COST PASS THROUGH APPLICATION

DRAFT DETERMINATION

March 2013

38 Cavenagh Street DARWIN NT 0800
Postal Address GPO Box 915 DARWIN NT 0801
Email: utilities.commission@nt.gov.au
Website: www.utilicom.nt.gov.au

TABLE OF CONTENTS

Call for submissions

Submissions are invited from interested parties concerning the issues raised in this Draft Determination.

Submissions should be directed in the first instance:

Executive Officer
Utilities Commission of the Northern Territory
GPO Box 915
DARWIN NT 0801

Telephone: 08 8999 5480
Fax: 08 8999 6262

Email: utilities.commission@nt.gov.au

The closing date for submissions is **Wednesday 17 April 2013**.

Confidentiality

In the interests of transparency and to promote informed discussion, the Commission will make submissions publicly available.

Persons wishing to submit confidential information should:

- clearly identify the relevant sections of the submission that are confidential, so that the remainder of the document can be made publicly available; and
- provide a copy of the submission suitable for publication with any confidential material removed.

Confidential information is defined in section 26 of the *Utilities Commission Act* as information that could affect the competitive position of a licensed entity or other person or is commercially sensitive for some other reason.

Public access to submissions

Subject to the above, submissions will be made available for public inspection at the office of the Commission and on its website (www.utilicom.nt.gov.au).

To facilitate publication on the Commission's website, submissions should be made electronically by disk or email. However, if this is not possible, submissions can be made in writing.

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 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.

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 nature of electricity networks and the uneconomic option of duplicating the infrastructure, 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 the Power and Water Corporation (PWC).

1.6 Nationally, network charges (transmission and distributions) account for some 45% 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.

---

[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 included provision for cost pass through events. A cost pass through event is an event, specified in a relevant Network Price Determination, that gives 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 Specifically, the Commission's 2009 Network Price Determination foreshadowed that it would favourably consider an application for a pass through of costs associated with the investigation of the failure of the Casuarina Zone Substation in September and October 2008 (the Davies Review)[4]. These costs were not allowed for in the 2009 Network Price Determination as it was too early at that time to be certain about the amounts involved.

PWC's cost pass through application

1.11 On 5 February 2013, the Power and Water Corporation (PWC) submitted an application to the Commission for a cost pass through of expenditure that has exceeded that allowed for by the Commission in its 2009 Network Price Determination.

1.12 PWC submitted that the application is consistent with the requirements of clause 71(c) of the Electricity Networks (Third Party Access) Code (NT Network Access Code) and the conditions established in the Commission's 2009 Network Price Determination.

1.13 PWC identified incremental operating expenditure totalling $227.3 million[5] and incremental capital expenditure totalling $148.4 million[6], resulting in a proposed positive cost pass through amount totalling $325.8 million, which includes an adjustment for the time cost of money.

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

1.15 PWC identified operating expenditure totalling $65.11 million and capital expenditure totalling $88.61 million directly attributable to implementation of the Davies Review recommendations. Based on these expenditures, PWC identified a cost pass through amount of $104.55 million which includes an adjustment for the time cost of money.

1.16 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).

---

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

[4] The Davies Review was an independent inquiry, chaired by Mr Mervyn Davies, established by the Northern Territory Government to investigate events surrounding a number of electrical equipment failures that resulted in widespread disruptions to Darwin's northern suburbs in September and October 2008, and to recommend improvements to PWC's operating and maintenance practices.

[5] 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.

[6] 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.

Grounds for a cost pass through

1.17 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.

1.18 The Commission considers that the implementation of recommendations arising from the Independent Enquiry into Casuarina Substation Events and Substation Maintenance across Darwin (Davies Review) satisfies the requirements for a cost pass through set out in the Networks Pricing: 2009 Regulatory Reset – Final Determination:

- 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, which resulted in the PWC Board having no other rational option but to take immediate remedial action to ensure the ongoing security of the network.

1.19 Consistent with clause 71 of the NT Network Access Code, the Commission considers that the cost pass through event, the recommendations of the Davies Review, is an extraordinary development 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;
- 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
- the on-going commercial viability of the network provider.

Cost pass through amount

1.20 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.

1.21 The Commission is 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 is directly related to the implementation of the Davies Review recommendations. The Commission is also not convinced that all projects identified in the further information provided by PWC are related to the Davies Review recommendations.

1.22 Following provision of further information by PWC, the Commission engaged Parsons Brinckerhoff (PB) to assess the expenditure identified by PWC and advise whether this expenditure is reasonably attributable to the Davies Review recommendations.

1.23 PB recommended adjustments totalling $21.91 million to operating expenditure and adjustments totalling $26.83 million to capital expenditure.

1.24 PB’s report forms part of this draft determination and the Commission invites comments on the report.

1.25 For the reasons discussed in Chapter 4, the Commission has reduced PWC's proposed capital and operating expenditure by the amounts recommended by PB. The Commission has used this adjusted capital and operating expenditure to calculate the building blocks costs.

1.26 The Commission has then determined the total amount to pass through to network users to be $65.26 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 $30.0 million to be recovered in 2013-14, the final year of the current regulatory control period, and the remaining $35.26 million ($12/13) to be recovered over the next regulatory control period.

CHAPTER 2

Draft 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 Draft Determination is that the approved cost pass through amount is $65.26 million ($12/13), which includes an adjustment for the time cost of money to 2012-13.

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

- $30.0 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.

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

2.5 For the 2013-14 regulatory year, the Commission's Draft 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%, in accordance with the Commission's 2009 Network Price Determination; and

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

2.6 The manner in which remaining amount of $35.26 million is recovered over the 2014-2019 regulatory control period will be determined as part of the 2014 Network Price Determination process.

CHAPTER 3

Grounds for 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[7] 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 service in the Territory is PWC.

3.6 Nationally, network charges (transmission and distributions) account for some 45% of total electricity charges.[8] 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.

---

7 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.

8 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 included provision for cost pass through events. A cost pass through event is an event, specified in a relevant Network Price Determination, which gives 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 Specifically, the Commission's 2009 Network Price Determination foreshadowed that it would favourably consider an application for a pass through of costs identified following investigation of the failure of the Casuarina Zone Substation in September and October 2008. These costs were not allowed for in the 2009 Network Price Determination as it was too early at that time to be certain about the amounts involved.

3.11 A cost pass through mechanism 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.

3.12 In its 2009 Network Price Determination, the Commission noted that provision for appropriate cost pass throughs is an important component of the overall regulatory framework. However, it is not the nature of any cost increase, but its source and magnitude that is relevant. Accordingly, the Commission considered that it was important that such events be both unanticipated at the time the determination and beyond PWC's control (ie not as a result of PWC's actions).

3.13 Consistent with the requirements of the NT Network Access Code, such cost increases need to be the result of "extraordinary developments" which are "outside the network provider's control".

3.14 The Commission's 2009 Network Price Determination specifically excluded additional spending arising from correcting the failure of the Casuarina Zone Substation in September and October 2008, on the basis that it was too early to be certain about the amounts involved.

3.15 The Commission instead included provision that consideration of these costs could be triggered under the cost pass through arrangements upon application from PWC.

Legislative requirements

2009 Network Price Determination

3.16 The 2009 Network Price Determination provided that:

In accordance with its general powers, and consistent with clause 71(c) of the NT Code, the Commission will only consider cost pass through applications during the third regulatory period if they are the consequence of:

- *change in tax or insurance events; or*
- *force majeure events; or*
- *regulatory compliance events; or*
- *service standard events; or*
- *such other events that satisfy the following requirements: (i) the occurrence was not anticipated at the time of the preceding reset or were, while allowable, explicitly excluded from affecting the outcome of that reset on the grounds that the likely impact on Power and Water was*

unknown or too difficult to quantify at the time, and (ii) the occurrence is not a result of actions of Power and Water's board or management or of decisions of the Government in its capacity as owner or shareholder or guarantor of Power and Water.

The Commission will only consider a cost pass through application based on the above types of events if it at least satisfies the materiality threshold of 1% of the annual revenue from standard control services in the financial year in which the event occurs.[9]

NT Network Access Code

3.17 Unlike the National Electricity Rules, the Electricity Networks (Third Party Access) Code (NT Network Access Code), does not specifically address cost pass through arrangements.

3.18 Rather, the Commission would give effect to a cost pass through decision by revoking and resetting the revenue or price cap for a particular financial year or years under clause 71 of the NT Network Access Code.

3.19 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.

3.20 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:

(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;

---

9 Utilities Commission, *Networks Pricing: 2009 Regulatory Reset – Final Determination*, March 2009, p.11.

(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 – grounds for a cost pass through

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

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

3.23 The Davies Review Final Report[10] 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.

3.24 PWC submitted that the additional capital and operating expenditure resulting from its implementation of the Davies Review recommendations is consistent with the necessary cost pass through provisions set out in clause 71(c) of the NT Network

---

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

Access Code and the conditions established in the Commission's 2009 Network Price Determination.

3.25 PWC submitted that the release of the Davies Review Final Report and the need for consequent expenditure by PWC that was explicitly not allowed for in the Commission's 2009 Network Price Determination was an 'extraordinary development' as provided for under clause 71(c) of the NT Network Access Code.

3.26 This 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)].

3.27 PWC further submitted that its 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. 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.

Commission's assessment

3.28 Under clause 71 of the NT Network Access Code, the Commission is only allowed to revoke or reset a revenue or price cap (ie electricity network pricing) under certain circumstances, ie the previous cap was based on false or materially misleading information provided to the Commission, there was a material error in the setting of the cap or there were 'extraordinary developments' with respects to any of the key factors identified in clause 68, in the opinion of the regulator were 'outside the network providers control'.

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

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

3.31 The Commission considers 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 which affects one (or more) of the key factors in listed in clause 68 of the NT Network Access Code.

3.32 In line with the construction that revenue or price caps only be changed in very limited circumstances, the extraordinary circumstances that have arisen since the previous network price determination (if the Commission finds that any have occurred) must have been completely outside the control of PWC to satisfy the criteria in clause 71(c).

Did an extraordinary development with respect to any key factor set out in clause 68 of the NT Network Access Code occur?

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

3.34 While each recommendation taken in isolation may not be onerous, the Commission considers that the magnitude and scope of the required work program in its entirety and the initial large step changes and short timeframe over which the more urgent recommendations were required to be implemented constitute an extraordinary development.

3.35 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 of the Davies Review[11]. This was because the Commission considered that it was then too early to be certain about the amounts involved.

3.36 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)].

3.37 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 service provider. Likewise, the additional operating expenditure undertaken has also increased the costs of providing regulated services.

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

3.39 The Commission is satisfied that the Davies Review was an extraordinary development in that it identified general unanticipated degradation of the network condition that PWC, as a prudent network operator, had no other rational option but to address. The costs incurred, 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)].

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

Was it beyond the control of PWC?

3.40 The 2009 Network Price Determination requires that the occurrence is not a result of actions of PWC's board or management or of decisions of the Government in its capacity as owner or shareholder or guarantor of PWC.

3.41 The Davies Review found that the Casuarina failures were the consequence of general unanticipated degradation of the network condition. The Commission considers that the unanticipated discovery of that degradation through the Davies Review and the subsequent decision by PWC to undertake immediate remedial action was beyond PWC's control.

3.42 The Commission considers that the response of PWC to embark on a major investment program was a rational and necessary response to an unforeseen development.

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

3.44 While the *Government Owned Corporations Act* sets out a detailed and formal process by which Government may issue direction to PWC, in practice, such a process has rarely been undertaken.

3.45 Rather, PWC is also conscious of directions that are given through 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.

3.46 The Commission considers that statements made by the (then) Minister for Essential Services in relation to implementation of the Davies Review recommendations as advice on public policy positions and implying a direction to PWC to adopt such position.

3.47 The statements were made by the Portfolio Minister, who has responsibility for the provision of essential services, rather than the Shareholding Minister.

3.48 The Commission is satisfied that the extraordinary development, the identification by the Davies Review of general unanticipated degradation of the network, was not a result of actions of PWC's board or management or of decisions of the Government in its capacity as owner or shareholder or guarantor of PWC.

Does it satisfy materiality threshold?

3.49 The Commission's 2009 Network Price Determination provided that a cost pass through must at least satisfy a materiality threshold of 1% of the annual revenue from standard control services in the financial year in which the event occurs.

3.50 The Commission is satisfied that the materiality threshold has been met. Relevant calculations are set out in Chapter 4.

Commission’s draft decision

3.51 The Commission considers that the implementation of recommendations arising from the Independent Enquiry into Casuarina Substation Events and Substation Maintenance across Darwin (Davies Review) satisfies the requirements for a cost pass through set out in the Networks Pricing: 2009 Regulatory Reset – Final Determination:

a) 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

b) the findings of the Davies Review identified an unanticipated degradation of the network assets, which resulted in the PWC Board having no other rational option but to take immediate remedial action to ensure the ongoing security of the network.

3.52 Consistent with clause 71 of the NT Network Access Code, the Commission considers that the cost pass through event, the recommendations of the Davies Review, is an extraordinary development 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;
- 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
- the on-going commercial viability of the network provider.

3.53 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.

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 includes 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 direct 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%;
- 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 cost pass through 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 is 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 includes 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 NPD (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 argues 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 proposes 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 assessment

4.15 The Commission remains unconvinced 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 is 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 Territory Government through the Statement of Corporate Intent (SCI) process, the Commission's view is 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 considers that PWC has 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 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 were directly attributed to the Davies Review appear 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 appears unreasonable or inefficient for implementing specific recommendations and projects (operational and capital);
- summary of actual and forecast costs (operational and capital) which are directly attributable to the Davies Review recommendations.

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

4.24 The Commission has 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' Report recommendations
- project scope components unrelated to Davies' Report recommendations
- distribution system augmentation
- purchase of spares above the levels required
- 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' Report. 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' Report.

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

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

4.30 PB recommended that the Commission considers 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 were 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 views is that such an assessment would require significant resources and not result in a material change.

4.33 The Commission has 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 related and other) that has been undertaken in recent years.

Calculation of appropriate cost pass through amount

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

4.35 PWC has 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.[12] Straight line depreciation with an assumed average asset life of 50 years has been applied.

4.36 However, PWC's model applies 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.

4.37 The Commission considers that it is 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 4.4: 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

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

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

Table 4.5: 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	

4.39 The 2009 Network Price Determination included a single-year 'cost of service' building block 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% was used.

4.40 However, for the purposes of this cost pass through application, the equivalent pre-tax real WACC of 6.82%, as calculated by the Commission in its Po Adjustment Model[13] accompanying the 2009 Network Price Determination, has been used as the asset base roll forward includes an allowance for indexation.

Table 4.6: 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**

4.41 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.

4.42 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%, as calculated by the Commission in its Po Adjustment Model accompanying the 2009 Network Price Determination, has been applied.

[13] 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 4.7: 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**

Materiality

4.43 The Commission's 2009 Network Price Determination provided that the Commission would only consider a cost pass through application if it at least satisfies the materiality threshold of 1% of the annual revenue from standard control services in the financial year in which the event occurs.

4.44 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.

4.45 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%, then escalated by CPI-X each year. The estimated CPI is that set out in Table 4.4 above, and an X factor of -0.85% was determined by the Commission. An estimated annual quantity growth of 2.50% has been used, consistent with the estimated quantity growth used by the Commission in assessing financial viability in the 2009 Network Price Determination.

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

Table 4.8: 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%**

Recovery of cost pass through amount

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

- $30.0 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.

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

4.49 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.

4.50 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%, 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.

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

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

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

4.53 Based on the parameters set out above and an estimated average quantity growth of 2.5%, the "C" factor required for PWC to recover the first stage of the approved cost pass through amount is 24.4%.

4.54 The Commission acknowledges 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%, PWC will not recover the full amount, while should growth exceed the Commission's estimate, then PWC will receive a windfall.

4.55 Commission will reflect further on this matter before making its final determination and welcomes comment on viable alternatives.

Commission's draft decision

4.56 The Commission considers that the approved cost pass through amount should be $65.26 million, which includes an adjustment for the time cost of money.

4.57 The Commission considers that PWC should recover the approved cost pass through amount in two stages:

- $30.0 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.

4.58 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%, in accordance with the Commission's 2009 Network Price Determination; and

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

4.59 The manner in which remaining amount of $35.26 million 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[14] 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.

Other matters raised by PWC

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

5.6 Firstly, 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 over expenditure at the commencement of the fourth regulatory control period.

5.7 The Commission addressed this matter in its Framework and Approach for the 2014 Network Price Determination[15].

5.8 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.

5.9 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.

---

[14] 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.

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

5.10 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.

5.11 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.

5.12 Again, the Commission addressed this matter in its Framework and Approach for the 2014 Network Price Determination[16].

5.13 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 service provider's decisions and actions.

5.14 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.

5.15 General regulatory practice to date[17] has been for a return on and return of (depreciation) assets resulting from capital expenditure over that allowed for in the 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.

5.16 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

5.17 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.

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

---

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

[17] 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.