25 October 2012

Mr Richard Khoe
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Richard

ERC0134/ERC0135: TRANSITIONAL ARRANGEMENTS

CitiPower and Powercor Australia (**Businesses**) are pleased to provide this submission in response to the Australian Energy Market Commission (**AEMC**) *Consultation Paper on Savings and Transitional Arrangements* of 14 September 2012 (**Consultation Paper**).

The Businesses could comfortably submit their regulatory proposals under the Commission's proposed National Electricity Rules for Distribution (**proposed Rules**) and consequential new guidelines. However, the Australian Energy Regulator (**AER**) informed the Businesses that timing constraints on the AER and other stakeholders originating from necessary transitional arrangements for the New South Wales Distribution Network Service Providers (**DNSPs**) would not allow proper consideration of the Victorian DNSP regulatory proposals due to resourcing constraints. The AER believes that a one-year transition for the Victorian DNSPs is preferable. Accepting this, the Businesses are keen to identify a transitional arrangement which best meets the stated AEMC's principles.

There are two broad approaches to setting prices / revenue for a transitional year in Victoria:

1. **Mini Electricity Distribution Price Review (EDPR)**: The transitional year becomes a one-year regulatory control period with a mini-EDPR process to determine prices / revenue in that year. The approach put forward in the AEMC's Consultation Paper is consistent with this approach.
2. **True up:** The transitional year is the first year of the next five-year regulatory control period. Placeholder prices / revenues are determined for the transitional year and then later trued up to the allowances in the final determination for that regulatory control period. The approaches put forward by Transgrid, the AER and the mechanistic and hybrid approaches discussed with the industry are consistent with this approach.

The Businesses are of the view that the true up option is preferable. Below is an assessment of the two broad options, applying the AEMC's principles:

- **Final rules should apply to all service providers as soon as possible:** Both options would allow for the final rules to apply in Victoria. Both transitional options may require suspension of certain incentive schemes in the transitional year.
- **Sufficient time for stakeholder consultation:** The true up option provides a greater opportunity for stakeholder consultation on the final allowances in the transitional year because the final allowances would be determined under a full determination process rather than a mini-EDPR.
- **Recovery of efficient costs:** The true up option is more likely to result in recovery of efficient costs because more time is available to determine efficient costs and the AER will be able to consider expenditure allowances for the transitional year in the context of a five year proposal.
- **Resourcing constraints**: The mini-EDPR process would need to be more robust than the true up process because the mini-EDPR process will be the only process for determining allowances in the transitional year. The true up option only determines placeholder prices / revenue in the transitional year, which is later trued up to the final determination allowances.

The Businesses propose the following key elements of a true up approach for Victoria:

- The next regulatory control period would be the same as that with no transition, that is, 1 January 2016 to 31 December 2020.
- The true up approach would apply to standard control services, services currently regulated under the Victorian AMI Order in Council (AMI services) and alternative control public lighting services. All remaining alternative control services would have their prices rolled forward into the transitional year at CPI + 2% with no true up (most alternative control services are labour rate based and labour costs tend to increase at a faster rate than consumer prices).
- The control mechanism for the next regulatory control period, which is decided through the framework and approach process, would also apply in the transitional year. The specified method of true-up should be sufficiently flexible to accommodate different control mechanisms.
- The rate of return for the next regulatory control period would also apply in the transitional year. The framework and approach process would determine the cost of debt methodology. The measurement period for any relevant market observable rate of return parameters[1] would need to be proposed by the DNSP and approved by the AER prior to the submission of the regulatory proposal. It is proposed that the DNSP would propose this period one month after the framework and approach paper is finalised and the AER has one month to approve or reject

[1] To the extent that any rate of return estimates rely on prevailing conditions, it will be conditions that are prevailing at the time of the measurement period which are relevant. Information available between the measurement period and the final determination should not be considered by the AER.

the DNSP proposal. The nominated averaging period is confidential and dependent on the cost of debt methodology and therefore cannot readily be dealt with in the framework and approach paper.

- Placeholder prices / revenue for the transitional year would be decided with minimal effort and no consultation because they will be trued up. However, placeholder prices /revenue should not exacerbate price volatility. It is proposed that the DNSP nominate in its regulatory proposal one of the two following options for setting placeholder prices / revenue:
    - Placeholder prices /revenue determined based on a rules-specified mechanistic approach. For example, last year of current regulatory period revenue requirement adjusted for a placeholder WACC, the opening RAB updated with actual capital expenditure as reported in the RIN for the first four years of the current regulatory control period, and CPI escalation. The placeholder WACC would be updated for any relevant market observables during the measurement period. The AER would provide an example PTRM calculation of the mechanistic calculation of prices / revenue with the framework and approach paper, to clarify the calculation method; or
    - Propose-consider approach where placeholder prices / revenue are determined by the AER starting with the DNSP proposed building block revenue requirement (including revenue increments and decrements arising from incentive schemes in the current regulatory control period). The AER would consider the first year of the DNSP's regulatory proposal and make a determination on placeholder prices / revenue without any draft determination or consultation. As a minimum, the AER would update the proposed rate of return with one that is based on the market observables in the agreed measurement period. The overriding AER consideration will be to minimise price volatility over the regulatory period within its resourcing constraints.

- For avoidance of doubt, the Businesses do not believe it necessary to true-up to actual opex and capex in the transitional year, or for the capex and opex allowances for the transitional year to be set ex-ante.

- Connection policies would be based on the new Rules and guideline.

- The Service Target Performance Incentive Scheme (**STPIS**) factor arising from service performance in the penultimate year of the current regulatory control period will be applied to placeholder prices in the transitional year, but will not form part of the true-up process.

- The distribution STPIS scheme would apply in the transitional year with the transitional year target deemed to be the target that applied in the last year of the previous regulatory control period, with the same amount of revenue at risk. The Businesses consider that it is fundamental to incentive regulation that a service performance incentive scheme is applied during the transitional year. Further, the Businesses consider that it would be relatively simply to apply the incentive scheme for the transitional year.

- The Victorian F-Factor scheme should be able to continue to operate in the first year of the transitional regulatory period by rolling over existing targets and incentive rates.
- Expenditure incentive schemes would be suspended in the transitional year because the final allowances for that year would be determined in retrospect.
- The transitional rules would ensure that, during the first year, the DNSP would have access to the same pass through events on the same basis as apply in the current regulatory control period. The nominated pass throughs to apply from years 2 to 5 would be determined using the new rules in the full determination.

Attached is a timing diagram consistent with the above proposal.

Alignment to a financial year

Mr Chris Pattas indicated in a meeting with the Victorian DNSPs on 19 October 2012 that the AER did not intend to pursue alignment of the Victorian distributor regulatory year to a financial year. The Businesses take comfort from this assurance, given that:

1. Two of the five Victorian distributors, CitiPower and Powercor Australia, have a statutory reporting year which is aligned to the regulatory year. There would be transitional costs associated with changing systems and processes to report regulatory information on a financial year and ongoing internal costs associated with planning and reporting with the permanent misalignment.
2. Two of the five Victorian distributors currently have a statutory reporting year ending 31 March which means that an alignment of the regulatory year to a calendar or Australian financial year would not result in alignment with their statutory reporting years. These businesses would incur transitional costs associated with change without receiving any benefit.
3. The one Victorian distributor with a statutory reporting year which is aligned to the Australian financial year (United Energy Distribution), indicated in the AER meeting that it would prefer to retain the current regulatory year because of the transitional costs associated with change.
4. The alignment could only occur by including a half-year in a regulatory control period. This would add complexity to the determination and potentially distort incentive schemes which are designed to only accommodate a full year.

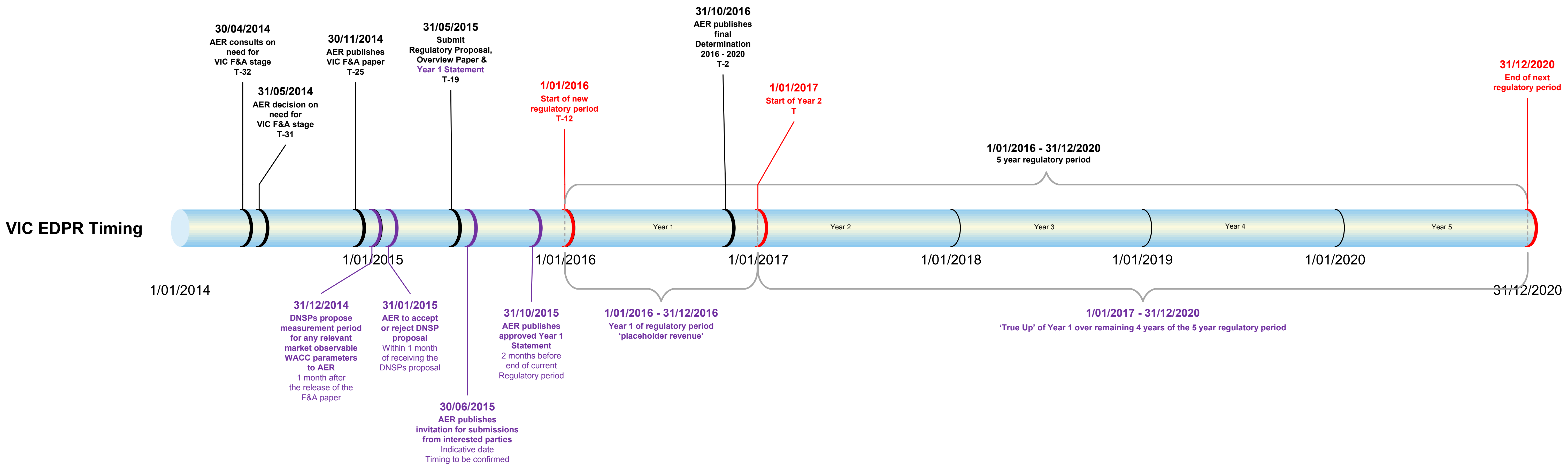
Please contact myself on 03 9683 4508 or Mark de Villiers on 03 9683 4907 if you have any questions.

Yours sincerely

[signed]

Richard Gross
GENERAL MANAGER REGULATION

Victorian Electricity Distribution Price Review (EDPR) Timing Overview



Sources:

- **AEMC draft rule determination, Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, released 23 August 2012**
- **AEMC consultation paper on savings and transitional arrangements, Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, released 14 September 2012**
- **AER Staff working paper – DNSP Discussion Version 18 October – as amended by the VIC DNSPs, 22 October 2012**