adjustment factor, as per section 4.12; and

- the measurement of the capital base, as per section 7.4,

but,

- section 6.16 proposes calculating inflation as the difference in yields on nominal and indexed 10 year Commonwealth bonds for use in calculating the weighted average cost of capital.

We therefore seek clarification as to why:

- there is not consistency in the application of the inflation rates used for these various purposes; and

- a national, rather than capital city specific (eg. Darwin), inflation rate is proposed.

In addition, it is unclear how the GST adjustment process would work, as described in equation (3) on page 7. Does the "▲PI" factor seek to reflect a GST-adjusted inflation rate and the "▲GST" factor seek to reflect an adjustment for the effects on PAWA specifically from the GST? This needs further explanation and clarification, particularly as it would appear that there is the potential to duplicate the adjustment for the GST through this process.

C. NT Power seeks clarification of how the IUC will estimate the quantity of electricity transported over the networks between 1 April and 30 June 2000 for use in the apportionment factor.

D. Treating the Darwin and Katherine networks separately for the purposes of determining revenue caps requires an appropriate mechanism for fairly apportioning costs between the two regions. Because NT Power recognises that cost allocation is largely a subjective process, we reserve our comments on the merits of treating the networks separately until we fully understand the nature of the cost allocation process.

E. No comments at this stage

Chapter 5, "Network Services Included in the Cap", section 5.4 page 11

A. It would appear that the discussion paper proposes that any of PAWA's electricity supply services that are excluded from the revenue cap would effectively become unregulated activities. In NT Power's view, this would be untenable given that:

- it would result in PAWA retaining a monopoly right to provide unregulated services where others could equally easily supply them. Wherever possible these services should be made contestable and be made open to competition;

- there are precedents in other jurisdictions (including Victoria for example) for the regulatory determination of prices for "excluded services" (ie. monopoly services that are not regulated by price cap) on a fair and reasonable basis. Excluded services should also be regulated by the IUC in the Northern Territory if they are not opened to competition; and

- in other jurisdictions there has been evidence of network service providers seeking to shift costs between unregulated and regulated activities and between excluded services and services regulated by price cap. The IUC will need to be vigilant to ensure this does not occur in the NT.

Chapter 6, "Weighted-Average Cost of Capital", section 6.26 pages 16-17

A.- H.In relation to the WACC, NT Power:

- seeks clarification of the method used by the IUC for transforming the nominal pre-tax WACC of 10.9% to a real pre-tax WACC of 7.4%. We were not able to reconcile this transformation.

- supports the use of a pre-tax real WACC and relevant tax rates;

- supports the use of industry-wide, rather than company-specific, values for each of the specific parameters.

Chapter 7, "Measuring the Capital Base", section 7.20 pages 20-21

A. NT Power believes that the proposed definition and method for calculating working capital for inclusion in PAWA's capital base is faulty and has the potential to provide perverse incentives for PAWA.

Working capital is defined for accounting purposes as the difference between current assets and current liabilities. However, the NSW Independent Pricing and Regulatory Tribunal (IPART) has identified a number of items that would normally fall within this definition that should be excluded from the definition of regulatory working capital and the regulatory capital base.

In October 1999, IPART published a report[1] that argued that the following items should be excluded from the regulatory capital base:

- *Goodwill and unidentifiable assets* – these should be excluded otherwise investors would earn returns in excess of the fair value of their underlying identifiable assets.

- *Assets and liabilities that are not associated with the regulated business* – these should be excluded as they do not relate to the regulated activities of the business.

- *Cash, overdrafts, other short-term borrowings and investment* – these should be excluded as they already attract a market-determined return.

- *Interest and dividend payable accounts and investment income accruals* – these should be excluded as they represent market-determined returns on a business's assets.

- *Income tax assets and liabilities* – these should be excluded where the WACC and returns on capital are calculated on a pre-tax basis.

On this basis, the report indicated that regulatory working capital would normally be limited to:

- trade debtors and accrued income; plus

- inventories; plus

- prepayments; less

- trade creditors and accruals.[2]

Given that the derivation of network revenues is essentially a forward-looking exercise it will be necessary for the IUC to choose an appropriate approach for forecasting future

[1] IPART, "The treatment of net working capital in establishing the regulatory asset base for AGL Gas Networks Limited", October 1999
[2] IPART, "The treatment of net working capital in establishing the regulatory asset base for AGL Gas Networks Limited", October 1999, page 2

working capital. We refer the IUC to the IPART report that identified three alternative approaches for addressing this task.[3]

B. The IUC’s proposed treatment of net capital contributions received before 1 July 1998 would appear to give PAWA a perverse incentive to demonstrate that its records are deficient and unreliable and cannot therefore be used in determining its capital base. While NT Power acknowledges that it would not appear to be feasible for the IUC to estimate PAWA’s unrecorded capital contributions, we seek the IUC’s assurance that it will conduct every possible investigation to satisfy itself of PAWA’s claims in relation to contributed assets.

C. NT Power considers that there are a number of matters needing to be resolved in relation to equation (9) on page 18 of the discussion paper, including:

- why is the inverse square root taken of the term (1+▲PI)? This does not appear to be necessary.

- how is any provision made in this formula for depreciation? It would appear that this should be included.

- why is it proposed that PAWA’s actual capital expenditure be included in the capital base, rather than a view of efficient capital expenditure as is required under clause 69(2) of the Access Code?

- how is this formula rolled forward beyond the first year? There should be a clear mechanism for determining the value of the capital base in the following year without revaluing the assets.

In addition, there is a need for the IUC to be satisfied that, with effect from 1 April 2000, PAWA maintains separable asset records that are sufficient to allow the arithmetic calculation of the roll forward of the asset base.

Chapter 8, “Measuring the Annual Depreciation Charge”, section 8.5 pages 23

A. No comments at this stage.

B. No comments at this stage.

[3] IPART, “The treatment of net working capital in establishing the regulatory asset base for AGL Gas Networks Limited”, October 1999, page 47

Chapter 9, "Measuring Allowable Operating Costs", section 9.9 page 25

A. NT Power opposes in the strongest possible terms the IUC's proposal to allow PAWA to phase-in the introduction of efficient pricing over a three-year period. This approach is clearly inconsistent with the requirements of clause 69(2) of the Access Code, which states that:

> *The revenue cap set by the regulator is to provide a fair and reasonable risk-adjusted rate of return to the network provider on efficient investment and maintenance practices on the part of the network provider.*

This approach is also inconsistent with the approaches that have been taken in other jurisdictions, such as Victoria and South Australia, where there has been no phasing-in of efficient performance. Indeed, clause 6.10.2(a)(2) of the National Electricity Code explicitly states that the price regulation of distribution services should provide:

> *on a prospective basis, a sustainable commercial revenue stream which includes a fair and reasonable rate of return to Distribution Network Owners on efficient investment, given efficient operating and maintenance practices of the Distribution Network Owners.*

PAWA should not be able to continue to pass the costs of its inefficiencies on to its customers. Rather, it should be forced to charge in an efficient manner from the beginning of the new regulatory period, even if its operations are themselves not efficient. End-customers should not be penalised any longer for PAWA's inefficiencies.

Importantly, if PAWA does not charge on an efficient basis it will, in NT Power's view, be failing to comply with both the meaning and intent of paragraph 7(3) of Schedule 6 of the Access Code, which states that:

> *As one of the objectives of the regulation of network prices is to provide the network provider with incentives to utilise efficient operating and maintenance practices, the operating expenditure to be included in the calculation of a revenue cap is to be based on costs facing an efficient operation in Territory circumstances.*

The "Glidepath"

NT Power is unfamiliar with the use of this term to describe the phased introduction of efficiency into a regulated market. Instead, our experience of the glidepath has been in reference to a mechanism for a network service provider and end consumers sharing, in the following regulatory period, the benefits of the network service provider outperforming its regulated efficiency requirements in the previous regulatory period.

The glidepath therefore potentially gives network service providers the opportunity to include an additional "increment" in their allowed revenue, being a reward for out-performing their regulatory efficiency requirements in the previous regulatory period.

Conversely, in principle a glidepath mechanism such as that outlined by the ORG[4] would also penalise a business and reduce prices to customers if a business under-performed in relation to its efficiency targets in a preceding regulatory period.

The result of the proposed approach would be for prices to be charged above what would apply if PAWA were to operate efficiently, when in fact the "conventional" glidepath if applied to PAWA would bring about a price reduction.

Other comments

General

It would appear that the proposed NT Access Code mandates that a revenue cap is the only form of price control that the IUC may impose in regulating PAWA's future revenues. NT Power seeks clarification of the way in which the proposed revenue cap will work in practice and in particular:

- the nature of the incentive mechanisms for PAWA to operate in an efficient manner; and
- the nature of the mechanisms for avoiding price volatility and rate shocks.

Additional comments on Chapter 5, "Network Services Included in the Cap"

It is unclear from section 5.3(c) how the IUC intends regulating charges for system control activities. It is NT Power's strong view that this function should not be performed by PAWA but rather by a separate, independent body.

In any event, a separate mechanism needs to be developed for levying and regulating charges for system control that are transparent and clearly separated from all network charges. This would ensure the Northern Territory's arrangements are consistent with those that apply to the National Electricity Market.

[4] ORG, "2001 Electricity Distribution Price Review – Efficiency Measurement and Benefit Sharing", Consultation Paper Number 2, December 1998

Additional comments on Chapter 7, "Measuring the Capital Base"

Need for due diligence of asset valuations

In NT Power's view, there is likely to be a need for the IUC to undertake appropriate due diligence activity in relation to both the asset and capital expenditure information provided to it by PAWA to ensure it is satisfied with the quality of this information. NT Power seeks confirmation that the IUC will conduct appropriate analysis to ensure that these values have been calculated appropriately. They are critical factors in the determination of PAWA's capital base and have the potential to impact significantly on their final distribution tariffs.

As has been mentioned above, there will clearly be a need for the IUC to satisfy itself that PAWA's proposed investment is efficient, in accordance with clause 69(2) of the Access Code.

Effect of GST on capital expenditure

The Trade Practices Act requires that PAWA's estimates of capital expenditure beyond 30 June 2000 not only make an allowance for the newly imposed GST but also for the resultant abolition of many other taxes and charges. No GST should be included where it would otherwise be refunded to PAWA.

Additional comments on Chapter 9, "Measuring Allowable Operating Costs"

Need to avoid cross-subsidies

Because PAWA is currently both vertically integrated (with interests in generation, transmission, retail and system operation) and horizontally integrated (with interests in both electricity and water) it is essential that effective ring-fencing arrangements and regulatory accounting guidelines be implemented to ensure there are no cross-subsidies between its activities. In particular, PAWA should not be able to include the charges it pays NT Power for transmission services in its operating and maintenance costs, as these are not distribution-related costs and there should be clear ring-fencing between transmission and distribution charges.

Effect of GST on operating and maintenance expenses

As with its estimations of capital expenditure, the Trade Practices Act requires that PAWA's estimates of operating and maintenance expenditure beyond 30 June 2000 not only make an allowance for the newly imposed GST but also for the resultant abolition of many other taxes and charges. No GST should be included where it would otherwise be refunded to PAWA.

Conclusion

NT Power sees the IUC's determination of PAWA's revenue cap as a fundamental step in the reform of the Northern Territory's electricity supply industry. Consistent with its obligations under the clause 7(2) of the Utilities Commission Bill, 1999, we believe it is vital that the IUC seeks to promote the most efficient possible network pricing arrangements from 1 April 2000, to provide appropriate:

- incentives for network service providers to improve efficiency; and

- means for network service providers and customers to share the benefits of efficiency gains.

We welcome the IUC's proposal to conduct a roundtable to discuss these important issues further and would be pleased to participate. In the meantime, I would be pleased to speak with you regarding any of the above issues, and can be contacted on (08) 8932 2140.

Yours sincerely

Jeff Hutchison
Chief Executive Officer