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Dear Ms Sutcliffe

I would like to thank the Utilities Commission for the opportunity to comment on the recently released Draft 2014-19 Network Price Determination, in which the Commission recommends a 38 per cent step increase in network charges from 2014-15, plus a further 5 per cent increase relating to the pass through of costs previously approved.

As you would be aware, the Northern Territory Government has increased regulated retail electricity tariffs by 20 per cent on 1 January 2013 and an additional 5 per cent on 1 January 2014. A further 5 per cent increase will occur on 1 January 2015. These increases were introduced to ensure the long-term financial sustainability of the Power and Water Corporation (PWC). Consequently, while it was expected that the 2014-19 network price determination process would result in an increase in network charges, the scale of the step increase in 2014-15 proposed in the Draft Determination was not anticipated.

Following review of the Draft Determination and PWC's Revised Regulatory Proposal the following issues have been identified which I believe warrant the Commission's further consideration.

Options for Alternative Price Paths

While the 43 per cent step increase on 2013-14 network tariffs is considered significantly large, excluding depreciation, the proposed 2014-15 revenue allowance is relatively consistent with actual network costs incurred in the past. The Commission maintains that this is the revenue required for PWC to deliver an efficient, secure and reliable energy supply over the forthcoming regulatory control period. However, consideration should be given to price paths which phase in the 43 per cent increase over the regulatory control period, with the view to minimising price shocks for consumers.

Incremental Efficiency Adjustment

Based on benchmarking, it is understood that Parsons Brinckerhoff initially determined that PWC was operating 27 per cent less efficiently compared to the average of its peers. However, instead of applying an equivalent reduction to PWC's operational expenditure, the Commission determined an incremental efficiency adjustment to operational expenditure of $2.5 million in 2015-16, increasing to $10 million in 2018-19, totalling a reduction of $25.2 million (5 per cent) over the regulatory period.

A glide path approach to the efficiency adjustment may reduce the risks associated with introducing a more aggressive reduction of costs over a short timeframe. However, it is considered reasonable that the Commission review the scope for the glide path to be introduced earlier in the regulatory control period together with increasing the total adjustment to more closely align PWC's allowance for operational expenditure with PWC's peers.

Regulatory Asset Base

Determining an accurate and reliable Regulatory Asset Base (RAB) has a significant impact on the building block approach, in that it affects both the return on and return of capital which, when taken together, represent a large component of the network revenue allowance.

The methodology used by the Australian Energy Regulator (AER) in calculating the RAB is based on the Roll Forward Model (RFM). To maintain regulatory certainty and consistency with the AER's approach, it is considered appropriate that the RFM methodology be applied by the Commission, to the extent possible, in calculating PWC's opening RAB.

I am aware concerns have previously been raised about the integrity of the RAB set by the Commission as at 1 July 2002 in its 2005 Off Ramp Decision, where PWC's assets were revalued using a Depreciated Optimised Replacement Cost (DORC) methodology, based on a desktop assessment of eligible assets. However, using the DORC methodology to assess the RAB should only be used where the initial value of the asset is unknown. This was a comment also expressed by the Northern Territory Major Energy Users in its response to PWC's Initial Regulatory Proposal. Accordingly, it is not considered appropriate to re-open the entire asset base to determine the opening RAB.

DORC is a valid valuation method and is considered appropriate to apply to the value of assets acquired prior to July 2002. As the value of the assets acquired after this date can be readily identified, it would be prudent to apply the roll forward methodology to these assets for the 2014 determination rather than reopening the RAB, thus retaining capital allowances that are consistent with the AER's preferred regulatory methodology, to arrive at a new opening RAB. Continually re-opening the RAB, as the Commission has done in 2005 and 2009, generates significant regulatory uncertainty. Maintaining the RFM approach, combined with ongoing assessments of its prudence of PWC's capital program and regulatory determination, should see PWC move to a more efficient regulatory asset base over time.

Depreciation

Under the AER methodology, an asset's standard life and remaining life must reflect those used in the previous regulatory determination.

By accepting the revised RAB, the Commission's draft Determination has also accepted a revised regulatory depreciation charge associated with a change in the remaining lives of the assets. This has resulted in significant movements in both the standard life and remaining asset lives of assets between the RFM and Sinclair Knight Mertz (SKM) DORC valuation, as well as movement of assets between asset classes.

These variances combined with the change in opening RAB methodology have a significant impact on depreciation allowance over the regulatory period, estimated at around $53 million. Retaining the RFM methodology could result in a 6.7 per cent reduction in total revenue allowance, compared to the Commission's draft Determination.

While it is acknowledged that the SKM valuation provides a current analysis of standard and remaining asset life, the significant movement in some of the asset categories appears contradictory. For example, the remaining life of the asset class of zone substations have reduced from 29.1 years to 13.1 years while the remaining lives of distribution substation assets have increased from 4.3 years to 23.2 years. This warrants further investigation and justification, in particular whether the changes reflect prudent and efficient asset management. Furthermore, given the AER's requirement that standard and remaining asset lives should reflect those found in previous determinations, it is considered prudent that the impact of the revised asset lives be assessed.

Cost allocation

For regulated monopoly businesses, such as electricity networks, which receive a regulated revenue stream based on the costs of providing efficient services, effective and efficient cost allocations are imperative to ensure that all relevant costs, but only relevant costs, are included when determining the revenue requirements of the business.

PWC submitted as part of its regulatory proposal a cost allocation method (CAM) that set out the detailed principles and policies used by PWC Networks to allocate costs between the categories of its services which were found by the Commission to meet that required in its Framework.

While the cost allocation methodology and approach taken by PWC has satisfied the requirements of the Commission, there is insufficient evidence or transparency in the Commission's Draft Determination to establish that the actual allocation of costs is consistent with the CAM and that cost shifting to the regulated network business has not occurred. This is particularly pertinent given the Northern Territory Government's recent decision to structurally separate PWC's monopoly and contestable businesses from 1 July 2014.

The timing of both the final 2014-19 Network Determination and the commencement of structural separation places greater emphasis on the need to ensure network charges for the 2014-19 regulatory control period represent efficient and forward looking costs, and therefore I request the Commission undertake rigorous scrutiny of costs allocated to PWC Networks for the final determination.

The issues raised herein reflect components of the Northern Territory Revenue Model that are considered to require further clarification from the Commission. Please contact Mr Craig Graham, Assistant Under Treasurer on (08) 8999 6710 if you have any queries in relation to this submission.

Yours sincerely

DAVID TOLLNER

- 5 MAR 2014