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Ms Kimberlee McKay
Director
Utilities Commission NT
Via email: utilities.commission@nt.gov.au

Dear Ms McKay,

Consultation Paper – review of proposed 2024-27 system control and market operator consultation paper

The Northern Territory Electricity System and Market Operator (NTESMO) appreciates the opportunity to respond to the Commission's Review of proposed 2024-27 system control and market operator consultation paper (consultation paper), published on 3 June 2024.

We understand the Commission's consultation paper seeks to identify stakeholder feedback to inform the development of its draft decision in relation to NTESMO's regulatory proposal. The consultation paper also demonstrates the Commission's insight and intent to establish a fit for purpose and robust economic regulatory framework for NTESMO for the proposed regulatory period and for the future.

We support this approach and agree with the majority of the Commission's initial positioning on its proposal. This letter and Attachment A constitutes NTESMO's submission.

As you are aware, NTESMO is responsible for operating the Northern Territory's electricity market and power systems. The operation of the electricity market and NT power systems is governed by a range of national and Northern Territory legislation, including a national set of energy laws and rules and NT guidelines, standards and procedures. NTESMO's key functions include:

- System Control, overseeing the safe, secure and reliable operation of the power system
- facilitating wholesale trading arrangements between generators and retailers, through the Interim Northern Territory Electricity Market (I-NTEM)
- registering all market participants (retailers and generators) operating in the I-NTEM
- market settlements that involve calculating and issuing invoices to retailers and credit notes to generators
- daily publication of market prices and other wholesale trading data.

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In late December 2023, NTESMO submitted its regulatory proposal for the three-year period, from 1 July 2024 to 30 June 2027. Charges for the first year of the regulatory period (1 July 2024 to 30 June 2025) are covered by interim arrangements approved by the Commission in November 2023, which roll forward approved regulated charges for 2023-24, adjusted for inflation. NTESMO's current regulatory proposal submits proposed system control and market operator charges for 2025-26 and 2026-27 to the Commission for approval.

NTESMO's proposal seeks to ensure a more transparent and formal economic regulatory framework is adopted and applied, largely based on the national economic regulatory approach for electricity and gas network applied by the Australian Energy Regulator (AER).

This approach involves a step up in complexity regarding the calculation of required revenue relative to the approach taken for the current 2019-20 to 2023-24 period, including a proposed mechanism for recovery of capital expenditure over time, recovery of historical overspends, and recovery of an estimated shortfall in revenue relating to the interim arrangements for 2024-25.

Given that a clear and future economic regulatory approach is being developed through assessment and consultation on NTESMO's regulatory proposal, we encourage the Commission to continue to collaborate with NTESMO over key regulatory design questions throughout the process.

If you have any questions or wish to discuss this response further, please contact Ms Taryn Maroney, General Manager Regulation, Economics and Pricing on 08 8936 4617 or via email taryn.maroney@powerwater.com.au.

Yours sincerely

Djuna Pollard
Chief Executive Officer

19 July 2024

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Attachment A – NTESMO response to the UC's consultation paper questions

Design and Approach

Question 1

Do stakeholders agree the building block model is an appropriate method to calculate NTESMO's allowed revenues for the upcoming and future regulatory periods? Why or why not?

NTESMO agree with the Commission that the revenue building block model is the most appropriate method to calculate NTESMO's allowed revenue. This is particularly the case now that system control and market operator functions costs are no longer based on just forecast operating expenditure as was the case for the previous regulatory proposal.

The revenue building block approach is the accepted and standard methodology used by regulators in Australia and internationally to determine the efficient level of revenue regulated utilities require.

A building block approach ensures all costs are recovered by the regulated party, has clearly defined components which stakeholders can understand and provides a stable and clear framework for revenue determinations.

Time Period

Question 2

Do stakeholders agree NTESMO's proposed 3-year regulatory period (for the upcoming period only) is reasonable? Why or why not?

NTESMO agree a shorter three-year regulatory control period is reasonable given the level of uncertainty and changes expected to take place in these years as the Territory Government considers implementing significant electricity market reforms that are likely to impact NTESMO.

NTESMO agree with the Commission that once this current period of uncertainty passes, that reversion back to a five-year regulatory control period is reasonable.

Corporate Overheads

Question 3

Do stakeholders agree NTESMO's proposed approach to corporate overheads reasonable? Why or why not?

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NTESMO agree with the Commission's view that the cost allocation methodology applied by NTESMO is reasonable.

The first stage of cost allocation is to attribute identified indirect costs to Power and Water's business units consistent with the AER approved CAM. Therefore, there is no double counting as shared costs have been allocated consistently across lines of service including to core operations. That is, there is not a separate or different approach to allocating overall indirect costs to Core Operations for the specific purposes of the NTESMO Regulatory Proposal that may potentially give rise to instances of double counting.

The Core Operations CAM further allocates overheads to regulated and unregulated activity (which is excluded) is in line with the causal drivers in the AER approved CAM.

Operating Expenditure

Question 4

Do stakeholders consider NTESMO's proposed base-step-trend approach to forecasting operating expenditure, with the base year to be set as the most recent year of audited actual operating expenditure is reasonable? Why or why not?

NTESMO agree with the Commission that the base step trend approach proposed in the Regulatory Proposal is reasonable.

The proposed base step trend approach breaks down expenditure into distinct components, the base level of efficient expenditure, one-off or incremental step changes in costs due to specific changes in operational requirements due to such things as regulatory changes and the trend in expenditure over time due to such things as inflation and changes in demand.

NTESMO considers this approach provides a clear and transparent framework for forecasting operating expenditure and, importantly, allows the flexibility to adapt ongoing forecasts for changing market and regulatory conditions.

Question 5

Do stakeholders agree NTESMO's application of CPI to escalate professional fees, residual costs, and graduate and undergraduate contracts over the upcoming regulatory period is not appropriate? Why or why not?

NTESMO does not consider there is a double application of CPI apportioned to professional fees, residual costs, and graduate and undergraduate contracts over the upcoming regulatory period.

CPI was used as the appropriate labour escalator in the absence of other reliable measures of cost escalation for those identified costs.

NTESMOs revenue model inputs costs in real terms and applies a weighted average escalator adjusted to real terms (i.e., adjusted for CPI) to reflect the real escalation in costs for professional fees, residual costs and graduate and undergraduate contracts over the regulatory control period. Therefore, the impact of CPI is removed from the escalation in real costs meaning that the real increase in costs for professional fees, residual costs, and graduate and undergraduate contracts over the upcoming period is notionally zero.

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Question 6

Do stakeholders support inclusion of a productivity factor within the regulatory framework, to be applied in future regulatory periods? Why or why not?

NTESMO did not propose the inclusion of a productivity factor in the regulatory proposal given the level of uncertainty surrounding forecast expenditure in the forthcoming regulatory control period. As such, NTESMO agree with the Commission's preferred position to set the annual productivity adjustment to zero for the forthcoming regulatory control period.

However, NTESMO do support the inclusion of a reasonable productivity factor in future regulatory control periods.

The application of an annual productivity factor to operating expenditure aligns with the AER's approach and potentially drives operational efficiencies over time reducing costs to customers and government.

NTESMO is interested in understanding from the Commission what its preferred approach is to setting a productivity measure for future regulatory control periods. NTESMO's preference is for the most recent measure as applied by the PWC AER revenue determination. This provides a simple and transparent approach.

Capital Expenditure

Question 7

Do stakeholders support NTESMO's proposed approach to capitalisation? Why or why not?

Under Australian Accounting Standard (Standards) 138 Intangible Assets (Standards), capitalisation of costs can only begin when a project enters the development phase. That is, the project has met several criteria including:

- **Technical feasibility.** The project is technically feasible to complete.
- **Intention to complete.** Usually an approved business case.
- **Ability to use.** Ability for the entity to use the asset in the future.
- **Future economic benefit.** Ability of the asset to be able to generate a future economic benefit.
- **Availability of resources.** The entity has adequate financial and technical capability to complete the project.
- **Reliable measurement of costs.** The expenditure attributable to the asset can be reliably measured.

Research phase costs are initial project activities typically focused on obtaining new knowledge and understanding without plans for immediate commercial application.

Typically, research phase costs under the Standards cannot be capitalised even if they are incurred with a view to a project eventually having a commercial application. The Standards require that all research phase costs be expensed as incurred, regardless of the potential commercial benefits.

Given the unique nature of some of the software specifications and solutions required for the proposed transitional tools, settlement system and Territory Dispatch Engine projects, a significant component of historical and forecast expenditure prior to project approvals would likely be considered research phase costs under the Standards.

Application of the Standards in this case would have significant implications for customer charges in the near term. Practically this would mean all costs prior to project development phase would need to be expensed immediately in the year in which they are incurred and therefore passed on immediately to customers through NTESMO charges.

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As noted in NTESMO's Regulatory Proposal, a more pragmatic and customer focussed approach is to capitalise these early research phase costs over the period of future economic benefit. This means these costs can be amortised over the life of the asset reducing any initial customer price shock.

Question 8

Do stakeholders agree that the third capital expenditure assessment approach is the best option given the electricity market reform uncertainties as they relate to NTESMO Why or why not?

NTESMO is supportive of the Commission's preferred approach to apply an ex-post review. Given the level of uncertainty regarding the capital expenditure requirement to meet future regulatory obligations, a mechanism to review the prudency and efficiency of the capital projects undertaken at the end of the regulatory control period seems reasonable.

NTESMO would need to understand the proposed process further, noting that there can be a significant administrative burden with ex-post reviews as these can be resource intensive and require detailed documentation and review.

Specifically, NTESMO would need to understand further the proposed criteria against which the Commission will undertake any ex-post review of capital expenditure. The expectation is that the Commission would at a minimum take into consideration a number of measures consistent with the AER ex-post review approach including:

- The level of information that was available to NTESMO at the time that it undertook the relevant expenditure?
- NTESMO's capital expenditure performance against approved allowances over time?
- Were there appropriate project planning and governance in place?
- How does the expenditure benchmark against other network service providers?
- Did the overspend meet the capital expenditure criteria under the National Electricity Rules?

NTESMO welcomes a well-designed process which ensures accountability and improves investment planning over time.

Question 9

Are there any other approaches the Commission should consider in terms of assessing NTESMO's proposed capital expenditure?

NTESMO is not proposing any other approaches the Commission should consider in terms of assessing NTESMO's proposed capital expenditure.

Return of Capital

Question 10

Do stakeholders have any concerns regarding NTESMO's proposed capital (depreciation) approach? If so, what are the concerns?

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NTESMO agree with the Commission's view to apply straight-line depreciation and the use of AER standard asset lives as the most simple, transparent, and equitable approach.

Using a straight-line depreciation approach ensures the cost of the asset is allocated evenly over the life of the asset providing for predictable and stable cost recovery over the useful life of the asset.

Applying standard asset lives consistent with the AER is transparent and will simplify the regulatory process and avoid the need for extensive assessment and justification of asset lives for each type of asset included in the asset base.

Return on Capital

Question 11

Do stakeholders agree the WACC value calculated by the AER for PWC's regulated electricity networks should be used rather than that proposed by NTESMO? Why or why not?

For the regulatory proposal NTESMO applied the methodology in the AER's Rate of Return Instrument consistent with the approach applied for AER revenue determinations to derive the nominal WACC for each year of the next regulatory period. This included methods for incorporating recent market data, and a trailing average portfolio method to calculate the return on debt.

Given the time and cost requirements in calculating a WACC value using the AER rate of return instrument, NTESMO agree with the Commission's view that application of the WACC value calculated by the AER for Power and Water's recent network revenue determination is reasonable.

Noting that NTESMO's expectation would be that the WACC value is updated each year for the trailing debt average each year of the regulatory control period to more accurately reflect the cost of debt that NTESMO faces over time.

The AER updates WACC annually during the regulatory period. Each year the cost of debt component of the WACC is recalculated based on the trailing average approach which considers the actual cost of debt over the prior 10 years.

However, noting in NTESMO's case that the preferred approach would be to transition over time to a 10 year trailing average approach. Under this approach, the trailing debt average would only reflect the average cost of debt over the period from when NTESMO initially funded capital projects with the expectation over time that the trailing debt mechanism would eventually move to a 10 year rolling average. This approach would reasonably allow NTESMO to recover at least our efficient debt financing costs.

This approach would align with the AER's methodology and ensure WACC more readily reflects current market conditions and encourages more prudent debt management over time rather than relying on timing the market.

Tax Allowance

Question 12

Do stakeholders have any concerns regarding NTESMO's proposal regarding the tax allowance?

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NTESMO agree with the Commission's view that it is reasonable to include a tax building block in the revenue allowance to ensure the shareholder receives the required after-tax return.

This approach is consistent with the AER revenue building block approach which incorporates a tax building block to account for tax as a component of a regulated utility's overall operating costs.

Uncertainty Mechanism

Question 13

What are stakeholder's views on the application of the list of information, requested under the NT NER, for the Commission to determine whether an uncertainty mechanism event has occurred? Is there anything additional that should be included?

NTESMO agree in principle with the application of an uncertainty mechanism to address uncertainty around future material expenditure.

NTESMO also agree that the list of information under the NT NER is reasonable for the Commission to determine whether an uncertainty mechanism event has occurred.

Question 14

What are stakeholder's views on the application of the list of events, used by the AER, to NTESMO? Are there any additional events that should be considered?

Adopting the list of cost pass through events used by the AER would appear to be a reasonable approach. NTESMO will need to consider further if there are any specific additional events that may need to be contemplated by the Commission.

Question 15

What are stakeholder's views on the application of a materiality threshold? If supported, what would a reasonable materiality threshold be given NTESMO is an 'asset light' entity?

NTESMO would support the establishment of a materiality threshold to be applied to uncertainty mechanism events occurring over the relevant regulatory year.

NTESMO will need to consider further and work with the Commission to understand what reasonable materiality threshold could be applied.

Incentives

Question 16

Do stakeholders agree with the Commission views to not consider NTESMO performance incentives for the upcoming regulatory period? Why or why not?

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NTESMO agree with the Commission's view that no performance incentives should be applied for the forthcoming regulatory control period.

NTESMO agree with the Commission's view that once there is greater certainty regarding the electricity supply industry in the Northern Territory, performance incentives may be considered as an enhancement to the framework in future regulatory control periods. NTESMO looks forward to future discussions with the Commission regarding achieving the core outcomes for the system control and market operator functions and how monitoring and measuring performance can be effectively and efficiently achieved.

Question 17

Do stakeholders support the proposed cost incentive approach? Why or why not?

NTESMO agree with the Commission's initial position to support the cost incentive approach proposed by NTESMO. NTESMO are of the view that this represents a simple and pragmatic approach which encourages expenditure efficiencies over time.

Regulated Charges

Question 18

Do stakeholders agree with NTESMO's proposed approach for calculating regulated charges? Why or why not?

The NTESMO Revenue Model is a 'post-tax revenue model' (PTRM). When developing such a model, different cash flow timing assumptions can be used, with different regulators adopting different assumptions from time to time.

Recognising this, NTESMO opted to align the timing assumptions in the NTESMO Revenue Model with the version of the PTRM that the AER applies to Power and Water's regulated electricity distribution services. Power and Water have sought to align the revenue modelling applied across all of Power and Water's regulated services to ensure consistency of treatment.

The AER's PTRM adopts the following cash flow timing assumptions:

- revenue is received at the end of the year
- capex is incurred over the year
- opex is incurred at the end of the year.

The AER describes its capex timing assumption and why this leads to the need for a half year of WACC as follows (pages 22-23 AER DNSP PTRM handbook):

> *"Capex is assumed to be incurred evenly throughout the regulatory year and therefore a timing assumption is adopted that on average places capex half-way through the year. However, the PTRM calculates the return on capital based on the opening RAB for each regulatory year and capex is not added to the RAB until the end of the regulatory year in which the expenditure on the asset is incurred. To address this timing difference of modelling the real capex, a half-real vanilla WACC is provided (capitalised and recovered over the life of the assets) to compensate for the six-month period before capex is included in the RAB. This is calculated using the specific half-real vanilla WACC applying to the year in which the expenditure is incurred."*

Importantly, the AER has recognised that its capex timing assumption (or the PTRM cash flows more generally) is favourable to DNSPs and that this favourable treatment compensates DNSPs for both:

- working capital costs
- indirect debt raising costs.

This is why the AER has not provided allowances for these costs in the past.

On working capital costs, the AER notes (page 27 of the AER DNSP PTRM handbook):

> *"As a result of the PTRM's particular timing assumptions, i.e. all cash flows with the exception of capex are assumed to occur at the end of each regulatory year, there is no need to provide DNSPs an allowance for working capital in the modelling."*

On indirect debt raising costs, which refer to the costs of meeting early debt refinancing and liquidity requirements, the AER has stated (e.g., page 16, Draft decision for SA Power Networks for the 2020-25 period, Attachment 3):

> *"We note that we previously considered and rejected these indirect costs on the basis that the PTRM's timing benefits already fully compensated for them. We acknowledge CEG's submission that the PTRM's timing benefits have decreased due to a falling WACC. However, we are not satisfied that including either category of costs in the debt raising costs benchmark is necessary to compensate a service provider for the efficient costs of raising its debt. Our updated modelling continues to indicate that the PTRM's timing benefits fully compensates for CEG's proposed indirect costs."*

NTESMO concluded that if we were to adopt alternative timing assumptions, we would need to consider factoring these other costs (i.e., working capital and indirect debt raising costs) into the modelling in same way. NTESMO considered it was preferrable to align the revenue modelling approach with that used by the AER.

Recovery of Previous Overspends

Question 19

Do stakeholders agree with the Commission's initial view not to accept NTESMO's proposal regarding its opening RAB value for the current 5-year regulatory period (2019-2024), and instead set the value as zero? Why or why not?

NTESMO's view is that updating the 2014 PWC corporate-wide RAB valuation as proposed, which included allocating a portion of the existing regulatory value of corporate assets to the system control function to provide an opening RAB value for 1 July 2019, is a reasonable approach.

By not apportioning a reasonable regulatory value to the system control function, effectively the broader PWC business is funding a proportion of assets where reasonably the recovery of these costs should be through system control charges.

Question 20

Do stakeholders agree with the Commission's initial view to apply the proposed cost incentive approach to NTESMO's full overspend, consistent with the proposed approach to future any future overspends? Why or why not?

NTESMO will need to consider further the implications of the proposed options. However, NTESMO is not supportive of the Commission's position to apply the ongoing cost incentive approach to the overspend on opex in the 2019-24 regulatory control period.

As noted in NTESMO's Regulatory Proposal and since the Commission's 2019-2024 determination, there were significant change factors that required NTESMO to incur additional costs. These largely related to the need to manage increasing renewable technologies in the NT power systems, the need to update our settlements system to meet our compliance obligations, and the need to support rule developments and NTEM design. In the absence of expected NTEM reform, there was no trigger to recover these additional costs.

NTESMO is of the view that these costs should be allowed to be clawed back if it is considered that the expenditure was prudent and efficient.

Question 21

Do stakeholders agree that the difference between actual revenues in 2024-25 and allowed revenues (as determined by the Commission) be added to NTESMO's RAB and depreciated across a set 'asset life' or seven years? Why or why not?

NTESMO maintains its initial position to allow approved costs to be added to the RAB and depreciated across a set 'asset life.'