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Mr Alan Tregilgas
Utilities Commissioner
Utilities Commission
5th Floor, 38 Cavenagh Street
Darwin NT 0800

Dear Alan

Re: Networks Pricing: 2009 Regulatory Reset Issues Paper

Power and Water Corporation (Power and Water) thanks the Utilities Commission (the Commission) for the opportunity to respond to the 2009 Networks Regulatory Reset (2009 Reset) Issues Paper. Power and Water has highlighted and marked relevant sections of this response as confidential and requests that the Commission does not make these sections publicly available. A document suitable for publication will be provided.

In the attached response, Power and Water:

- is generally supportive of the process that the Commission has identified for the 2009 Reset;
- supports the continuation of the weighted average price cap form of price control;
- supports the Commission's establishment of services classification, in particular excluded services, prior to the establishment of the Z factor or the new weighted average price cap indices;
- supports the establishment in the Northern Territory of schemes that are currently in use elsewhere in Australia, such as gains sharing mechanisms and service target performance incentive schemes, and has provided some analysis on the forms that these could take;
- considers that, despite the short time available between now and the end of the current regulatory control period, it can provide the Commission with a well reasoned and substantiated submission on its forecast costs and asset values over the 2009 to 2014 regulatory control period; and
- considers that these forecast costs and asset values should provide the basis for the development of a weighted average price cap index.

The last point is critical for three reasons. Firstly, the 2004 Determination reflected both Power and Water and the Commission's best assessment of the reasonable costs and required revenues for a benchmark entity operating in the Northern Territory networks market at that time. The Commission expressed some severe reservations on the provenance of that information.

Since then, Power and Water has undertaken extensive process review and information gathering to improve its information.

Secondly, there is a pattern of evidence emerging both in Power and Water's costs and in national regulatory decisions that network companies are facing cost increases that are higher than CPI. This is in contrast to the assumptions that underpinned the previous reset's real reductions in base year operations and maintenance costs. Aside from this, there are many scope changes to Networks' baseline budget expenditure from 2008-09. These include maintaining and establishing new asset management databases, and increased training requirements for new employees due to the imminent retirement of a number of senior Networks personnel.

Thirdly, some significant events scheduled for the next regulatory period should be taken into account in establishing the base year costs. The first is the possible introduction of full retail contestability (FRC), which will make transparent a 'capability gap' within Power and Water – this will require significant additional expenditure. Furthermore, the current policy consideration being given to electricity market reform may, even if FRC does not occur, impose considerable costs on Power and Water in assessing and meeting whatever new regulatory and technical obligations are required of it.

In our view, the Commission's timeframe provides sufficient time to establish a forward looking assessment of costs to guide the Z factor adjustment. For its part, Power and Water has commenced the process of building its cost forecasts and supporting information internally.

Power and Water looks forward to working constructively with the Commission throughout the 2009 Reset process. Please contact Ms Djuna Pollard, Manager Regulation, Pricing and Economic Analysis, on 8985 8431 if you wish to clarify any matter in this response.

Yours sincerely

Andrew Macrides
Managing Director

December 2007

Attachment 1

Response to Issues Raised in the 2009 Regulatory Reset Issues Paper

Focus of the Reset

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

Power and Water:

- agrees that the focus of the Reset should take advantage of the learning that has taken place over the past four years and build on a working and successful regime; and
- considers that the decisions taken by the Commission in 2004 in relation to the form of price control and other structural matters were robust, consistent with general regulatory precedent at that stage and have been successfully integrated into Power and Water's operational and business practices.

There is no obvious reason to depart from the weighted average price cap form of regulation.

Issue 2: Is there any disagreement with the emphasis being on regulatory certainty and on the minimising of regulatory risk when the Commission is reviewing the 2004 methodology?

The Commission's decision to focus on regulatory certainty and minimising regulatory risk is helpful.

This should not just look back to the earlier reset. The Commission is also able to ensure regulatory certainty by looking forward and taking into account the business risks that are likely to be faced by Power Networks over the third regulatory period and in particular the potential for market reform.

Weighted Average of Network Access Tariffs

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

Power and Water:

- supports the continuation of the weighted average price cap form of price control. This approach has extensive precedent and has been recently selected as the form of price control for the upcoming NSW reset; and
- considers that the use of lagged quantity weights is the only practical method of making the weighted average price cap calculation work. Using quantity weights from a year earlier would not take advantage of the latest

information available, and using weights from the year after the existing method would require the use of uncorrected volumes and partial forecasts.

Issue 4: Is the current range of excluded services still appropriate for the third regulatory period?

Classifying services (for the purposes of the control) is a critical first step for the reset. Power and Water will complete this task during January and February 2008.

It would be helpful for prescribed and excluded services to be better defined. There is no clear description in the Code as to whether a service or asset is:

- regulated and subject to the form of price control;
- subject to regulation, but excluded from the form of price control; or
- non-regulated.

Over the course of the next six months Power and Water will seek to:

- define what is included in its prescribed services, what is an excluded service, and what is a non-regulated service;
- only include in its proposed Z factor adjustment the efficient forward looking costs for the prescribed services;
- propose a method of setting cost based prices for excluded services; and
- not include the costs of non-regulated services in either of the above.

Issue 5: Do the current new-tariff arrangements remain appropriate for the third regulatory period?

If a weighted average price cap remains the form of price control and if the Commission continues to use lagged quantity weights, then the current new-tariff arrangements remain the most effective means to introduce new tariffs within a regulatory period.

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

Power and Water:

- considers that a forward looking cost based assessment is an essential part of the establishment of the Z factor for the next regulatory period, for reasons outlined below;
- considers that financial and other supporting data can be provided to the Commission in order for an efficient and reliable Z factor to be determined for the following regulatory period; and

- has not under or over recovered to any material degree during the current regulatory period, although it did re-balance during the period in order to achieve efficiency in pricing.

On the first issue:

- Power and Water acknowledges the Commission's criticism in the 2004 Determination which led to its Off-Ramp Review but will argue that sufficient improvements have since been made through a number of important financial and asset management initiatives for the Commission to reconsider its approach;
- Power and Water submits that the parameters which underpinned the Commission's 2004 Determination no longer adequately reflect Power and Water's costs of supply. As noted in the covering letter, our indicative analysis shows that a positive Z factor would be a likely outcome for the 2009 Reset if the base year was established using the 2006-07 year (even without adjustment for forward looking costs);
- there is a pattern of evidence that network companies are facing cost increases that are higher than CPI (some as large as 6-7% per annum), caused by rising labour costs from skilled labour shortages and strong enterprise bargaining outcomes for employees, which suggests that forward looking costs may be higher than current costs; and
- there are significant events scheduled to occur during the next regulatory period which must be taken into account in establishing the base year costs. The first is the possible introduction of full retail contestability in 2010, which will make transparent a 'capability gap' within Power and Water that will require significant future expenditure. Secondly, the current policy consideration being given to electricity market reform will, even if FRC does not occur, impose considerable costs in meeting whatever new regulatory and technical obligations are required.

On the second issue, Power and Water is preparing its 2008-09 Statement of Corporate Intent. This is intended to establish reasonable and reliable forward looking forecasts of capital and operating expenditure for the Power Networks business and certified as such by Power and Water's Board of Directors. While these have not been separated into prescribed, excluded and non-regulated purposes as yet, they will provide a 'line in the sand' to which other numbers can be reconciled.

On the third issue, Power and Water has neither sought to, nor has it, over-recovered throughout the second regulatory period to any material degree. Power and Water has re-balanced its network tariffs throughout the second regulatory period in order to ensure that network tariffs were adequately focussed on areas where consumers were shifting demand. The most fundamental of these was the 2005 rebalancing exercise which was consequent to volume movements when some contestable customers were allowed to 'revert' to franchise status.

Issue 7: Should a gains sharing approach be considered for adoption during the third regulatory period. If so, what form should it take?

There is a role for a mechanism that shares efficiency gains between Power and Water and its customers.

Power and Water's early analysis on this suggests that:

- the Commission would need to decide whether the gain sharing would focus on revenues, which would operate in the event that Power and Water earned more revenue than a certain amount (as per the "additional revenue policy" provisions in the National Gas Code), or focus on costs by establishing "gains" as they relate to Power and Water's over or under expenditure compared to some derived "benchmark amount". In particular, Power and Water is unclear how setting benchmark amounts for operational or capital expenditure would work with the natural incentive powers of the weighted average price cap form of price control;
- if an expenditure based mechanism is decided upon, then the Commission would need to decide:
  - whether it would apply to operational and maintenance expenditure, or capital expenditure, or both. Power and Water notes that under or over spends in these types of expenditure impact customers in different ways;
  - whether the regime would be "symmetrical", i.e. would it penalise or reward Power and Water for over-spending as well as under-spending; and
  - what amount or proportion of "gains" would be shared; and
  - how these gains would be shared, in particular whether they would be shared in the following year or years from when they are reported, or carried over to the next regulatory period.

Power and Water will participate in the development of a gain sharing mechanism to meet the Commission's expectations, whether:

- developing and submitting a mechanism as part of a "proposal" at the same time or prior to submitting its forward looking costs to the Commission; or
- responding to the Commission's development of a draft mechanism.

Annual Escalation Arrangements

Issue 8: Is any change warranted to the definition and measurement of the composite X factor as used in the 2004 methodology, notably involving the separate consideration of the X1 and X2 factors?

The underlying cost bases of utilities have changed significantly, both in terms of a base year and the development of forward looking efficiency measures.

In order to articulate this issue fully, Power and Water has set out:

- how it sees the use of X factors in regulatory decisions, in order to put X1 and X2 into context; and
- how it believes that the current X1 and X2 factors can remain in use but be more consistent with industry trends.

On the first issue, Power and Water notes that X factors generally perform one of two roles within a regulatory decision, being:

- as a 'smoothing' mechanism, where:
  - X is calculated such that expected tariff revenue for each year of the regulatory control period is exactly the same as the net present value of the forecast revenue requirement established using a building block approach;
  - X may be the same for each year of the regulatory control period or it may differ for each or some years of the regulatory control period;
  - the X factor is generally set with regard to any required Z factor adjustment, which brings revenues from the previous period in line with those allowed for in the new regulatory period based on approved costs data; and
  - expected efficiencies are separately factored into each building block cost category - for example the 'opex' efficiency mechanism, such that an X factor is not required for these purposes.
- as an efficiency mechanism (whether applied to the 'opex' building block rather than pricing or in a Total Factor Productivity approach), the X is calculated to reflect underlying efficiency gains likely to be achieved, by either a specific distribution business or industry wide, during the course of the regulatory control period. These efficiency gains may be achieved for many reasons such as productivity changes or economies of scale.

The current X1 and X2 factors are the second form of X, and are intended to reflect broader efficiencies that Power and Water can make within its business. At the time that the 2004 Determination was made:

- an engineering study had been undertaken by the Commission, which suggested that Power and Water could reduce its operations and maintenance costs by 10%; and
- there was evidence of declining costs and increasing efficiencies in network businesses across Australia.

The Commission therefore chose an X1 factor in order to take account of long term efficiencies within Power and Water, and an X2 factor to take account of industry wide efficiencies.

Since 2004, two trends have been observable in the national utilities market:

- it is now far more difficult to attract and retain skilled electricity staff than previously. This has been well documented and it is now an accepted aspect of regulatory decision making that wage costs are rising by more than CPI.

The BIS Shrapnel Report[1] submitted by ElectraNet to the AER as Appendix D to its revenue proposal looked at wage costs for the electricity industry to 2017 and forecast wages growth of between 5% and 6% per annum for the industry from 2009 to 2014. This means that both operations and maintenance costs, and capital expenditure delivery costs, are rising; and

- it is more expensive than ever to buy the materials required to deliver capital expenditure programs. For example, the Evans and Peck Report[2] submitted by ElectraNet to the AER as Appendix E to its current revenue proposal forecast cost increases ranging from 3.4% to 7.5% over the period to 2014 based on forward looking prices for steel, copper and other materials.

Power and Water supports the continued use of a X1 and X2 factor, and notes that:

- while decisions on its own efficiency compared to a benchmark new entrant are best left to the Commission to determine, its own costs are increasing, not decreasing, with others in the industry in the same situation; and
- the work underpinning the selection of new X factors should seek to understand the national and Territory wide factors that are causing these increases, and reflect them into X factors as appropriate.

Power and Water will participate in the development of new X factors as the Commission sees fit, whether:

- developing and submitting X factors as part of a "proposal" at the same time or prior to submitting its forward looking costs to the Commission; or
- responding to the Commission's rationale or other papers in the development of new X factors.

Issue 9: Is there any disagreement with the Commission's intention to introduce an incentive mechanism into the price regulation methodology in support of the NT Electricity Standards of Service framework?

There is a role for a mechanism that rewards and penalises Power and Water for over or under performance in the network. Performance data is now available which could make it an appropriate and reliable part of the future regulatory regime.

At a high level, the Commission would need to, in developing a scheme, decide upon:

- the performance incentive scheme parameters that will apply to Power and Water;

[1] http://www.aer.gov.au/content/item.phtml?itemId=712386&nodeId=380044c2a7433ba82d4adb0e4ad9a600&fn=Appendix%20D%20ElectraNet%20Wages%20Outlook%20to%202017%20Final%20April%202007%20v3.pdf

[2] http://www.aer.gov.au/content/item.phtml?itemId=712385&nodeId=3d744031deb5d06e34a5a00450b70851&fn=Appendix%20E%20EP%20Escalation%20Report%20Final.pdf

- the process for determining the adjustments to the weighted average price cap (including the level of the financial incentive); and
- the requirements with which values for the parameters must comply, including:
  - the values for targets, caps and collars, if these are to apply; and
  - the weighting of the parameters;
- whether, once the next determination is made, the mechanism will be the mechanism whereby the weighted average price cap is adjusted each year or whether some other adjustments are made at the end of the period.

Power and Water will participate in the development of a new mechanism as the Commission sees fit, whether:

- developing and submitting a mechanism as part of a "proposal" at the same time or prior to submitting its forward looking costs to the Commission; or
- responding to the Commission's development of a mechanism.

Individual Network Access Tariffs

Issue 10: Is there any disagreement with the Commission's intention to leave unchanged the side constraint feature of the 2004 methodology?

Power and Water:

- accepts that side constraints are a necessary and robust mechanism for ensuring that impacts on retailers and customers are minimised in an environment of tariff rebalancing under a weighted average price cap; and
- proposes that deliberations on the appropriate numerical value of side constraints are addressed in later stages in the process.

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

Power and Water:

- notes the Commission's ability under the Code to increase its scrutiny of the pricing principles statement;
- would be pleased to provide whatever information is required to meet fully the spirit and intent of its obligations under the Code and so assist the Commission; and
- is continually mindful of the need for access prices to send appropriate signals to retailers looking to enter the market, and to ensure that cross subsidisation is kept to a minimum. This will be of critical importance in the event that full retail contestability occurs in the Northern Territory.