2006-2010 ESCoV

ELECTRICITY DISTRIBUTION PRICE REVIEW

OF

THE ELECTRICITY UTILITIES REVENUE

A Response to the ESCoV paper

"March 2005 Position Paper"

by

The Energy Users Coalition of Victoria (EUCV)

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"One suspects that [electricity] suppliers would rather the regulator just worried about the big picture, letting them get on with what they do best:

making money,

and – so far at least – providing efficient and reliable supply" (space breaks inserted)

Chanticleer, (John Durie)

Australian Financial Review, 16 April 2005

referring to the capex observations made by the ESCoV in its Position Paper on the EDPR, March 2005

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INTRODUCTION

The Energy Users Coalition of Victoria (EUCV) is a major energy end-user group formed with the specific purpose of addressing the current applications for access arrangements by gas and electricity service providers in Victoria. Its members are Ford, Holden, BlueScope Steel, OneSteel, Air International, Toyota and Unidrive. Additionally the members of the EUCV consider that their efforts in driving for competitively priced energy and energy network services will positively impact on the input costs incurred by their many suppliers, and provide benefits to the Victorian manufacturing sector.

EUCV welcomes the opportunity to provide its views on the issues addressed in the Position Paper released in late March 2005 by the Essential Services Commission of Victoria relating to the Electricity Distribution Pricing Review. This review concerns the revenue to be awarded to PowerCor, CitiPower, AGLE, TXU (now a part of SPI) and United Energy (now related to Alinta).

The EUCV would also take the opportunity to thank the ESCoV for the efforts it has taken in clearly and comprehensively summarizing the applications from the five businesses[1], in the clear and concise presentation of the issues[2] arising from these applications, and in the presentation of the Position Paper[3]. These publications have assisted immeasurably in providing informed consumer responses to address the claims for the massive increases in revenues made by the five electricity distribution businesses.

This response from EUCV, while addressing the issues specifically included in the Position Paper, also provides commentary on other important aspects of the applications from the five distribution businesses.

In broad terms, EUCV assesses that the applications from the five businesses will increase costs significantly above levels it considers necessary to provide the electricity distribution service. Our assessment is that as the single largest cost in electricity bills is the payment for electricity distribution services, the increased costs claimed by the electricity distribution businesses will inflate total electricity bills by up to 10%. This is of very serious concern to manufacturing industries (especially EUCV member companies who compete on overseas and domestic markets with overseas producers that either have subsidized energy inputs or other competitive advantages) and all electricity consumers in Victoria. Average electricity costs have increased consistently in Victoria since commencement of the NEM, well above the CPI, such that Victorian electricity costs are the second highest in the NEM, after those in South Australia; electricity costs in NSW

[1] ESCoV EDPR, Summary of price proposals, November 2004
[2] ESCoV EDPR, Issues Paper, December 2004
[3] ESCoV EDPR, Position Paper, March 2005

Queensland and Tasmania are all lower than in Victoria. The cost of electricity distribution is a significant contributor to this state of affairs.

In particular, the EUCV has identified that:-

1. Service levels are so extensively averaged that NSPs can have extremely poor service on specific elements of their network which does not show in the aggregated performance figures but which can have significantly adverse impacts on the consumers connected. More detailed measurements are required so that all consumers can have a degree of certainty that what they pay for will be delivered.
2. Guaranteed service level penalty payments bear little relationship to the cost and inconvenience caused.
3. The over-recovery from poor forecasting and the careful structuring of tariffs by NSPs has enabled them to significantly over-recover revenue in the current period. This has been at the expense of consumers who have effectively paid more for the electricity transport service than was intended by the regulatory bargain set in 2000. Thus forecasting of expected usage and tariff structure is extremely critical to ensuring that the NSPs receive about the target revenue in the coming period. Improvements are clearly required.
4. Despite protestations that regulated returns are too low, NSPs are actively seeking massive increases in capex despite the fact that they had a major underspend of regulated capex allowances in the current period
5. NSPs are seeking increases in opex significantly in excess of inflation, and in spite of the fact that electricity usage is increasing at a far lesser rate than the opex forecasts and the NSPs did not utilize all of the opex granted in the current period.

SUMMARY of EUCV VIEWS relating to the Position Paper

1. In the period 1995-2003 the DBs have underspent their allowances of capex and opex by some $640m and $430m respectively. Despite this they were awarded a major increase in capex in the 2000 review, and their opex was kept at much the same level. They forecast that they needed a major increase in capex and opex last review but never spent it. They are again seeking significant increases and these claims have to be put into context with the allowances they had previously.
2. The DBs are permitted an efficiency carryover into the new period (ie into 2006 year), based on the under-run of capex and opex during this period. As the underrun is essentially only due to the over allowance made by ORG in 2000, the DBs should not get an unearned efficiency carryover benefit in 2006.

3. By tariff manipulation, the DBs scored an over recovery of revenue in the period of 1995-2003 of some $570m, considerably over the revenue expected by the ORG. The tariff structure needs to be such that it returns something approximating the revenue the regulator sets as being reasonable, allowing only for growth changes.
4. The DBs have listed 35 reasons why their opex show be increased in the next period, but many of these reasons are not valid and need to be addressed in detail. Despite these step changes, some of which occurred during the current period, the DBs have still maintained their significant underspend of opex.
5. The DBs have listed 10 reasons why the capex should be increased in the next period, but many of these reasons are not valid and need to be addressed in detail. Despite these step changes, some of which occurred during the current period, the DBs have still maintained their significant underspend of capex.
6. The DBs have claimed a high growth in demand (to support the capex claim) but, as they did in 2000, they have forecast a low growth in volume so the tariffs will be higher. Their success in "shading" the forecasts has in part resulted in an over recovery of revenue.
7. The medium term security of the network has been potentially jeopardized because opex and capex in the past which was claimed as necessary to maintain the network have not been used for this purpose and taken to profit by the DBs. If there is a failure of the network in the future caused by this approach of the DBs, it will be consumers which will suffer, as any loss in revenue of the DBs will be minimal.
8. There are costs (eg for GSLs) which benefit small consumers but are denied large consumers, yet large consumers contribute to the costs of providing these benefits.
9. There are service standards which would bring a benefit to large consumers but there are no measures for these being included in the service standards and therefore are not included in the incentive scheme.
10. The DBs have claimed inputs which lead to higher WACCs. The WACC awarded should be benchmarked against returns earned in a competitive environment.
11. The DBs want a significant element of their costs to be "passed through", yet a number of these costs are already included in the previous levels of opex and capex.

The claims by the DBs are seen to be ambit and as there has been a significant under run against allowed levels of opex and capex, the ESCoV must ensure that the new levels of revenue are just sufficient for the needs. Further, the ESCoV must ensure that any savings that the DBs accrue for the incentive scheme are the result of genuine efforts to be more efficient and effective.

PART A

LESSONS LEARNED AND IMPLICATIONS FOR INCENTIVES

1. OVERVIEW

1.3 Performance over the current regulatory period

The ESCoV seems to imply that it considers that the fact that the DBs significantly exceeded revenue benchmarks to be a sign of good regulatory practice and an appropriate result from the incentive regulatory approach taken by the ESCoV:-

> "On the basis of performance against the cost and revenue benchmarks established at the last price review, **the approach developed by the ORG for the 2001-05 determination appears to have been *remarkably* successful**. The latest cost and revenue information provided by the distributors confirms an industry-wide picture of extraordinary financial out-performance against the benchmarks established by the regulator."[4] (emphasis added).

The Position Paper goes on to point out that the 18% revenue reward gained by the DBs was due in part to getting a greater revenue from the tariff structure used (6% revenue enhancement), underspending on opex and capex (9% revenue enhancement) and reduction in interest rates from that allowed to those incurred (3% revenue enhancement).

Conversely a totally different construction – and one that we consider has greater validity – can be placed on the clear cost out-performance of the DBs. This is that the regulator permitted the DBs:-

- to manipulate the tariff structure to ensure there was an over-recovery of revenue from the tariffs likely to provide a greater income
- the opportunity to under estimate the likely growth in usage, and by doing so allowed tariffs to be set too high
- to successfully argue for excessive opex and capex allowances that the passing of time has shown not to be needed, with allowances significantly above those really needed, and

[4] Electricity Distribution Price Review 2006-10, ESCoV Position Paper March 2005, page 11

- to recover a return which due to the conservative nature of the inputs used, over compensated for the real needs of debt and equity raisings.

The ESCoV notes that:-

> "[The ESCoV] analysis highlights that the routine application of the building blocks framework and approach to the 2006-10 price review — before taking into account any potential step changes in expenditure or distributor service levels — could be expected to bring about substantial real reductions in distribution tariffs. The total value or 'rent' to be shared between the distributors and customers in the form of price-service outcomes is potentially as much as $255 million per year."[5]

It must be remembered that this reduction in opex and capex was made in an environment where demand (the driver of distribution network growth) was expected to increase by 3.4%[6], and this growth rate was actually exceeded[7].

By this over recovery, the regulator effectively permitted the DBs to accrue about $255m per year above the required costs to provide a secure electricity distribution system. This is equivalent to every household in Victoria making an unnecessary "donation" of about $150 to their local electricity distribution company. For this "donation", they have received no additional benefit above that which they notionally contracted to receive, yet the ESCoV suggests that in future this "rent" mighty be "shared" between consumers and distributors. The ESCoV adds that most of this "donation" has little relationship to efforts by the DB, other than their ability to convince the regulator to maximize tariff revenues by careful structuring and enhancing returns. It does however attribute the minimization of expenditure on operations and capital to the DBs whereas an independent observer might consider that there is little effort required to achieve reductions if the amounts awarded are over stated to start with!

A review of the 1995-2000 actual expenditure[8] by the DBs indicates that total capex was of the order of $1400m trending upwards towards the end of the period, and total opex was about $1800m, trending upwards in the final years of the period, after falling significantly during the period. The ORG permitted the DBs an increase in capex of over 40% (after the DBs had claimed well over a 50% increase), and based on benchmarking the ORG effectively maintained the same average level of opex as in the previous period (after the DBs had claimed an increase of nearly 40%), after implying in the draft determination that opex should have been some 13% lower than the final decision. The bulk of the

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[5] Position paper, page 13
[6] Final Decision 2000, table 3.1
[7] Position paper figure 1.4
[8] 2001 Electricity Distribution Price Review ORG Issues Paper, February 2000

revenue over-run from increased capex granted from the previous period, and the increase in the opex granted above the draft decision to the final decision is equivalent to the net “donation” consumers have made to the DBs over the current period. Thus the regulator has made it possible for the DBs to extract unearned revenue at the expense of consumers.

For the ESCoV to claim that because the DBs received this premium in the current period, then consumers can look towards a lower cost in future ignores the fact that consumers have been paying an unnecessary premium for the past five years, and that the saving they might get in the future is really a return to the proper costs they should have been making. For a recovery of the overpayment requires the $255m to be deducted from the appropriate revenue stream set for the next period.

It is therefore incumbent on the regulator to recognize that consumers have been paying a significant premium for the electricity distribution service, and to use this new review as a means to rebalance the revenue permitted to the DBs in favour of consumers, and to ensure that the tariff structure permitted does not allow such an excessive reward to the DBs for “gaming” the tariff structure and the forecast usage.

It is because of this very demonstrable concern of excessive costs being awarded that EUCV has consistently maintained that the average opex and capex for the current period should be used as the basic benchmark for the review and not a single year such as the 2004 expenditure.

1.4 Allocation of risk

In the first 8 years of regulated income (ie since 1995) the DBs have underspent allowed opex by $430m[9] and allowed capex by $640m[10]. Despite this massive underspend the DBs still continue to argue that:-

- earlier savings made are unsustainable
- assets are aging fast and need replacement, and
- the requested increases in new capex and opex are essential otherwise they can no longer maintain current performance levels.

Even though this massive underspend has occurred, the DBs had requested opex of more than $100m pa[11] above the final decision amounts, so that if the ORG had acceded to their request the over run for the eight years since 1995

[9] Position paper figure 1.2
[10] Position paper figure 1.3
[11] Position paper figure 1.2

would have been closer to $750m more than actual opex. A similar trend but a lesser amount applies for capex. None of these massive savings have been returned to consumers!

In addition to the savings the DBs have made in opex and capex, they have recovered additional tariff revenue of $570m[12] above the relevant benchmark in the eight years since 1995. Whist some of this additional revenue can be attributed to a slight increase in volume[13], the bulk of the over-recovery of revenue must have come from other sources, such as tariff re-balancing (read: manipulating) to maximize revenue.

Despite this major under investment in the networks (opex and capex) by the DBs, the ESCoV reports that service performance has increased. There is no doubt that the DBs have maintained a concerted publicity program to convince governments and regulators that they are being underfunded, yet at the same time it can be clearly demonstrated that they are taking major windfalls at the expense of consumers.

A trend analysis (graph 1) of the actual opex since 1995 shows that using forecast 2004 opex as the basis for setting new opex is flawed. The following figure uses data from figure 1.3 of the Position Paper, with data added from the 2005 Issues Paper[14] and the 2000 review Issues Paper[15]. This clearly shows that the DBs consistently request increases in opex above current levels, and that after the review actually underspent significantly (by some $120m) on the forecast opex for year 2000, after the final decision was issued.

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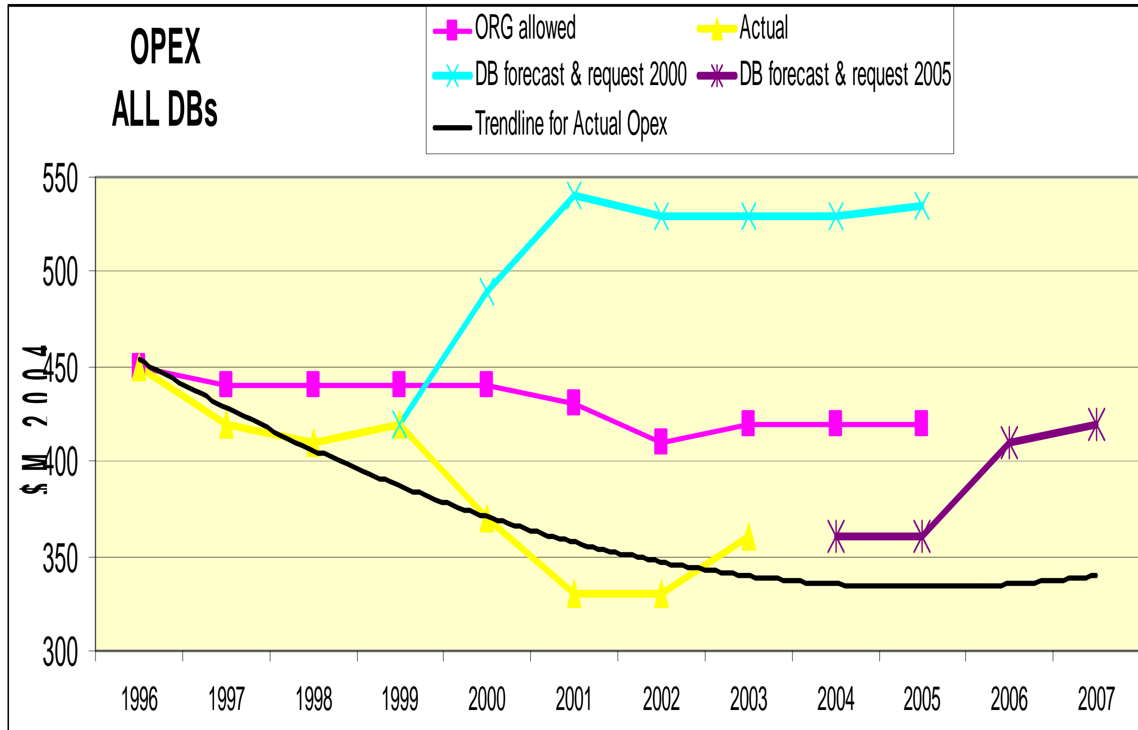
[12] Position paper figure 1.5
[13] Position paper figure 1.4
[14] Tables 3.2 and 3.3
[15] Figure 4



Graph 1

Graph 1 also shows that in 1999 (the equivalent year to the base year 2004 for this review) opex rose slightly above the previous year (despite a consistent fall over earlier years) and then fell dramatically for year 2000, even though the DBs had forecast an increased opex to $450m for that year.

Graph 1 shows that the DBs significantly overstated their needs in 2000, and are doing so again in 2005. The trend line clearly shows that the ORG awarded opex since 1995 has been too high, and that the base opex (without step changes should be some $340-350m, with the arithmetic average of the opex for years 2001, 2002, 2003 and 2004 at $345m pa. Against this backdrop, the DBs are seeking a base opex of $360m, increasing to over $410m when their assessment of step changes is added.

A trend analysis of historic capex (graph 2) indicates that capex levels should remain at about $400m pa across all DBs. Graph 2 is based on data from the Position Paper[16] and the Issues Papers from 2004[17] and 2000[18].

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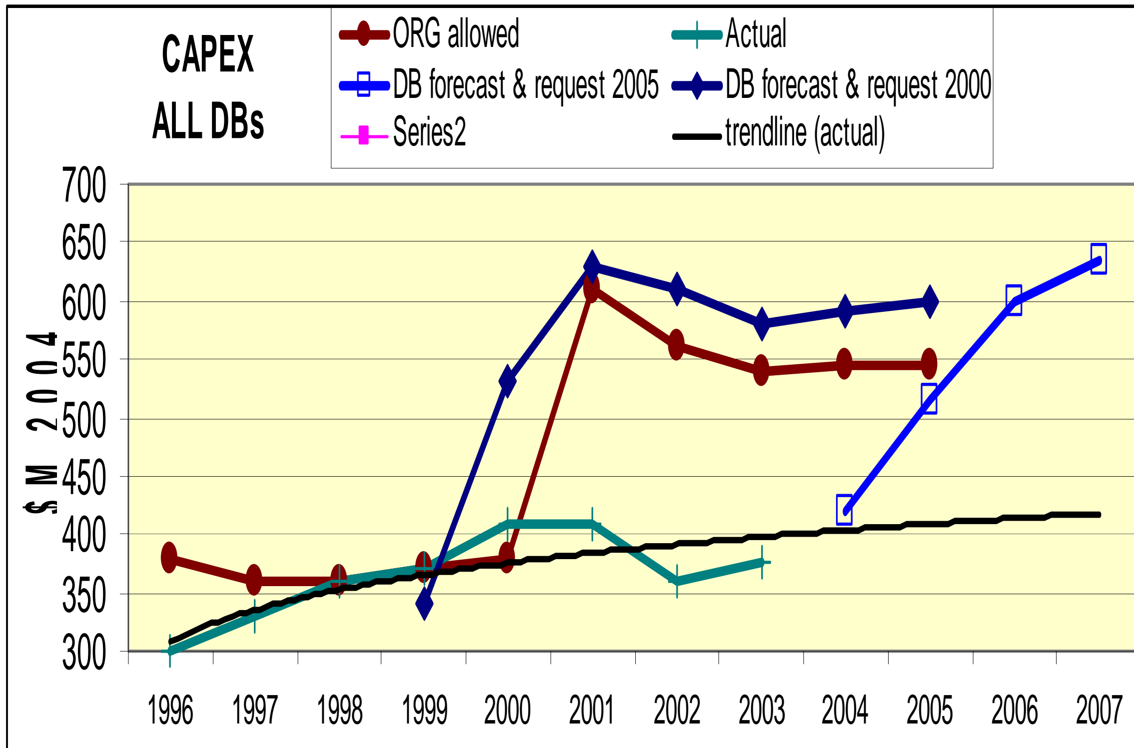
[16] Figure 1.3
[17] Table 4.4
[18] Figure 5



Graph 2

The large capex increase awarded in 2000 was at the behest of the DBs and the amount allowed was only a small amount less than what the DBs had sought. Even so the allowed capex has not been replicated by actual capex although it is interesting to note that whilst all DBs underspent capex in the first three years of the current period, they forecast a major reversal for expected capex in the last two years, no doubt just in time for the review! As can be seen, the large increase in capex forecast by the DBs for 2000 failed to eventuate by an amount well over $100m.

After the 2000 review there was an expectation that capex would significantly climb and ORG allowed for this in the 2000 review, yet the DBs maintained it at 1999/2000 levels. The expected capex for 2004 is in keeping with the trend line, but the forecast capex for 2005 and thereafter bears no relationship to the trend line at all.

These observations clearly demonstrate that consumers were correct in their views that there was little basis for the ORG increasing capex, and not further reducing opex.

1.5 Lessons over two regulatory periods

Of concern to EUCV is that for the last review, the ORG accepted the forecast opex of the DBs for 2000 to be a significant increase[19] on the 1998 and 1999 amounts. In fact the DBs **underspent** the 2000 allowed amount[20] by some $80m effectively reducing the first period opex. A similar result (but to a lesser extent) applies to the capex for all DBs in 2000. Thus ESCoV should be aware that the opex and capex forecasts by the DBs for the 2005 year of the period are not robust or rigorous, and could well be a repeat of the experience over the current regulatory period whereby the DBs will be extracting further savings.

There is no doubt that the DBs have underspent on allowed opex and capex since 1996 (except for a small overrun on capex in 2000. The approach used in the last review was to inflate the second last year expenditure and forecast even higher expenditure in the final year implying “unsustainable savings” in the early part of the period, and transfer some costs to the fourth year and recover this in the final year. The claims from the DBs for the 2005 review follow this same pattern, and as the ESCoV has forecast it intended to use the 2004 expenditure as the starting point for this review, it is quite understandable (but not acceptable from the EUCV viewpoint) that the DBs will attempt the same formula for this review.

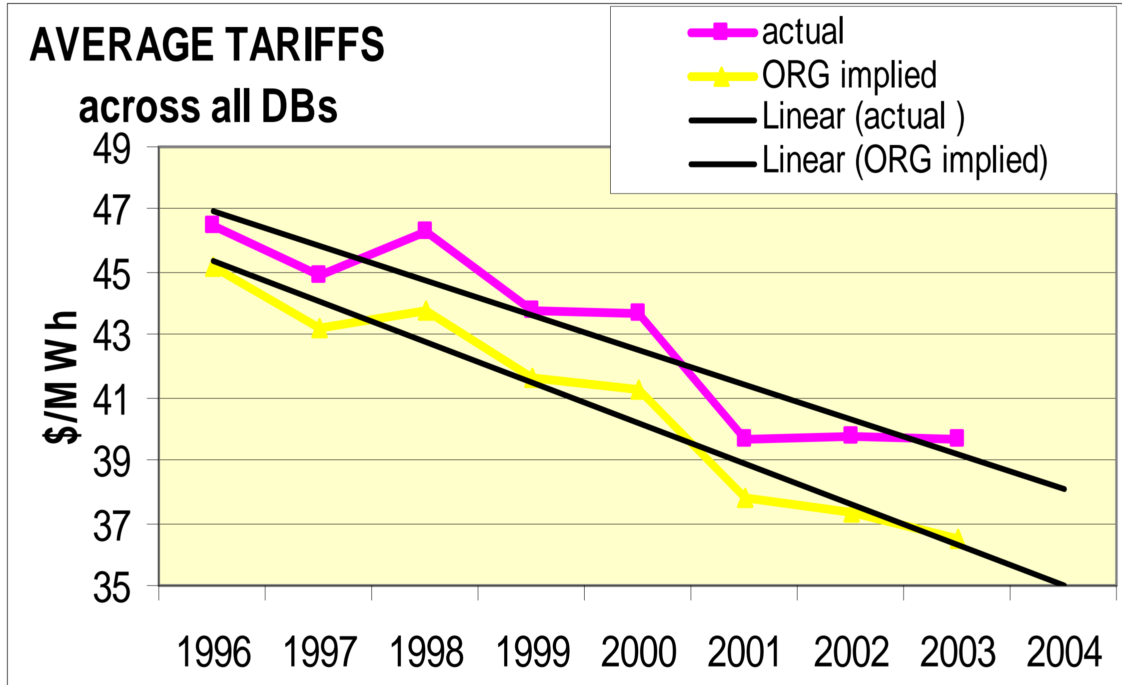
Thus historical assessment of the review process demonstrates that using the latter years as the benchmark for the future enables the DBs to game the process at the expense of all consumers. EUCV member companies cannot accept these manipulations as legitimate costs which they should be required to pay. Whilst every effort is made by EUCV companies (and many others) to increase their energy efficiency, the only other adjustment avenue available to such large and unjustifiable energy cost imposts is through reducing employment.

The results of the over-recovery of revenue are clearly shown in the Position Paper on Figure 1.5. Also Position Paper Figure 1.4 shows that the forecasting of usage was underestimated in the first three years of the current period, with the trend of usage continuing to be above forecasts. If this trend continues, it will result in a continuation of the over-recovery of revenue in favour of the DBs at the expense of consumers.

Extending the data from figures 1.4 (usage in GWh) and the revenue allowed and actually received shows again that consumers have suffered. The following chart (graph 3) shows the average tariffs which result from the data. This shows that the average tariffs related to usage have reduced over time, with a major shift between 2000 and 2001 when the new review was enacted. It also shows that

[19] Position paper figure 4
[20] Position paper figure 1.2

the actual average tariffs show significant rises in the early part of this period, again to the significant disadvantage of consumers.



Graph 3

The trend lines show that the reduction in tariffs is diverging in favour of the DBs with the ORG allowances leading to a 1.1% reduction pa, but the DBs achieving a 10% improvement above the ORG allowances. These reductions in tariffs were readily exceeded by inflation so that in nominal terms consumers have seen only price increases.

In absolute terms the DBs have achieved an over-recovery from tariff mismatch by some $570m in the eight years since 1995. This is a transfer of cash equivalent to $320 per household for this eight year period and several millions from EUCV member companies and other industrial enterprises.

As the DBs also underspent on opex and capex, none of this over-recovery was necessary to increase reliability or performance, and therefore went as unearned profits for the businesses.

This clearly shows that the DBs are well experienced in tariff restructuring to maximize revenue above levels which the ORG expected them to receive.

1.6 Re-specifying the regulatory bargain

The ESCoV states in the position paper (page 20) that:-

> "[It] considers that although the current arrangements have worked well and have delivered important benefits to customers, the experience to date has exposed some persistent problems and emerging concerns regarding the reliance on forecasts and accountability for service provision."

It is true that consumers have seen (in real terms) a continuing fall in average tariffs and therefore the ESCoV can claim some credit for a benefit to consumers, but so much more could have been achieved for consumers without jeopardizing the financial stability of the DBs.

The ESCoV states that the regulatory bargain encompasses price against service performance whilst managing service related risks. The DBs have not incurred any significant cost exposure in risk or its management, but they have improved service performance and taken a massive increase in revenue whist significantly underspending on opex and capex. There does not appear to be much equity in the regulatory bargain, with consumers effectively paying well over the mark for a service which could be provided for much less cash.

The regulatory bargain also requires the DBs to take responsibility for investing to meet long term service performance. Consistently consumers see publicity from supply side representatives bemoaning the fact that regulators consistently are preventing investment in essential services and that premiums are required for investment in networks because of regulatory risk. EUCV considers however that the DBs are already being provided with supra premiums and that it is a misnomer to describe the regulatory bargain as one of regulatory risk. We have demonstrated above that Victorian consumers have had the rough side of the regulatory bargain and it now appears that a repeat performance is in train unless ESCoV takes the necessary action to prevent it.

The Position Paper notes that in order to redress the clear imbalance between the funds provided by the consumers and the revenue and profit maximizing of the DBs, the Commission is proposing[21] to:-

- ensure variations to historic levels of expenditure are clearly supported and linked to service outcomes;
- increase the penalties under the S-factor scheme for not maintaining levels of service by reference to the value of customer reliability and align any rewards to the cost of achieving the improvements capped at the value of customer reliability (VCR);

[21] Position paper pages 21 and 22

- extend the S-factor scheme to include additional measures such as MAIFI (frequency of momentary interruptions) and call centre performance;
- extend the GSL scheme, by reducing the thresholds at which payments are made and increase payments to more closely reflect VCR for residential customers; and
- introduce additional reporting requirements focused on improving transparency and accountability in long term network planning, management and performance.

Whilst these steps are all laudable in themselves, there is still the issue of the excessive over-recovery of revenue and the massive underspend on opex and capex. In addition to the money which has been unnecessarily transferred from consumers to DBs, there is the residual concern that because the investments in opex and capex were not made at the time the DBs stated that theoretically they were needed, is there a risk that because of the actions (or rather inactions) of the DBs in maximizing short term profitability that consumers will be exposed to poorer quality service in the future? At that time it will not be the DBs that will suffer, but the consumers who have paid for the quality but have been denied it by short term profit taking.

As the ESCoV observes later in the Position Paper, the penalties on DBs cannot be sized to reflect the costs incurred by poor performance of the electricity supply to industrial consumers. Yet industrial consumers have been required to pay the cost premiums associated with the intended provision of the investment (opex and capex) stated as being required by the DBs and as permitted by the regulator.

This is an issue in the regulatory bargain that the ESCoV has not addressed, yet the ESCoV blithely discusses the need to incentivise the DBs to provide out performance. It is clear that the current regulatory bargain is heavily weighted in favour of the DBs to the extreme disadvantage of consumers.

Over the years the ORG and now the ESCoV have espoused the benefits of “incentive regulation” and “light handed regulation”. The EUCV has severe doubts as to the efficacy of either of these approaches as it appears that both are used by the DBs to maximize revenue and minimize costs. Any incentive consistently goes to the DBs and is paid for by consumers. Incentive carry-overs are added to future revenue streams for the DBs. There are no countervailing penalties for under funding the network by the DBs yet the outcome will be a penalty on the consumer when the networks fail. This is a clear case of “heads” the DB wins, and “tails” the consumer losses. Where is the equity in the incentive based light handed regulatory regime?

1.7 Longer term refinements to the framework and approach

The ESCoV points out the constraints faced by a regulator as the DBs “talk up” the need for greater expenditure, and “talk down” the forecast revenue[22]. It goes on to accept the essential asymmetry inherent in attempts to rebalance the debates. The ESCoV refers to a “total factor productivity” approach as an attempt to redress this imbalance, but any attempt in this direction requires the starting point to be correct, notwithstanding any inherent shortcomings in using TFP.

The EUCV supports any approach which will reduce the information asymmetry and knowledge imbalance.

At the same time the EUCV sees that where a sincere attempt at “getting it right” has been made there is no reason not to look back and redress any imbalances that can be learned by reviewing past performance. One such approach is the concept introduced by the ACCC when reviewing the ElectraNet SA revenue, where the ACCC will claw back not only the underspend on capex, but the return included in the revenue for such an underspend.

In the eight years since 1995, the DBs have been able to take to profit over $1Bn (’04) of enhanced revenue, and underspend on opex and capex. This is equivalent to every household being required to pay an extra $600 to increase the profitability of the five DBs (or EUCV members and other industrial enterprises contributing many millions of dollars to enhance DB revenues). There is no justification for this to have occurred and the new framework must recover this amount and ensure there is no similar premium placed on consumers.

[22] Position paper page 22

2. ACTUAL REPORTED EXPENDITURE

2.1 Related party transactions

2.1.2 Commission's preliminary view

The Commission is of the view that accurate, credible, historical regulatory accounts provide the basis for effective regulation over the long term. The actual costs incurred by related parties in undertaking activities to fulfil the distributor's licence obligations should be reported, except where those contracts have been appropriately market-tested.

This approach is fully supported. The use of a related party transaction to provide a veil over the ESCoV obtaining accurate data must be prevented. This is becoming a common problem in energy network regulation and the ESCoV would need to be vigilant in establishing a clear precedent for transparency and accountability in network accounts. Market testing must include for verification of costs using demonstrably independent costing carried out in a truly competitive environment.

Where the actual costs have been revealed, the Commission needs to consider an appropriate profit margin to include in its trend analysis in assessing reasonable expenditure proposals.

If costs are competitively tendered, then the tenderer will include in its costs for the markup and profit needed by the service provider. The DB will add its own markup for corporate attendance and this will be shown as a direct opex cost of the DB.

If the work is carried out by a related party and actual costs incurred by the related party are declared there is no competitive pressure on the service provider to contain costs. In this case the opex awarded should be based on benchmarking (competition by comparison). This is no different to awarding an opex to the DB as if it was directly carrying out its own opex. The DB should only award the work to a related party if it can carryout the work for less than the DB would do directly. Thus the use of a related party contract has its own inbuilt profit margin for executing the work. If the ESCoV includes for a margin over costs then it is tantamount to assessing a cost based regulated amount and entering into the realms of heavy handed regulation.

If the work is carried out by the DB using its own workforce there should be no markup or profit as the markup is to provide corporate attendance which is included in the opex.

There is no need for the ESCoV to assess a reasonable profit margin, as it should be either assessing the actual costs based on competitive tendering

or ensuring the expenditure is benchmarked to provide competition by comparison.

> *The Commission also proposes that efficiency gains, regardless of whether they have been obtained by the distributor or through the related party, will continue to be returned to customers as envisaged by the regulatory framework, that is, through the efficiency carryover mechanism, refer Chapter 5.*

This approach is supported by the EUCV. Any efficiency gain that is earned must not be left to enhance the DB or contractor profit margin and should be returned to consumers.

> *As stated above, the Commission will review its Regulatory Accounting Guideline with a view to including more specific guidance in relation to an appropriate form of market-testing for related party contracts.*

This approach is supported by the EUCV.

2.2 Allocation of IT assets

2.2.2 Commission's preliminary view

> *The Commission's view is that distribution customers should not pay more as a consequence of CitiPower's sale process. The Commission expects that the sale/purchase of CitiPower's retail business would have been based on the original allocation of assets to the distribution and retail businesses. Any losses that may have been incurred by shareholders during this process should not now be borne by CitiPower's distribution customers. Furthermore, the adjustment proposed by CitiPower is not consistent with the Commission's approach to rolling forward the regulatory asset base.*
>
> *The Commission therefore proposes to exclude the transfer of IT assets by CitiPower from the retail business to the distribution business, when assessing the historical capital expenditure.*

This view is supported and replicates the views espoused by EUCV in its submission to the Issues Paper.

2.3 Underlying trends in expenditure

2.3.2 Commission's preliminary view

> *The Commission will continue to seek information from the distributors to identify the extent to which expenditure has been reported on a consistent basis from year to year. Where appropriate, the Commission will make adjustments so that the underlying trend in expenditure is used as the basis for assessing expenditure proposals for the 2006-10 regulatory period. When all the information is*

provided, the Commission will seek agreement from the distributors to the adjustments that are made.

This approach is supported by the EUCV.

The regulatory accounting statements for 2004 are due at the end of April 2005. The Commission will review these, on a similar basis to the current review, prior to the Draft Decision. The Commission will make similar adjustments to the expenditure reported for 2004 to ensure that the information is reported on a consistent basis.

The EUCV has demonstrated that using 2004 year expenditure as the only base point for forecasting future opex is essentially flawed. The tend analysis carried out in section 1.4 above highlights that to follow the ESCoV approach will not show a fair trend in opex over the past years. The opex should be based on a clear trend and this shows that the base point for the review is $340-350m pa rather than the 2004 data. The base point suggested is an average of the last four years which is $345m pa.

The EUCV does not support using the 2004 data, and believes the average of the past four years ($345m pa) should be the basis for the starting point. To do so will mean a repeat performance of excessive over-recovery of unearned revenues at the direct expense of consumers in Victoria.

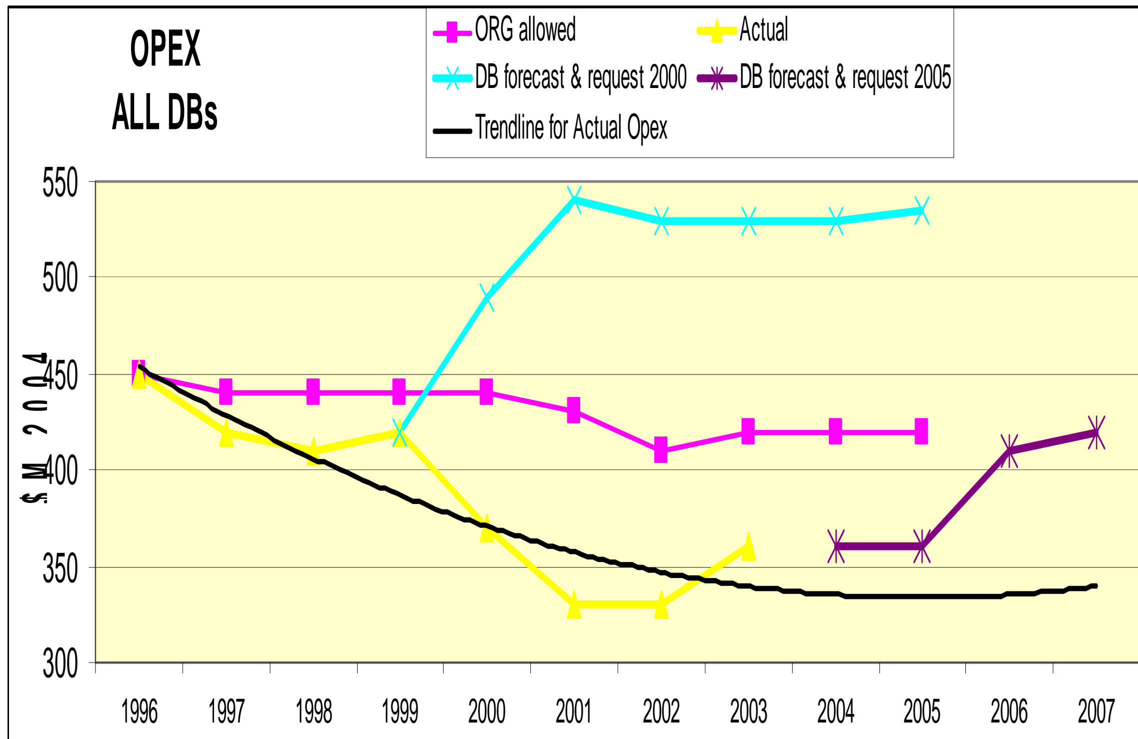
3 OPERATING AND MAINTENANCE EXPENDITURE

3.2 Base operating and maintenance expenditure

The Commission's Final Framework and Approach relies on analysis of actual, or out-turn, information to determine the opex requirements for the 2006-10 regulatory period. As outlined previously, the base opex for 2006 will be calculated using 2004 actual information, adjusted by an annual efficiency gain as implied in the forecasts established in the last price review for the years 2004 and 2005.

The following chart (graph 4) which was displayed in section 1.4 above shows quite clearly that opex for 2004 is above the trend, and that an average of the past four years opex is a better determinant than using just one year data.

During the last review the DBs indicated that the last year opex (ie for 2000) was to be significantly above the 1999 opex level used as the basis for the last review. As opex fell dramatically in year 2000 despite the forecast increase, it could well be assumed that the DBs had brought forward opex into 1999 that was to be expended in 2000, allowing the significant under-run from that forecast. This highlights that the DBs have the ability to "game" the regulator, to the detriment of consumers.



Graph 4

As well as significantly underspending allowed opex, the DBs have stated that as a result they are entitled to have a carryover of "efficiency gains" they see as a resulting from this underspend. This issue is addressed in more detail later in section 5, as the benchmark was set so high above needs, there is no reason for ESCoV to add insult to injury by permitting the DBs to claim any of this underspend as "efficiency gains".

The EUCV does not support using 2004 data as the starting point, but believes an average of the previous four years is a indicator for a starting point.

> *The Commission has undertaken a review of the actual information reported by the distributors to ensure that this forms an appropriate basis for its analysis (see Chapter 2). As part of this review, the Commission proposes to adjust the reported expenditure to present the information on a consistent basis for the purposes of assessing the underlying trend in expenditure (see Section 2.3).*
>
> *No stakeholder comments were received in relation to the proposed framework and approach for determining the base opex. The Commission therefore confirms that it will be applying its framework and approach.*

This is incorrect as the EUCV clearly stated in its response to the Issues Paper that using a single year as the basis for projecting forward is inappropriate, and that an average of the first four years of data from the current period is a better basis than a single point. This is demonstrated by the trend analysis carried out in section 1.4 above.

3.3 Step changes

3.3.2 Commission's preliminary view

> *The Commission's preliminary view with regard to the justification for each of the proposed step changes is summarised in Table 3.2. The Commission and its consultants will be undertaking further analysis of these step changes to assess the reasonableness of the associated expenditure for each of the step changes. The consultant's report is expected to be finalised in late March 2005 and will be published on the Commission's website for stakeholder comment. The Commission's consideration of this report and the impact on the decision process will be outlined in the Commission's Draft Decision.*

The responses from the EUCV to the various proposed step changes in opex in table 3.2 of the Position Paper are included in the following table.

Issue	*Commission's preliminary view with regard to the proposed step changes*	**EUCV comments regarding proposed step change**
Proposed step change	***Commission's preliminary view***	**EUCV comments regarding proposed step change**
Cost of safety compliance *Cost of safety compliance*	*Step change – reasonable incremental costs to be assessed by Wilson Cook and Co. based on ESMPs*	The EUCV accepts that safety of the electricity system is essential, and that the OCEI has the statutory responsibility in ensuring the five DBs comply with the safety requirements. Only those requirements arising from increasing the safety standards from the levels applying at the last reset should be considered. If there was an element of increased requirements in the forecast permitted at the last reset, these should not be allowed. As there is some doubt as to the extent that the OCEI intends to require the DBs to comply with the Electricity Safety Act 1998, then the ESCoV should seek a ruling form the OCEI directly to obtain clarity on this issue, and gain some indication from the OCEI as to what operational changes the OCEI has made which will impact on the DBs. If there is continuing doubt perhaps a better solution will be to treat the changes as a pass through rather than award an increase in opex which may never occur.
Enhanced customer service offering	*With the exception of increased local community representation, this expenditure is dealt with in Chapters 2 and 6. Increased local community representation is not a justifiable step change – not demonstrated that customers value this service*	There is no justification for increasing awarded revenue for providing improved customer service. Competitive industry has to improve customer service just to hold existing customers. As DBs do not have to source additional custom, they should be required to improve customer service as part of a continuous improvement program which is essential just to hold existing customers. Customers have no option but to receive service from the monopoly providers and therefore cannot leave a poor provider if service is lacking. Accordingly ESCoV should have expected each NSP to institute a CI program as part of the base revenue, and not increase revenue for providing improved customer service, but it should require a reduction in revenue for poor customer service. Such an approach replicates competitive industry practice and should be part of the regulatory bargain.

Ageing assets	*Not a step change – incorporated in underlying trend in expenditure*	As detailed in our response on the Issues Paper, ageing assets are an inherent part of the operation of the business. However the depreciation schedule shows that the average age of the assets has not increased over time, and therefore there is no justification for increasing opex as a result. If the NSPs had expended all of the allowed capex, then it is possible that the average age of the assets may well have reduced over the current period implying a reduction in opex should apply if the logic of the DBs is followed. **The ESCoV position is supported**.
Increased labour costs	*Not a step change – incorporated in underlying trend in expenditure*	Labour costs do increase over time, but this is offset by the allowance given to increase charges by CPI. Further the increased labour cost is also offset in part by increased productivity.
GSL payment scheme	*Incremental costs are a step change – forecast costs for the 2006-10 regulatory period considered separately in Section 6.2.7*	**This is not a step change,** and the ESCoV should not permit an increase in revenue to reimburse the DBs. The GSL arrangement is a penalty for poor service. If there is a failure to perform, a competitive business has to absorb the costs for the poor performance and is not able to increase the costs of its products to compensate, for to do so will reduce the competitive position of the businesses products. A competitive business acts to reduce its expenditure on poor service and by doing so improves its profitability. To increase the revenue to reimburse DBs for increased penalties paid for poor service is contrary to the concept of regulation replication competitive pressures. **This position is not supported**.
Road Management Act	*Step change – reasonable costs to be assessed by Wilson Cook and Co.*	If the RMA has changed during the current period, there is a basis for accepting this as a step change. However as the details and impact of the changes under the Act are still to be fully evaluated and this will occur over a number of years, it will be challenging to establish an accurate amount to be included in the opex. There is potential for this to be considered for pass through as and when the costs are properly identified.

Impact of industrial action	*To be assessed based on 2004 actual information. Supporting information to be provided with 2004 regulatory accounting statements*	Only two of the DBs claimed this as a step change and these two have a common owner. The fact that both consider that the 2004 actual opex will be impacted (understated) by industrial action gives support to the view that using just one year opex as the base point is a flawed approach. It would be more appropriate for the ESCoV to use the average of actual opex incurred for the previous five years as the base for the new period starting point. Averaging accommodates annual aberrations such as identified by PC and CP, and also eliminates the potential for the DBs to game the opex allowances in the current period. **The ESCoV position is not supported, and an average opex over the last five years is a better indicator of the opex starting point.**
Voltage com-pensation claims	*Step change – reasonable incremental costs to be assessed by Wilson Cook and Co.*	There two elements to this issue – one where the DB is culpable, and the other where the DB is not culpable. Where the DB is culpable, they should not be reimbursed by their failure to take appropriate action and there is no basis for arguing a step change. Where the DB is not culpable, then if it is incurring additional costs which are beyond its control or ability to manage then there is the basis for a step change, but only if this is a result of changes which have occurred during the current period. The ESCoV should only consider a step change where a DB does not have the ability to prevent an over-voltage incident, and if it can be clearly shown that the DB is liable for increased costs as a result.
Growth related faults	*Not a step change – incorporated in underlying trend in expenditure*	PC will gain additional revenue through the gradual growth as its tariffs are based on a price cap and not a revenue cap. PC provides no calculations to support its view that the additional revenue will not offset its increased costs. This issue is highlighted by the clear over-recovery from tariffs identified in figure 1.1 of the position paper which shows that the DBs all recovered an unforecast revenue from tariffs of nearly $80m. **The ESCoV position is supported.**
Audits and accreditation	*OCEI audit and regulatory audit – periodic expenditure. Base opex may need to be adjusted.*	Because of the need to justify what is and is not included in the 2004 year creates an asymmetry in information. Whilst the DBs point to what was not included in the 2004 opex, they have identified what was not included. The ESCoV could overcome this problem by using an average opex incurred for the past five years, which does cover all audits required during the period. If the frequency of severity of the audits changes this can be the basis of a step change, but not otherwise. **The ESCoV position is not supported, and an**

		average opex over the last five years is a better indicator of the opex starting point.
Audits and accreditation	*Financial audit – step change – reasonable incremental costs of special purpose financial report relative to a review report to be assessed*	See comments above. **Using a five year average opex cost prevents the need for assessing the impact of such changes.**
Audits and accreditation	*Internal audits – not a step change, incorporated in underlying trend in expenditure*	Every business is expected to carryout its own internal audit, and because a business may elect to change its internal auditing is a decision for each business, and does not result in a cost increase for the business products. **The ESCoV position is supported**
Occupational health and safety	*Step change during 2004 – reasonable proportional increase in costs to be assessed by Wilson Cook and Co.*	Only TXU sees that the OHS changes in 2004 provide the basis for a step change. The fact that the other businesses do not implies that there is little or no substance to the claim from TXU. If the value TXU subscribes to the changes is a cost of over $1m pa (total $6.8m for 5 years) it would be expected that the other DBs would have concluded that a step change was appropriate. The fact that they have not identified this amount of additional funding is significant. As the introduction of the changes is real, there is the basis of a claim, but because TXU is alone in claiming it throws significant doubt as to the magnitude of the claim. **There is considerable concern about permitting this claimed step change**
Critical infrastructure protection	*Not a step change – expenditure expected to be incurred during 2004*	Protection of electricity infrastructure has been an issue for many years, and is not a new phenomenon. There have been incidences in the past where electricity assets have been targeted by “green’ groups and such assets have also been protected for community safety reasons, so the issue of protection is not new. For the DBs to claim this is a step change is purely an attempt to use the current “terrorism” bogey as a basis for seeking more revenue. The EUCV remains concerned at the diversity of opex claims made by the DBs relating to this issue. Further there is concern that whilst identifying acts of terrorism as a step change, in truth there have already been acts of vandalism which have occurred in the networks aimed at lifting the profile of specific groups’ issues. These are no different to acts of terrorism. Further as the safety of electricity systems has a high profile already and safety of the assets has been seen as part of the DB activities since the beginning of

		reticulated electricity systems, there is serious concern that additional safety to specifically prevent "acts of terrorism" can be readily separated from the DB activities required to maintain safety and security from vandalism. As both safety and vandalism have consistently been part of the DB activities over the current period there is little doubt that this issue is not a sustainable reason for a step change. The EUCV does not consider the new concept of "acts of terrorism" justifies a step change in capex above the requirements to maintain community safety and prevent vandalism. **The ESCoV position is supported but for different reasons.**
Allowance for cost of self insurance	*Incremental expenditure to be assessed by an actuary engaged by the Commission*	The decision to self-insure is a business decision and is being made in order to reduce costs to the business (why else do so?). It is not a step change in that TXU has had appropriate insurance cover in previous periods and the cost of this was included in the awarded opex. **This is not a step change. If the decision increases the insurance costs it should not be permitted.**
Premature failure of XLPE underground cable	*Preliminary view to be informed by Wilson Cook and Co.'s assessment and other supporting information*	Premature failure of the XPLE, if it has occurred is not necessarily a step change. It could have occurred as a result of poor installation or poor maintenance. If there is premature failure, then the optimised value of the cable should be reduced, and attempts made by the DBs to seek restitution from the suppliers for failure to meet guaranteed performance rather than seek increased costs from consumers. **This should not be a step change for which consumers bear the cost**
Land tax	*Not a step change – incorporated in underlying trend in expenditure*	This issue is not raised by other DBs and therefore could well be seen purely as an ambit claim. Land tax has not increased as a result of tax changes (and may well be reduced). There is no offer by the DB to reduce costs resulting from the windfall profit gain by the property increase, so any increase in land tax is offset by the increase in land valuation. **This is not a step change and should not be included in the underlying trend expenditure**
Reliability investigations	*Not a step change – incorporated in underlying trend in expenditure*	This is part of the normal operations of a competent operator, and is not a step change. If the DB has identified areas of poor reliability, then it should take steps to rectify this as part of the basic regulatory bargain which provides a set charge for a given level of performance. **There is no basis for increasing opex to provide the basic service expected by a customer.**

Testing of CTs and VTs	*Preliminary view to be informed by Wilson Cook and Co.'s assessment and other supporting information*	There is no basis to provide additional funds for the testing of CTs and VTs. These items are a standard item included in every distribution network. It the DB has previously failed to test these items as required by the operational standards, then they should have funds removed for not previously complying. The fact that only one DB identifies this as a step change, implies an ambit claim. **Non compliance with previously set standards should result in a penalty rather than any reward by increasing opex.**
Embedded networks	*Not a step change – distributors currently have obligations associated with embedded networks*	Embedded networks are those owned by another party to which the DB connects. If the DB incurs costs as a result of interfacing with an embedded network, then it should seek restitution form the embedded network owner and not from all consumers. It is noted that this claim was noted by only one DB and therefore should be considered an ambit claim **All consumers should not pay for costs associated with interface problems relating to a network owned by others.**
Embedded generation	*Not a step change – separate cost recovery mechanism for costs associated with the connection of embedded generators*	Shallow connection costs for connecting new generation are the responsibility of the generator. This is clearly detailed in the NEC. If new generation creates problems deep in the network, then these need to be discussed with the generator proponent. As there is no benefit to all consumers in the network, these costs should not be attributed to the shared assets. It is noted that only one DB saw this as a basis for a step change and therefore should be considered an ambit claim and denied. **EUCV supports the ESCoV position**
SCADA master station upgrade	*Periodic expenditure – reasonable costs to be assessed by Wilson Cook and Co. Base opex may need to be adjusted.*	DBs are required to monitor the performance of their network and SCADA is a part of this. If a DB elects to subcontract this service to another party, this is its election. If the supplier considers an upgrade is necessary to provide services for its own system this is its election. If there is no requirement for the DB to provide an enhanced service as would arise form an upgrade, then consumers should not be liable for the costs of the upgrade which do nothing to increase the level of service. Unless there is a definable improvement in service and which is sought by the DB customers, there is no basis to require consumers to pay for the additional upgrade. **EUCV does not support an upward adjustment in opex**

Potential retailer liquidation costs	*Not a step change – refer to Section 11.6 for a discussion as to whether this should be a pass through event*	This risk is identified by only one DB. As the risk is common to all DBs, this should be considered an ambit claim and denied. Already DBs are awarded a return on their activities which is equal to or higher than that achieved by businesses in the competitive environment. To allow a risk to be passed through to consumers, effectively increases the return achieved by the DB. Failure of a creditor in the competitive environment is accepted by debtor businesses as a risk of doing business. **EUCV does not accept the pass through of such risks.**
Mobile computing implement-tation	*Not a step change – only expected to be implemented if benefits exceed costs, so additional expenditure not required*	A DB should not require consumers to provide funds if there is no benefit to them. A cost benefit analysis needs to be undertaken and the DB must justify that consumers will benefit from the implementation before any funding should be considered. **EUCV supports the ESCoV reasons and position**
Outage management, market and billing systems	*Not a step change – only expected to be implemented if benefits exceed costs, so additional expenditure not required*	A DB should not require consumers to provide funds if there is no benefit to them. A cost benefit analysis needs to be undertaken and the DB must justify that consumers will benefit from the implementation before any funding should be considered. **EUCV supports the ESCoV reasons and position**
Head Office relocation costs	*Not a step change – would only expect AGLE to relocate if benefits exceed costs. Head office costs reflected in underlying trend in expenditure*	A DB should not require consumers to provide funds if there is no benefit to them. A cost benefit analysis needs to be undertaken and the DB must justify that consumers will benefit from the implementation before any funding should be considered. **EUCV supports the ESCoV reasons and position**
Ring fencing	*Step change – AGLE currently not compliant with ring fencing requirements. Reasonable costs to be assessed by Wilson Cook and Co.*	The DB has always been required to provide ring fencing of its retail function from its distribution function. The fact that the DB is currently non-compliant with regard to ring fencing should require a penalty for past poor performance rather than an increase in future opex. No other DB has sought an increase for this reason implying that they already comply and do so within their current cost structure. There has not been an increase in regulatory requirements for ring fencing, therefore this is considered am ambit claim and one with no basis for a step change. **EUCV does not consider this DB is uniquely entitled to more funding to overcome a failure to comply with regulatory requirements.**
Electricity demand side response	*Not a step change – incorporated in underlying trend in expenditure*	Demand side response is a retail function and has nothing to do with distribution. **EUCV supports ESCoV that this is not a step change. There is no cost that the DB incurs as a result of demand side responses**

Public consultation on various matters	*Not a step change – incorporated in underlying trend in expenditure*	The DB is expected to consult with its customers and provide a basic service commensurate with the regulatory bargain. For consumers to pay for consultation about the provision of the service is absurd and not replicated in the competitive environment. **EUCV supports ESCoV that this is not a step change.**
Sponsorship and marketing costs	*Not a step change – incorporated in underlying trend in expenditure*	A DB has a tied customer base and does not need to carryout marketing or sponsorship to increase its profile and secure more custom. If the DB wishes to increase its corporate profile, it should do so using its own funds. **EUCV supports ESCoV that this is not a step change.**
Additional EWOV cases	*Consideration of expenditure incorporated under 'voltage compensation claims'*	See comments under "voltage compensation claims"
Gather and provide data on all public lighting poles	*Not a step change – public lighting is an excluded service*	**EUCV supports the ESCoV position**
Financial report for 2009 regulatory financial information	*Step change – reasonable incremental costs of additional financial report for 2009 to be assessed by Wilson Cook and Co.*	Why have not the other DBs claimed this? Has the DB continued to be out of step with previous reporting requirements? **EUCV supports ESCoV position, but believes that the costs should be minimal**
Automated B2B	*Not a step change – issues to be addressed prior to 2006*	Only one DB sees this as a cost increase, yet all are equally impacted by the benefits of automated trading. This could mean that the other DBs see this a benefit rather than a cost as automating trading should result in a saving to the DB but there is no indication of any saving being attributed to consumers by any DB. If the current system is manual then the automation proposed should result in a decrease in costs to consumers. **EUCV supports ESCoV position, but believes that there should be a saving passed onto consumers not a cost increase.**
Distribution Code –	*Preliminary view to be informed by Wilson Cook and Co.'s assessment*	There is only one DB seeking additional funds for this purpose, yet all would be subject to balancing demand to meet the DCode requirements. This is seen as an ambit claim.

Quality of Supply	*and other supporting information*	There has been no change in this requirement during the period, therefore there is no step change. **EUCV does not consider this a step change and no costs should be incurred by consumers**
Utility Meters Act and Regulations	*Not a step change – no additional obligations anticipated. Additionally, metering not part of DUoS price control from 2006*	**EUCV supports the ESCoV position**
NEMMCO standard for data com-munications	*Not a step change – costs associated with large wind farms should be recovered from the embedded generator concerned*	**EUCV supports the ESCoV position**
OCEI levy savings	*Step change – savings forecast by AGLE, CitiPower, Powercor and United Energy to be provided to the Commission by the end of March 2005*	**EUCV supports the ESCoV position**
Licence fees for Commission and/or AER	*Step change - licence fees will be treated as a pass through (see Section 11.7) and are to be removed from the expenditure requirement*	Due to the great uncertainty as to the way future funding of regulators will occur, it is considered that a pass through be agreed until there is certainty of the costs. **EUCV supports the ESCoV position**

3.4 Rate of change

3.4.2 Commission's preliminary view

The Commission will continue its analysis to determine an appropriate rate of change. The Commission is currently considering various options including partial factor productivity measures, decomposing the historical opex to identify increases in productivity due to technological changes and scale effects, and the underlying trend in opex. Each of these approaches will incorporate labour cost movements.

There is no doubt that there is a continuing improvement in productivity in every industry, even in mature industries (such as the steel, auto and cement

industries) which have operated for decades yet still achieve a continuing reduction in costs for the same or improved quality. In the EUCV response to the ESCoV Issues Paper, we attached a graph of motor car costs which shows a constant real price over a 12 year period but with dramatically improved quality. The steel, cement and auto industries (to name a few) have been actively operating for as long as the electricity supply industry, and yet they are still seeking and achieving major improvements in productivity with resultant cost reductions.

For the electricity transport industry to assert that it has now achieved the maximum in productivity is not only absurd, self serving and self aggrandizing in the extreme, but it is not supported by the observed continued improvements in productivity across all industries throughout the world. It is recognized that industries and companies which do not achieve continued productivity improvements are soon superseded and disappear. Unfortunately the electricity transport industry is a natural monopoly and therefore attempts to confound regulators and consumers from its position of no true competition.

It should be noted that the DBs have consistently maintained that they need more opex to maintain their networks, and that all productivity improvements have now been implemented. This has been alleged at each regulatory review. The very fact that after the 2000 review the actual opex required by the DBs continued to fall significantly below the average of the preceding years indicates that productivity improvements are still there for the seeking.

If it is accepted that all industries can and do continue to improve productivity with time, the electricity transport industry must not be exempted from this world wide trend.

The EUCV supports the ESCoV in requiring the DBs to continue to improve in productivity and reduce its costs.

3.5 Growth forecasts

3.5.2 Commission's preliminary view

The Commission will continue to review the information presented to it by the distributors regarding forecast growth rates. The basis for determining the growth rate (marginal cost per customer or average cost per customer) will be consistent with the basis for determining the rate of change.

Overstating demand supports claims for added capex, and understating usage permits inflation of the tariffs. It is noted that during the current period actual usage has identifiably exceeded the 2000 forecast used by ORG, with a resultant that the DBs have significantly over-recovered on revenue, to the distinct detriment of consumers.

The EUCV recommends that independent advice must be sourced to verify and/or modify the claims made by the DBs.

4 CAPITAL EXPENDITURE

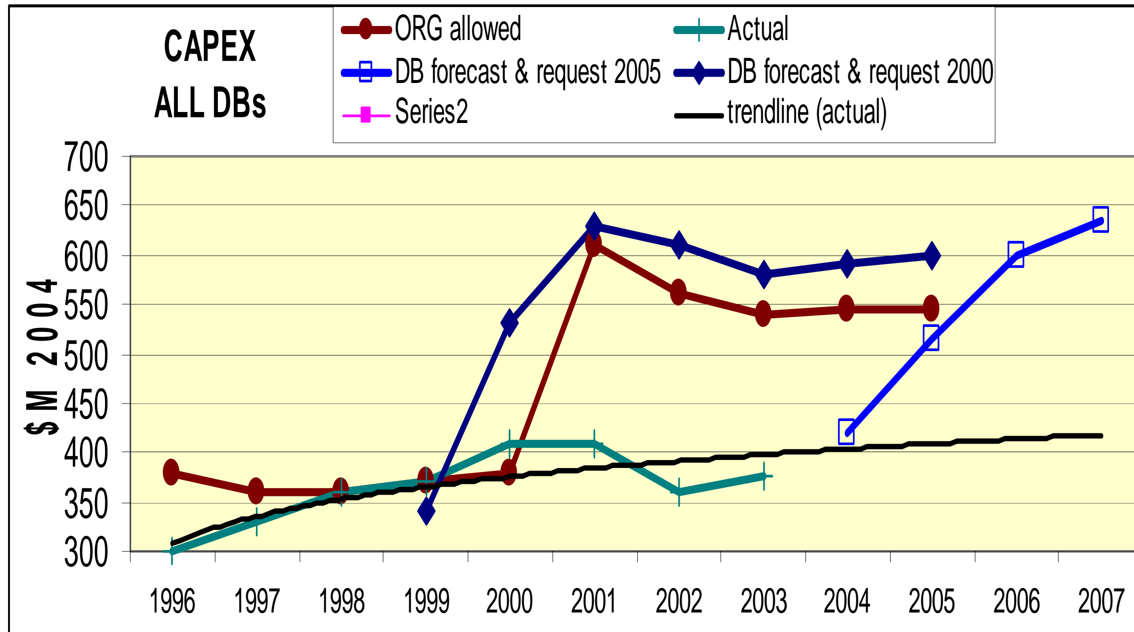
4.1 Commission's framework and approach

4.1.2 Commission's preliminary view

The Commission is of the view that establishing a starting point for expenditure levels through the use of trend analysis (based on out-turn information) is the most effective means to assess the reasonableness of expenditure claims. The Commission acknowledges that whilst trends cannot be completely determinative of future requirements, they do provide a reasonable basis for assessing capex for the 2006-10 regulatory period.

The ESCoV is correct to assume that the DBs must have assessed the needs for managing ageing assets and growth in demand in the current period, as these issues were raised by the DBs as drivers for the increased capex allowed by the ORG. The fact that the DBs have not invested to address these issues clearly indicates that the claims may have been somewhat overstated. Alternatively the DBs may have elected to risk not investing the permitted capex and taken to profit the unearned return on the capital they received. If the DBs are serious that the capex was not needed at the time it was provided (ie deferred) then the benefit of the cash taken by the DBs should be given back to consumers who effectively took the risk of what would otherwise be an undercapitalized network. Incentive regulation is to encourage the DBs to share with consumers the benefits, not to extract monopoly rents.

The approach suggested by the ESCoV is supported, as the best determinant for needed capex is the approach taken by the DBs themselves. The chart (below (also used in section 1.4) indicates that the expected forecast of capex for 2004 appears to match the trend line, but the forecast capex for 2005 provided by the DBs is significantly above the trend line.



Graph 5

This analysis above (graph 5) indicates that during the last review the capex forecast by the DBs was to show a significant increase above the 1999 capex forecast, yet the actual capex for 2000 was well below the forecast amount and only marginally above the capex for the previous year. The capex amount for year 2000 was higher than the capex incurred throughout the current period, and for the first time in five years exceeded the benchmark. The capex forecast for 2004 is the first time the actual 2000 capex will be exceeded.

There can be little doubt that the DBs used their capex forecasts to "game" the regulator in the last review and there is every expectation (and incentive for them to do so) that they will do so again.

> *The extrapolation of underlying expenditure trends from out-turn information enables the Commission to focus on changes in future expenditure requirements, and to thus concentrate its analysis on the underlying activities driving that change. To facilitate this analysis, the Commission's Final Framework and Approach emphasised that distributors should provide asset management plans and strategies to assist the Commission identify the need for, and the distributors' ability to implement, the expenditure associated with capital works outlined in their price-service proposals for the 2006-10 regulatory period.*
>
> *The Commission has engaged Wilson Cook and Co. as its principal technical consultant to assist in the review of the variations proposed by the distributors and their asset management planning processes.*

The risk in using the asset management plans for the next five years, is that a reasonable argument can be presented for increasing capex as part of the plan. In 2000, the DBs presented what were seen as reasonable arguments to justify the massive increase in capex claimed, and the ORG effectively acceded to the blandishments of the DBs. The outcome however was totally different to what the DBs claimed they were going to do – the DBs have underspent forecast and allowed capex for the past five years (2000 – 2004) by about $1Bn. To put it another way, the DBs were entitled to increase their asset base by an additional 20% but elected not to do so.

Either the DBs have "gamed" the system, or their ambit claims are excessive. The ESCoV and its consultant need to recognize that an asset management plan can be used to "game" the system just as effectively as they convinced the ORG of the need to increase the capex allowance significantly above what is needed.

4.2 Expenditure forecasting methodologies used by the distributors

4.2.2 Commission's preliminary view

The Commission maintains the view that the trend in capex continues to be an appropriate starting point for considering each distributor's capex forecasts for the 2006-10 regulatory period. The Commission notes that capex at a disaggregated level may be lumpy, but exhibits a trend at an aggregated level. To assess the reasonableness of the price-service proposals, the Commission continues to require that variations in the trend be explained and supported with robust quantitative and qualitative information.

In reaching its draft decision, the Commission will consider the historic trend in capex in addition to its consultants' report and supporting information provided by the distributors.

The EUCV shares the concerns implied by the ESCoV regarding claims made by the DBs which are at odds with the historic trends clearly shown over the past 10 years. There is no doubt that capex does show features where there are large amounts expended at specific times (ie "lumpy") but when capex is measured across the five DBs and over a ten year period, a high degree of the "lumpiness" is dissipated. This is demonstrated by the minimal variance (<10%) identified of actual capex from the trend line shown in the graph above.

The EUCV supports the ESCoV in using the trend in actual capex as a basis for setting future capex.

4.3 Plans and processes

The Commission notes that the distributors have supplied information to the Commission's technical consultant, Wilson Cook and Co., in relation to their asset management plans and processes. Wilson Cook and Co. is currently reviewing this information, and the workforce management plans, to form a view as to the reasonableness of the distributors' capex forecasts.

As noted above care should be taken is accepting the asset management plans at face value, as to do so could well lead to the "gaming" that occurred to the ORG at the last review.

4.4 Variations from trend

4.4.1 Electricity safety regulations

Commission's preliminary view

The Commission will rely on the trend in capex, as well as the work program for the 2006-10 regulatory period detailed in the distributors' ESMPs, to assist to form a view on the reasonableness of the costs identified by the distributors.

Where incremental costs are of sufficient magnitude, these costs may be considered to be a variation from the historical trend.

The Commission will also take into consideration any findings that arise out of the technical review that is currently being conducted by Wilson Cook and Co.

The EUCV accepts that safety of the electricity system is essential, and that the OCEI has the statutory responsibility in ensuring the five DBs comply with the safety requirements.

As there is some doubt as to the extent that the OCEI intends to require the DBs to comply with the Electricity Safety Act 1998, then the ESCoV should seek a ruling form the OCEI directly to obtain clarity on this issue, and gain some indication from the OCEI as to what operational changes the OCEI has made which will impact on the DBs.

If there is continuing doubt perhaps a better solution will be to treat the changes as a pass through rather than award an increase in capex which may never occur.

4.4.2 Environmental

Commission's preliminary view

The Commission considers that, since the identified environmental obligations have taken effect in the current regulatory period, the associated costs should already be reflected in the capex trend. If this is so, this does not justify a material variation from the underlying trend in capex unless supported by ESMPs. The

Commission awaits the results of the technical review currently being undertaken by Wilson Cook and Co. in this regard.

The EUCV supports the ESCoV in this view. We would caution the ESCoV and the consultant that the ESMP and the Asset Management Plans can be used to provide a basis for a step change for funds which, as seen over the current period, are not used by the DBs to achieve the outcomes professed by the DBs to be essential.

4.4.3 Undergrounding

Commission's preliminary view

No evidence has been provided to the Commission that customers are willing to pay for undergrounding the network where it is not economically efficient to do so.

Based on regulatory precedent, and the lack of any information to suggest that a reassessment of the current stance is required, the Commission's view is that no additional funding for undergrounding should be considered as part of this review. Where customers desire undergrounding of assets, the Commission maintains the view that associated costs should be covered by that customer.

Additionally, the Commission is of the view that the incentive-based nature of its framework and approach will provide suitable stimulus to ensure that distributors assess such projects on their merits, and undertake undergrounding where the benefit to the distributor outweighs the cost.

EUCV supports the ESCoV reasons and position.

4.4.4 Meter replacement expenditure

In the Issues Paper, the Commission noted that CitiPower and Powercor had included expenditure associated with meter replacement in their forecast capital expenditure for the DUoS price control. Both CitiPower and Powercor have since revised their templates, removing this item from their expenditure forecasts.

4.4.5 Security of supply in the CBD

Commission's preliminary view

Unless evidence is provided that it is economically efficient to change the planning standards for the CBD (or any other area) or that customers in this area are willing to pay for it, the Commission will not include the proposed expenditure in the revenue requirement for the 2006-10 regulatory period.

EUCV supports the ESCoV reasons and position

4.4.6 Infrastructure security

The Commission is awaiting Wilson Cook and Co.'s report before forming a view on the expenditure proposed for infrastructure security.

Protection of electricity infrastructure has been an issue for many years, and is not a new phenomenon. There have been incidences in the past where electricity assets have been targeted by "green' groups and such assets have also been protected for community safety reasons, so the issue of protection is not new. For the DBs to claim this is a step change is purely an attempt to use the current "terrorism" bogey as a basis for seeking more revenue.

The EUCV remains concerned at the diversity of capex claims made by the DBs relating to this issue. Further there is concern that whilst identifying acts of terrorism as a step change, in truth there have already been acts of vandalism which have occurred in the networks aimed at lifting the profile of specific groups' issues. These are no different to acts of terrorism.

Further as the safety of electricity systems has a high profile already and safety of the assets has been seen as part of the DB activities since the beginning of reticulated electricity systems, there is serious concern that additional safety to specifically prevent "acts of terrorism" can be readily separated from the DB activities required to maintain safety and security from vandalism.

As both safety and vandalism have consistently been part of the DB activities over the current period there is little doubt that this issue is not a sustainable reason for a step change.

The EUCV does not consider the new concept of "acts of terrorism" justifies a step change in capex above the requirements to maintain community safety and prevent vandalism.

4.4.7 Network voltage conversion

The Commission will be working with its consultants to assess the reasonableness of the costs associated with converting the Preston network from 6.6kV to 22kV and the extent to which this cost is already reflected in modelling undertaken by PB Associates for AGLE in formulating its capex forecasts.

There is no doubt that increasing the voltage from 6.6kV to 22kV will bring benefits from a reinforcement viewpoint, standardization and increase in capacity. However the underlying trend in capex already provides for capex to be dedicated for such purposes.

To use the fact that there is a review underway should not be the basis for granting a step change. Additionally AGLE underspent its allowed capex for the current period[23] and AGLE needs to verify that the capex for this purpose was not included in the review carried out by ORG.

The EUCV accepts that this work may well be required but is concerned that the funds required for this work is already implicitly included in current allowances.

4.4.8 Road Management Act

The Commission will be working with its consultants to assess the reasonableness of the capex proposed by AGLE to comply with the RMA.

The EUCV comments made under point 4.4.7 above apply equally to this issue.

4.4.9 Safety

The Commission will be working with its consultants to assess the reasonableness of AGLE's and United Energy's proposed capex for safety.

The EUCV supports ensuring the safety of the networks and for those working on it, is given high priority. However the reasons given for claiming a step change would indicate that these safety measures are not new and therefore would be included in the base capex trend.

4.4.10 Other initiatives

Commission's preliminary view

The Commission is of the view that United Energy has not provided adequate support or justification for additional capex for a Technological Development Fund, and that Powercor has not provided adequate support or justification for additional capex for a trial of energy efficient technologies or a loss reduction strategy.

The incentive-based nature of the Commission's framework and approach would suggest that such initiatives should be self funding in the long term where the benefit to the distributor outweighs the cost. Consequently, no additional funding should be necessary.

EUCV supports the ESCoV reasons and position

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[23] Issues Paper table 4.11

4.5 Further analysis and process for addressing issues

4.5.2 Commission's further consideration

On reviewing the historical trends in capex and the distributors' capex forecasts, the Commission is not convinced that the distributors' forecasts of expenditure are more appropriate than assessing variations to trends as outlined in its Final Framework and Approach. The Commission therefore maintains the view that its Final Framework and Approach will provide an appropriate balance between adequate investment in the networks (particularly in light of improved and maintained reliability over the past period) and ensuring customers pay no more than is required for efficient investment.

The Commission recognises the large expenditure increases claimed by the distributors in their price-service proposals but is reluctant to include these in the revenue requirement for the 2006-10 regulatory period where they do not reflect historical trends or have not been adequately supported as variations to the trend.

Analysis of the trends resulting from the actual approaches used by the DBs clearly shows that they have made high ambit claims, and then underspend significantly below the allowances granted by the regulator. This provides the DBs with a substantial income which they can then take to profit.

Underspend of capex also is used as a basis for carry over efficiency gains. As with opex, there is little basis for the underspend in capex to be anything else than operating below a benchmark set too high. Section 5 addresses this issue in more detail.

The introduction of a method for encouraging better and more accurate forecasting by the DBs is seen as an approach which will reduce ambit claims. Such a method must provide for penalties which allows the DB to retain significant benefits from underspending and putting consumers at risk at some point in the future due to a DB attempt to maximize profitability in the short term by not investing as intended to meet the needs of the future security and reliability of the network.

It should be remembered that the DB can readily maximize its profitability in the short term by not investing. As the cost to consumers for network failure to supply is in most cases much greater than the marginal cost to increase security of supply, then a network failure in the future will impact more heavily on consumers than any short term loss of revenue to the DB which is the outcome of such a failure. This concern is magnified when it is remembered that most Australian CEOs are now seen to hold their position for an average of under 5 years, which is the standard regulatory period. Thus there is an underlying incentive for management to maximize profitability in the short term as any network failure is

likely to occur after the current CEO (and its senior management) have either retired or moved on to other roles.

It is because of the pressure on management for short term profitability that makes the EUCV concerned about the future, and therefore supportive of the ESCoV approach to place penalties on DBs for not matching planned expenditure with the rhetoric they use to support their ambit claims.

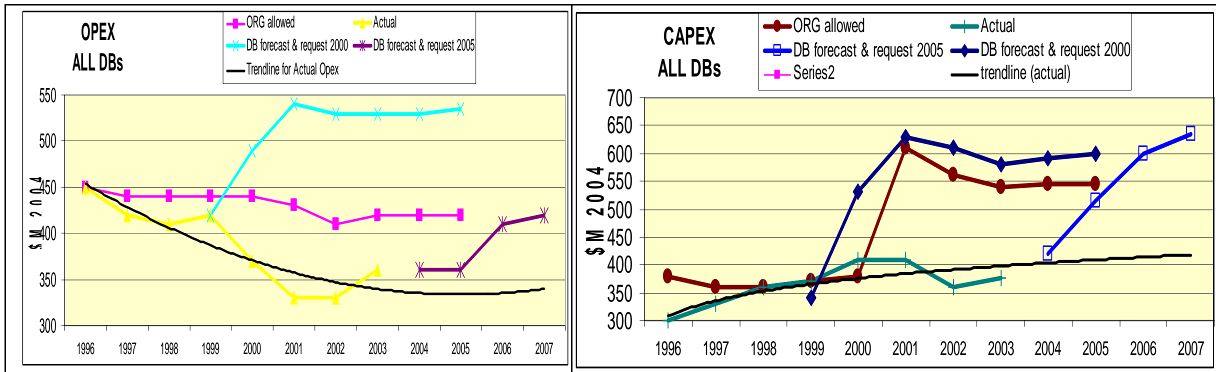
EUCV supports the ESCoV reasons and position

5 EFFICIENCY CARRYOVER MECHANISM

> *The carryover strengthens the incentive for distributors to pursue efficiency improvements by providing a financial reward (or penalty) for achieving efficiency gains (or losses) beyond those already inherent in the use of price cap regulation.*

The principle of encouraging the DBs to increase effectiveness and productivity so that in the medium term consumers can benefit, is supported by the EUCV. Such an incentive should have rewards and penalties attached to it otherwise the impact is entirely one way, ie to the benefit of the DBs.

It is the outworking of the incentive scheme that appears to be non-consistent with the principles behind the incentive scheme.



Graph 6 **Graph 7**

The two charts above (graphs 6 and 7) show clearly the approach used by the DBs to maximize their revenue and the expense of consumers, and to minimize any carry forward of sustainable savings. The “game” played in 2000, was to increase opex and capex marginally in 1999 and forecast a greater increase in 2000, which allowed the final decision to be published before the actual expenditure in 2000 could be known. The DBs noted that the earlier under-runs on opex and capex were “unsustainable” and that all savings that could be made had been incorporated. The regulator, based on these observations of the DBs, permitted a major increase in capex, and a very small reduction in opex for the period 2001 - 2005. Based on 1999 actual results, an efficiency carryover (additional profit) was permitted to two DBs as there was a positive carryover, but the other DBs suffered no penalty as negative performance was not penalized at that time.

The benefit to consumers of earlier under-runs was not rewarded due the DBs claiming “unsustainability” of these outcomes based on forecast increases in opex and capex in 1999 and 2000 (which never occurred in 2000); the large under-runs in 2000 have since been effectively ignored. The actual expenditure

in 2000 was massively below forecast but by then it was too late for the regulator to make any changes. This approach by the DBs has permitted them to hold massive benefits, without having to share them with consumers under the incentive carryover scheme.

As the DBs had convinced the regulator that more capex was needed, and the opex level needed to be essentially maintained, the DBs have been able with no effort to under-run significantly on opex and capex throughout 2001-2005, implying that the under-runs are due to their hard efforts rather than the provision of a less-than-challenging allowance by the regulator.

It must be remembered that this reduction by the DBs in actual opex and actual capex was made in an environment where demand (the driver of distribution network growth) was expected to increase by 3.4%[24], and this growth rate was actually exceeded[25].

Although the ORG stated in its final decision in 2000 that the DBs should be permitted a share of the under-runs incurred in 2002-2005, it is quite clear that the work required by the DBs has been so minimal to achieve this outcome, that the ESCoV should seriously review the ORG commitment to allowing any efficiency carryover into 2006.

To give anything to the DBs will be a travesty of fairness to consumers, who not only will have not only paid an unnecessary premium for the service during 2001-2005, but will have:-

1. implicitly incurred the potential loss of security in the medium term through the under-run of investment (opex and capex) that was to ensure this medium term security (the DBs will suffer little penalty in future for a less secure service), and
2. suffer the indignity of the regulator allowing the DBs additional profit in 2006-2010 to reward the DBs for fooling the ORG about the needs of capex and opex in 2000.

5.1 Commission's framework and approach

The ESCoV must review its approach to rewarding the DBs for under-running capex and opex due to any excessive allowances made by the regulator. Consumers are prepared to incentivise the DBs for putting in effort to reduce long term costs, but not to profit from any reward from windfall gains.

[24] Final Decision 2000, table 3.1
[25] Position paper figure 1.4

5.2 Zero floor NPV approach

5.2.2 Commission's preliminary view

To ensure that the distributors have regulatory certainty, the Commission considers that the efficiency carryover amounts to be carried over to the 2006-10 regulatory period should be calculated in accordance with the approach set out in the 2001-05 determination. However, the amounts to be carried over from the 2006-10 regulatory period into the 2011 regulatory period will be calculated without the operation of the zero floor to ensure that the mechanism operates in accordance with the mechanism's stated objectives.

Elimination of a zero floor is supported in principle (there must be a penalty on the DBs if there is to be a reward), but the challenge must be made in fairness, and not allow the DBs to receive a reward which in unearned.

However, the ESCoV must be aware that if the DBs do exceed the benchmark expenditure, then they may have already incurred a penalty in the period and to further penalize them in the next will reduce available expenditure in the following period. As loss of supply or low stability of the network create greater costs for consumers (especially industrial consumers who get no benefit from the GSL approach) than the loss of revenue to the DBs from failure to supply or stability issues, then reducing revenue to the DBs by way of penalties in the next period has the potential for greater loss to consumers than just the revenue gained by the imposition of a penalty.

5.3 Sharing ratio

In both its Final Framework and Approach and the Issues Paper, the Commission stated that it would consider evidence that suggests a different sharing of efficiency benefits would be of benefit to customers. As discussed in Section 4.5, the Commission is considering the operation of a 'sliding-scale' type mechanism in conjunction with the efficiency carryover mechanism. If a 'sliding-scale type' mechanism is introduced, it may impact on the implied sharing ratio.

The following statement made by the ORG is considered an essential element of any sharing.

> *"The term "fair" does not equate to the term "equal." The concept of a "fair" sharing of benefits is necessarily subjective"*[26].

After all the DBs are entitled to retain all of the benefits they accrue in the current period and only then share a proportion of the carry forward amount. As the actual expenditure graphs show, the DBs tend to make much of their "savings" in

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[26] Position paper, page 81

the earlier part of the period, so they already have an enhanced NPV benefit. When an NPV analysis is made of the savings which accrue to the DBs versus the benefit to consumers, even at zero discount rate the DBs get nearly twice the reward returned to consumers, and at a 10% discount rate the DBs are even further ahead[27] when a 70:30 sharing ratio is used.

5.4 Adjustments to expenditure allocations

Consistent with this approach to the allocation of forecast expenditure allocation, any indirect costs capitalised by the distributors over the 2001-03 period have been transferred from capital expenditure to operating expenditure for the purpose of calculating the efficiency carryover mechanism. Any adjustment to 2004 reported expenditure will be made upon receipt of the 2004 regulatory accounts.

This approach is supported. It is considered essential that all amounts are allocated appropriately otherwise comparisons are not valid.

5.5 2001-05 efficiency carryover growth adjustment

5.5.2 Commission's preliminary view

The Commission will adjust the 2001-05 DRR capital expenditure benchmarks for growth as per its Final Framework and Approach method — that is, by re-running the PB Power growth models using out-turn peak demand data. However approval of the DRR growth adjustment calculated on this basis is dependent on the distributors' compliance with the Commission's information requirements. Should this not transpire the Commission will adopt an alternative method of DRR growth adjustment based on the difference between forecast and actual energy consumption.

The actual carryover to be used must reflect the difference between forecast and actual growth, and as the DBs have experienced a greater growth than forecast, then the fact that they were able to continue to reduce opex and capex well below benchmark could imply some activity by them led to this reduced expenditure. The fact that there may have been an impact of temperature on the actual growth versus forecast is exogenous and should not lead to a windfall benefit – after all if there had been a significant temperature spike and the DBs had not incurred the necessary expenditure to manage such a spike, it is consumers that would have suffered rather than the DBs. Likewise if there had been lower temperatures than forecast and the DBs had not expended funds and

[27] Using 10% discount rate (~ the nominal WACC) the actual and forecast opex savings made by the DBs from 2001-2005 have an NPV of over $360m (allowing carryover of 30% in 2006), whereas even if consumer get 70% of these savings paid over 2006-2010, the NPV is ~$123m (less than one third of the reward the DBs get).

were saved from any embarrassment for network failures, then the benefit should accrue to the party which incurred the risk – ie the consumers.

5.6 2006-10 efficiency carryover growth adjustment

5.6.2 Commission's preliminary view

The Commission considers that adjustment of the DRR capital expenditure based on energy consumption best supports its objective of removing potential barriers to distributor uptake of demand side responses. Such adjustment would provide distributors with greater incentive to maintain or improve their load profiles — since increased DRR capital expenditure caused by worsening profiles would impact the distributors' efficiency carryover amount.

EUCV supports the ESCoV reasons and position.

6 SERVICE INCENTIVE MECHANISMS

6.1 S-factor scheme

Commission's preliminary view

The Commission's preliminary view as to the measures that should be incorporated into the S-factor scheme is as follows:

- *unplanned SAIDI;*
- *unplanned SAIFI;*
- *MAIFI*
- *call centre performance (proportion of calls responded to within 30 seconds, including calls answered by the IVR except where an operator has been requested or substantive information is not provided by the IVR);*
- *if planned SAIDI deteriorates significantly (more than 20 per cent above targeted levels) during the regulatory period, planned SAIDI; and*
- *if the reliability experienced by the worst served 15 per cent of customers deteriorates significantly (more than 20 per cent above 2003 levels) during the regulatory period, unplanned SAIDI for the worst served 15 per cent of customers.*

All of the measures of network performance are related to a loss of supply and there is no doubt that the above listed factors all impinge on consumers to a greater or lesser extent. From the viewpoint of industrial consumers (and the EUCV members) is that in addition to these features, it is the significant excursions of voltage (above and below the standard voltage range) that creates significant lost time for consumers. As voltage excursions can cause significant damage to industrial plant, those consumers have to install protection equipment in addition to expecting the DBs to provide a service which matches the needs of consumers. The cost impact of this distribution equipment is not a cost to the DBs or to other consumers, yet it is a cost which is ignored by both the DBs and the regulators when assessing the variations which occur within the networks.

In addition to the measures included in the listing above, there is a need to include for a measure which reflects the frequency and duration of voltage instability as well. Until such a measure is recognized industrial consumers will be treated as "lesser consumers" as not only are their concerns at the extent of voltage variations being ignored, but they are also excluded from any recompense from the GSL programs.

Industrial and commercial customers are expected to provide their share of funding to improve the overall performance incentive scheme, yet the measures proposed by the ESCoV are more biased to the large number of smaller consumers. It is therefore incongruous that the payment of an incentive is levied across all consumers, yet the actual performance levels are biased against the needs of the larger consumers of electricity. It should be borne in mind that

industrial and commercial consumers in total use more electricity than smaller users in total.

6.1.2 Incentive rates and weightings

Commission's preliminary view

For the purposes of the S-factor, the Commission will weight the reliability measures based on the results of the South Australian willingness to pay research.

Given the Commission's preliminary view that the level of risk and accountability of the distributors for service outcomes be increased, the magnitude of the incentive rates for reliability for deteriorations in reliability will be based on the VCR determined for VENCorp by CRA ($29,600 per MWh). The basis for setting incentive rates for improvements in reliability is between the cost of reliability improvements and VCR. The Commission will investigate further options to appropriately reflect a reasonable value for the cost of reliability improvements.

The incentive rate for the call centre performance measure will also be based on the results of the South Australian willingness to pay research. The incentive rates are a function of revenue and therefore cannot be finalised until a Final Decision has been made regarding the distributors' revenue requirement for the 2006-10 regulatory period.

Some consumers receive excellent service from their DB, whilst others receive quite poor service which is not in keeping with the amount they pay for a "standard" service. As a result there must be an incentive to improve the worst performing feeders, so that the regulatory bargain with those consumers is commensurate with that for others. EUCV notes that ESCoV believes that an incentive scheme to improve the performance for the worst performing feeders is impractical[28] yet until, some steps are taken in this direction, then nothing will change. As a start the ESCoV can require each DB to report performance in relation to each feeder. After all the measures of SAIDI can be recorded for the worst served 15% of customers, then so can the performance of specific feeders.

Subject to the foregoing comments, the ESCoV reasons and position are supported.

6.1.3 Targets for the measures in the S-factor scheme

Commission's preliminary view

In the case of unplanned SAIFI, the targets for 2006 for the purposes of the S-factor scheme will be the same as the targets for 2005. The 2006 targets for MAIFI and call centre performance will be the same as those established for reporting and monitoring purposes.

[28] Position paper page 96

A transition will be required from the unplanned CAIDI measure to the unplanned SAIDI measure to enable the S-factor scheme to be rolled forward from the current regulatory period to the 2006-2010 regulatory period. It is proposed to do so in 2008, by multiplying the unplanned CAIDI targets and actuals for 2005 by the unplanned SAIDI targets for 2005 divided by the unplanned CAIDI targets for 2005. The targets for unplanned SAIDI for 2006 will be the same as the target for 2005.

The outcome proposed here is equivalent to beginning the scheme anew for the next regulatory period, and setting the target for 2006 equal to actual performance for 2004 less the last forecast in the last price review of the improvement (that is, a reduction) between 2004 and 2005.

Subject to the earlier comments the ESCoV reasons and position are supported.

6.1.4 Price control formula

The Commission's preliminary view is that this price control formula will be unchanged from the current regulatory period to the next regulatory period. The indicators and the incentive rates used in calculating S_t *and* S_{t-6} *will be updated based on the measures outlined in Section 6.1.1 and the incentive rates outlined in Section 6.1.2.*

The ESCoV reasons and position are supported.

6.2 GSL payments scheme

The GSL scheme is intended to provide commercial pressures onto the DBs in an attempt to replicate the need to provide service of value to customers. The EUCV notes that the GSL scheme provides little or no benefit to larger consumers of electricity (who in aggregate use more electricity than smaller consumers in aggregate) yet the whole scheme is biased to the many smaller users yet is funded to a greater extend by large consumers.

The ESCoV needs to assess the equity in such an approach.

6.2.1 GSLs for poor reliability

Commission's preliminary view

The Commission's preliminary view is that GSLs should continue to be paid by distributors to customers experiencing poor reliability with respect to the duration and frequency of interruptions (of duration longer than one minute). The threshold for the GSL payments will be reduced as indicated in Table 6.5 below

and the magnitude of the GSL payments will increase from $80 to $100. An additional GSL payment will also be made at a higher threshold level. Additionally the distributors will make GSL payments to customers experiencing poor reliability with respect to momentary interruptions. The threshold for payment and the magnitude of the payments are in Table 6.5 below.

Table 6.5: Proposed GSLs for reliability

Level 1		Level 2
Interruptions of duration longer than 1 minute		
Annual number of interruptions	9	15
Annual duration of interruptions	10 hours	20 hours
Magnitude of payment	$100	Additional $50 ($150 in total)
Momentary interruptions		
Annual number of interruptions	20	30
Magnitude of payment	$25	Additional $10

The Commission requires GSL payments to automatically be made to customers where their supply does not meet the thresholds specified.

Subject to the comments made above the ESCoV reasons and position are supported.

6.2.2 GSLs for appointments

Commission's preliminary view

The Commission's preliminary view is that it is necessary to mandate the maximum appointment window that should be specified by distributors. This appointment window is a minimum standard and, as such, the Commission does not expect a distributor to provide a lower level of service than currently provided unless customers specifically indicate they are prepared to accept a lower level of service. The Commission proposes that the appointment window should be:

- *a maximum of 2 hours where the customer or its representative is required, or chooses, to be in attendance; and*
- *a maximum of one day where the customer or its representative is not required, and does not choose, to be in attendance.*

The Commission expects that CitiPower and Powercor will advise the cost impact to reduce the appointment window from half a day to two hours.

Subject to the comments made above the ESCoV reasons and position are supported.

6.2.3 GSLs for connections

Commission's preliminary view

The Commission's preliminary view is that the standard connection time should be reduced from 20 business days to 10 business days. Information provided by the distributors in their regulatory audit reports indicates that such a timeframe is reasonably achievable and is more consistent with the 6 business day timeframe in South Australia. As this timeframe is already being achieved, the cost of achieving it is already included in the out-turn expenditure. However, a small expenditure allowance will be provided to the distributors to make the additional GSL payments that may arise from such a reduction, (see Section 6.2.7).

Concern is expressed at the position that additional funds should be provided to make payment for a failure to provide for a standard of service that is now being provided. A GSL is an incentive/penalty for not meeting a performance standard. To include an allowance in the revenue for sub-standard performance is not only contradictory but does not replicate the commercial incentive for a business to hold its existing customers.

Subject to the comments made above the ESCoV reasons and position are supported.

6.2.4 GSLs for public lighting

Commission's preliminary view

Given the high proportion of public lights maintained by the distributors, the Commission's preliminary view is that the public lighting GSL should continue to be paid by the distributor where it is responsible for operating and maintaining the public lights. At the next price review the Commission will review the proportion of lights for which the distributor is responsible to ascertain whether this continues to be appropriate.

Given the transition to a more contestable market for public lighting, the Commission does not support an increase in the minimum GSL payment from $10.

The lighting of public areas is of vital importance and interest to all members of the public, including industrial consumers. The great preponderance of public lighting is still provided by the DBs, and this point is made well by the ESCoV when it states[29]:-

[29] Position paper page 107

> "… the recent review of public lighting excluded service charges would indicate that the market for the repair of public lighting is not effectively competitive and there is an insufficient threat of potential competition to mitigate the monopoly power of the distributor."

As the supply of public lighting is an essential safety issue to members of the public, not impress pressure on the DBs to repair such lighting implies that the ESCoV has not considered the safety impact of not having such lighting repaired s soon as possible. As the dominance of public lighting still rests with the DBs and they have not provided adequate data to support the view that contestability of public lighting will reduce their dominance over the new period.

The ESCoV reasons are not considered sufficient to justify not increasing the penalty for not increasing the GSL penalty as recommended by EWOV and the Streetlighting Group. If the DB is able to demonstrate that they are not liable for a GSL payment on this issue due to the lighting in question not being their responsibility then the ESCoV can waive the GSL payment.

The ESCoV position is not supported and the GSL penalty should be increased as recommended by EWOV and the Streetlighting Group.

6.2.5 Other GSLs proposed

Commission's preliminary view

The Commission will introduce two new GSL payments of $20 where, when the distributor is the Responsible Person:

- *a special meter read is not undertaken on the scheduled date for reasons within the control of the distributor; and*
- *a customer requests that a meter be tested and it fails the meter test.*

The Commission specifically seeks comment on the appropriateness of the additional GSL payments of $20 proposed for metering.

EUCV supports the ESCoV reasons and position.

6.2.6 GSL payments to large customers

Commission's preliminary view

Given the lack of support for GSL payments to large customers and the ability of large customers to negotiate their own terms and conditions with the distributor, the Commission's preliminary view is that the GSL payment scheme should continue to apply only to customers with annual consumption less than 160 MWh. A distributor may choose to make the payments to customers with annual consumption more than 160 MWh, but it is not required to do so.

The reason for a lack of support for GSL payments to large consumers, is that the penalties bear little relationship to the costs incurred by large users by a failure to meet the GSL.

The bald assumption made by ESCoV that large consumers have

> "… the ability … to negotiate their own terms and conditions with the distributor"

and that therefore:-

> "… the GSL payment scheme should continue to apply only to customers with annual consumption less than 160 MWh [although a] distributor may choose to make the payments to customers with annual consumption more than 160 MWh, but it is not required to do so."

does not recognize the actuality of any agreement between supplier and large consumer. Being a monopoly the DB has the power to set the terms for supply, and they do not provide a higher level of service to large consumers than to smaller consumers – the level of service is defined by the Distribution Code. Usually the only concession made by a DB to a large consumer is the provision of an account executive who is responsible for a number of large consumers – the value of this "service" is mainly to the DB as it eliminates the need for time consuming re-learning of the needs of the large consumer. There is no guarantee that better service will be provided.

The cost of providing the GSL scheme is not dedicated to the consumers who benefit from the scheme and therefore the large consumer is providing a significant element of the costs of the GSL scheme but does not receive any benefit except at the election of the DB. This is not equitable and an arbitrary cut-off relating to size should not be seen as appropriate.

The ESCoV reasons are not considered equitable and therefore the position is not supported.

6.2.7 Forecast expenditure on GSL payments

The cost of meeting the minimum levels associated with the GSL payments will not be included in the revenue requirements.

EUCV supports the ESCoV reasons and position.

However, the Commission's preliminary view is that expenditure for making GSL payments will be included in the revenue requirements. The forecast expenditure required will be calculated by the Commission after the 2004 performance data has been received and analysed.

This position of the ESCoV appears to be contradictory. On the one hand the ESCoV considers that there needs to be a "commercial" pressure on the DB for achieving a service which replicates a business in a competitive enterprise. The ESCoV then states that if there is to be a penalty for not providing the service guaranteed, then the penalty for failure which will be incurred should by paid for by all consumers by including the cost of the penalty in the revenue.

Put more bluntly, if the DBs fail to meet guaranteed service levels, all consumers have to pay the penalty which is due to the affected consumer. This is bizarre!

The EUCV does not support the reasons and position of the ESCoV.

6.3 Other proposed service incentive arrangements

6.3.1 Incentives to protect reliability in the long term

Commission's preliminary view

The Commission's preliminary view is to publish a "health card" in its annual comparative performance report as outlined in the previous section. The Commission seeks specific comments from stakeholders in relation to this "health card".

The Commission will also require the distributors' directors to sign off on an annual basis that nothing has come to the attention of the directors that would reasonably lead them to believe that the distributors' plans and processes will not ensure that the reliability of the network will be maintained or improved over the next twenty years and that the underlying risks of a deterioration in reliability are not increasing. When submitting their regulatory accounts, the directors will also be required to sign off that nothing has come to the attention of the directors that would reasonably lead them to believe that expenditure incurred will not ensure that the reliability of the network will be maintained or improved over the next twenty years and that the underlying risks of a deterioration in reliability are not increasing.

To facilitate more proactive reporting, the Commission require that at any time senior management or the directors of a distributor become aware that the underlying risks of a deterioration in reliability are increasing, they will be required to advice the Commission accordingly.

Over recent years, the life time of a CEO in Australian business has been becoming shorter, the mobility of senior executives has increased and the level of ownership of public companies by funds managers has also increased. These factors all point towards a need of shareholders, CEOs and senior executives to look at performance over a shorter time horizon, and particularly they lead to focusing on short term profits at the expense of the longer term viability of the enterprise.

Bearing this in mind, and observing the performance of the DBs over the past ten years, where there has been a consistent under-run in opex and capex, with the benefits taken to profit, there is a real concern that the long term performance of the networks will be a risk by a "short-termism" approach by the DBs which are all owned privately.

The ESCoV is rightly to be concerned at the long term viability of the networks as it has consistently been of the view that the DBs have a similar view. With the points made above and the perceived actions of the DBs there is no confirmation that the DBs have the long term in mind at the expense of short term profits, and their actions certainly do not support they have a long term view on network reliability.

This same approach apparent in privately owned DBs has been seen in NSW and Queensland, where the government owners have required additional (special) dividends from their DBs replicating the pressures on the privately owned DBs to maximize profits. Dividend stripping in the northern states has led to a well publicized and severe deterioration of performance of the distribution networks.

The proposals of the ESCoV are the beginning of sound techniques to require the DBs to have a longer term view regarding their assets.

EUCV supports the ESCoV reasons and position.

6.3.2 Loss incentive mechanism

Commission's preliminary view

The Commission's preliminary view is to introduce a loss incentive mechanism in the 2006-10 regulatory period to provide an incentive to the distributor to forecast distribution losses as accurately as possible. The loss mechanism will operate as follows:

- *the distributors will continue to forecast losses for year t as they do currently;*
- *the Commission will continue to approve these loss factors as it does currently;*
- *in year t+2, the Commission will adjust the revenue through an 'L' factor in the price control formula, applying a penalty where the actual losses more than x per cent lesser or greater than the approved losses; and*
- *in the 2006-10 regulatory period, the penalty will be calculated based on a value of $30 per MWh.*

The Commission will compare the actual losses incurred by distributors over the last few years relative to forecast losses to inform it as to the appropriate value of x.

Additionally, the Commission will require a specific statement in each of the Distributor's Annual Planning Reports and Transmission Connection Reports that the cost of distribution losses has been considered in identifying the least cost options for network augmentations.

Further, during the annual approval process, the Commission will continue to monitor the levels to ensure that they remain within an appropriate range, and assess the reconciliation between actual losses and forecast losses as required by the National Electricity Code.

Losses in the network should be minimized but there needs to be a mechanism that establishes the optimum solution for augmentation to minimize losses with the actual cost the losses bring. As there are a number of variables (such as usage, voltage and line length) which all impact the level of line losses, the ability to forecast losses in any location in a network is difficult. As the DBs have the greatest ability to control losses, yet are fully paid by consumers for them (via retailers), there needs to be an incentive for the DBs to be proactive. Accurate forecasting of losses is an essential step in identifying the optimum solution to the level of losses.

By setting a value on losses, and requiring an accurate forecasting of losses, DBs are now able to identify the least cost option to consumers to optimize the amount of system losses.

EUCV supports the ESCoV reasons and position.

6.4 Operation of the service incentive mechanisms

6.4.1 Exclusions

Commission's preliminary view

The Commission's preliminary view is that distributors will be able to apply to have the impacts of the following events excluded from the calculation of the S-factor and from the requirement to make certain GSL payments:

- *supply interruptions made at the request of the distribution customer affected;*
- *load shedding due to a shortfall in generation, but excluding a shortfall in embedded generation that has been contracted to provide network support;*
- *supply interruptions caused by a failure of the shared transmission network;*
- *supply interruptions caused by a failure of transmission connection assets, to the extent that the interruptions were not due to inadequate planning of transmission connections; or*

- *supply interruptions that exceed a daily exclusion criterion yet to be determined.*

The EUCV supports the reasons and position of the ESCoV except for the last criterion which allows the DBs an as yet undetermined amount of unserved energy. The initial proposal of the ESCoV (dot point 5[30]) was that the DBs should not be liable failure to supply for reasons outside their control and where the DBs could not mitigate the impact. This approach is fully supported. The proposed change provides a basis for DBs to avoid penalty for any reason and this is not in keeping with the expectation that the DBs should be penalized for not performing their tasks correctly.

6.4.2 Asymmetry and volatility

Commission's preliminary view

The Commission's preliminary view is that the concept of an "S bank" should be adopted whereby:

- *the maximum S-factor that may be applied in any one year is within the range –2.5 per cent to +2.5 per cent of the revenue requirement for that year;*
- *the maximum S-factor that can be banked without applying any S-factor in any one year is –5.0 per cent to +5.0 per cent of the revenue requirement for that year; and*
- *the balance of the "S bank" will be returned to or recovered from customers at the next distribution price review.*

Returning the balance of the "S bank" to customers at the next distribution price review, where required, explicitly recognises that the distributor has been required to deliver a specific price/service package during the regulatory period, but has failed to deliver on service. The amount returned to customers will be offset, at least in part, against the efficiency carryover mechanism.

The Commission seeks specific comments from stakeholders on the introduction of an "S bank" to reduce the volatility associated with the S-factor.

Certainty of future tariffs is a feature that large consumers support, as this assists in setting future budgets; thus variability of future tariffs should be mitigated where possible. On this basis the concept of smoothing the variability through use of an "S-bank" is supported.

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[30] Position paper page 117

6.4.3 Transitional issues

Commission's preliminary view

The Commission's preliminary view is that a transition mechanism is not required. However, if it is evident that distributors are not seeking to exclude events during 2005, to benefit from an improvement in performance in 2006 with higher incentive rates, then the Commission will introduce a transition measure. Under the transition mechanism the reliability performance for 2005 will be "normalised" by excluding days that meet its new quantitative exclusion criterion.

The concept that there be no transition period is supported but perhaps for additional reasons. The current under-run on opex and capex and over-run on revenue has created a significant cash surplus for the DBs. If there is to be a severe event which would expose them to a negative amount in the "S-bank" then they will have sufficient funds to manage such an event.

Additionally the ESCoV has the position that there will be no negative carry over of incentive scheme. This is asymmetric favoring the DBs so that any disadvantage the DBs may have in relation to a severe event will be offset by the favoritism given by the ESCoV in this other area.

7 X-FACTORS

Commission's preliminary view

The Commission's preliminary view is that, whilst maintaining the NPV equivalence principle when calculating the P0 adjustment, the X factors for the latter years should reflect industry wide movements in total factor productivity and aim to align forecast tariff revenue in 2010 with the forecast building block revenue requirement in 2010.

Ac certainty of future tariff movements is preferred for budgeting purposes, an X-factor option which minimizes a step adjustment at the next period is preferred. Based on the reasons provided by the ESCoV in relation to option 3, as this option would lead to the desired outcome, then this option is preferred.

The expectation of the ESCoV that there might not be the need to carryout an indepth review by use of option 3 presupposes that the ESCoV will set the correct revenue requirement at this review. As the DBs have demonstrated that the levels of opex and capex actually required over the past 10 years have been significantly below the benchmarks set by the regulator, then consumers have little faith that the regulator will get the P_o correct at this review.

At this stage the EUCV remains unconvinced that the opex and capex requirements of the DBs have reached the level where only productivity improvement will deliver the savings that the DBs will achieve.

Until there is a high level of confidence that the savings that the DBs can earn only come from productivity increases, then the ESCoV must remain wary of total dependence on TFP being the basis for future tariff adjustments.

PART B

OTHER ISSUES

8 SERVICE STANDARDS

8.1 Reliability measures

8.1.2 Appropriateness of reliability measures

Commission's preliminary view

The Commission will continue to require distributors to report against the average reliability measures during the 2006-10 regulatory period.

To enhance the reporting and monitoring of the reliability experienced by the worst served customers, the Commission has proposed two options. The Commission is seeking specific comments from stakeholders in relation to these options. Additionally, the Commission is seeking comments from stakeholders in relation to a measure that identifies the cause of interruptions. Subject to comments received from stakeholders regarding these additional measures, the Commission proposes to adopt these measures for the 2006-10 regulatory period.

The main challenges to using averages are that there will be consumers who are experiencing significantly less performance than others, but this disparity does not get revealed. Equally the way consumers are disadvantaged by the type of interruptions varies between consumers – a momentary voltage drop may cause lights to flicker for one consumer, whereas the same problem to another consumer might cause their entire system to fail and require resetting. One to the main concerns with regard to reliability measures experienced by large consumers has been the lack of firm data relating to the problem of recurring faults, and of the inability of the DB to be able to identify the cause of the recurrent problem, usually because the data has not been considered necessary to collect.

Until sufficient data has been collected such complaints by consumers about reliability remain only hearsay, but real nonetheless. The first step in setting performance standards must be the collection of reliable data. The ESCoV proposal under option 2 provides much more useful information about durations and frequency of occurrences.

Collection of the data under option 2 provides the hard data required to underpin actions required in the future about reinforcement and augmentations. As the ESCoV has identified in section 6.3 the need to develop forward looking

benchmarks and the future "health" of the network, the data collated under option 2 will provide a sound trend basis for concerns about the "health" of the network

The proposal to introduce additional data collection under option 2 is supported.

8.1.3 Proposed improvements in reliability

Commission's preliminary view

At this stage no evidence has been provided that customers are prepared to pay for improvements in reliability through the expenditure requirements. Accordingly, it is appropriate that any improvements in reliability be paid for through the service incentive arrangements, that is, improvements in reliability will occur where it is economically efficient to do so based on the incentive rates. However, the Commission will continue to consider any evidence that is presented to it as to the preparedness of customers to pay for improvements in reliability.

Because the reliability of supply in some locations is so poor, consumers have had to pay for protection of the plant and equipment by installing protection devices within the confines of the consumer's premises. Where the reliability is so poor and this can not be confined to environmental conditions or locale, there is an expectation that all consumers will receive the same reliability of supply that all other consumers receive for the same tariff.

This implies that where there is a substandard supply the DB has a responsibility to improve the basic service to a minimum standard typical for the environmental conditions and locale.

The Commission notes that, if specific groups of customers are willing to pay for improvements in reliability, then they have the option to pay for such improvements. For example, if customers choose to reside in heavily treed areas which are not conducive to a reliable supply of electricity, and it is not economically efficient for the distributor to improve reliability, then these customers have the option to discuss this with their distributor and pay for the improvements in reliability as an excluded service if they are willing to do so. This would be outside the price control arrangements – specific customers would pay rather than all customers.

EUCV supports the ESCoV reasons and position.

8.1.4 Appropriateness of proposed targeted levels of reliability

Commission's preliminary view

The Commission's preliminary view is to accept the targeted levels proposed by the distributors except where:

- *a distributor has improved its performance against the reliability measures during the 2001-05 regulatory period, in which case the Commission's preliminary view is that the targeted levels for the 2006-10 regulatory period should reflect this improved performance; or*
- *a distributor has proposed an improvement in the reliability measure based on proposed expenditure, and the Commission is not proposing to include the expenditure.*

The Commission's preliminary view of the appropriate targeted levels for unplanned SAIFI, unplanned SAIDI and MAIFI is provided in Tables 8.1 to 8.3. These targeted levels will need to be reviewed based on the 2004 actual data should there be any significant departure from existing trends. The 2004 actual data will be available prior to the Draft Decision. Given the dependence of planned reliability on capital expenditure, the Commission is not in a position to comment on the targeted levels for planned SAIFI and planned SAIDI until the review of capital expenditure is completed.

EUCV supports the ESCoV reasons and position.

8.1.5 Definition of momentary interruptions

Commission's preliminary view

The Commission continues to be of the view that momentary interruptions should be defined as interruptions of less than one minute duration, consistent with the current definition. The historical information has been collected, and the targeted levels have been set, on this basis. If the definition was changed to interruptions of less than three minutes duration, the information would need to be collected for a period of time on this basis to enable targeted levels to be established.

The Commission will not require distributors to collect data based on a three minute definition during the next regulatory period. However, if distributors continue to support a change in the definition of MAIFI, they would all need to collect data during the next regulatory period based on a one minute and a three minute definition. They would also need to undertake customer research to demonstrate that customers would support a change in definition and to ascertain the difference in customers' willingness to pay for reductions in three minute interruptions compared to one minute interruptions.

EUCV supports the ESCoV reasons and position.

8.2 Quality of supply measures

8.2.1 Appropriateness of quality of supply measures

Commission's preliminary view

The Commission specifically seeks comment as to whether stakeholders would value segmenting the reporting of voltage variations by zone substation and by feeder, and a breakdown of 10 second voltage variations by voltage variations less than 70 per cent, less than 80 per cent and less than 90 per cent of nominal voltage. Subject to comments from stakeholders, the Commission will introduce these measures for reporting and monitoring quality of supply during the 2006-10 regulatory period.

The Commission will set targeted levels for quality of supply for the 2006-10 regulatory period, where appropriate, based on the actual data for 2003 and 2004.

For many consumers a significant under voltage is equivalent to a loss of supply. Accepting that most large consumers have voltage sensitive equipment (as do some small consumers) the severe voltage drop can cause protection equipment to trip the whole facility. Whilst many of the measures for reliability are more appropriate to many small consumers, the bulk of electricity supplies is consumed by the larger users of electricity. Thus a measure for assessing quality of supply which may have more relationship to large consumers is therefore appropriate.

As the ESCoV has instituted a program for measuring the duration and frequency of outages for establishing performance, the same principle applies equally to severe voltage drops. Whilst the ESCoV proposal is to measure voltage swings of duration greater than 10 seconds, it should be noted that swings of shorter duration can have the same impact as those of longer durations.

It is accepted that to measure the extent of the swings of under-voltage will require additional monitoring, and the EUCV sees that this is a step in the right direction to identifying the causes and impact of voltage variations. Whilst the ESCoV proposal is to apply such measuring at zone substation and each feeder, it is suggested that over time these measurements are taken deeper in the network as well. It should be remembered that performance at a zone substation does not necessarily equate to performance at the consumer connection point, and after all, it is the quality of supply at the consumer connection that dictates how a consumer can use the power the network is intended to transport.

EUCV supports the ESCoV reasons and position, although there is a preference for measuring swings of a lesser duration than 10 seconds, and for measurement deeper into the network**.**

8.2.2 Proposed improvements in quality of supply

Commission's preliminary view

Where a distributor is not compliant with the minimum standards for quality of supply as set out in the Electricity Distribution Code, reasonable expenditure will be provided to that distributor to ensure it is compliant over time. The improvement in quality of supply is to be quantified by the distributor and should be measurable. The Commission will also be considering the reasonableness of expenditure proposed by the distributors for additional monitoring of the quality of supply.

Such an approach is supported as the regulatory bargain implies that all consumers will receive a minimum standard of supply for a given tariff. For one consumer to get a lower reliability or quality of supply (given the same environmental conditions and locale) than another for the same price, is not equitable.

Additionally, the Commission specifically seeks comment as to whether there are any regulatory barriers for the customers to pay for improvements to the quality of supply, where the minimum standards are not sufficient for their application.

Experience with the DBs indicates that they are prepared to institute changes to enhance reliability and quality of supply when done at a consumer's expense. Equally the DBs have indicated what additional equipment a consumer might install in their own premises for this purpose.

The most common complaint that consumer's have is that the reliability and quality of supply do not meet the stated standards, yet enhancements proposed by the DBs are still to be at the consumer's expense.

8.2.3 Compensation for voltage variation claims

Commission's preliminary view

The Commission's preliminary view, subject to further evidence regarding customers' preferences, is that customers should not pay more to the distributor for a "new for old" compensation policy.

Currently large consumers must provide protection equipment of their own and at their own expense to ensure that any surge or major under-voltage does not damage their plant. Whilst small consumers are recompensed for such events causing damage to their equipment and plant, large consumers are not. Thus large consumers incur costs but receive no benefits, whereas small consumers receive recompense but do not have to make any investment. This is inequitable.

The ESCoV should ensure that the costs for any recompense program for small consumers should be funded only from the small consumers which receive this benefit.

8.3 Customer service measures

8.3.1 Call centre performance measure

Commission's preliminary view

The Commission will set a targeted level of 75 per cent for the proportion of calls responded to within 30 seconds (including those responded to by IVR providing substantive information but excluding calls where an operator response has been requested or where no substantive information is provided by the IVR), for all distributors.

The Commission will also monitor the number of overload events that occur in the distributor's call centre each year. The Commission specifically seeks historical data from the distributors regarding the number of overload events that have been experienced in their call centre in each of the last few years.

The EUCV has no comment regarding this service measure.

8.3.2 Other customer service measures

Commission's preliminary view

Subject to comments received from stakeholders, the Commission will introduce a range of additional customer service measures during the next regulatory period. These customer service measures are targeted towards the customer transfer process and metering related services. The Commission specifically seeks comment on the customer service measures and metering-related measures that have been proposed.

The EUCV has no comment regarding this service measure, other than to comment that there is an expectation that the data and equipment provided by a DB must be accurate, as it is on this basis that decisions are made by a consumer.

8.4 Other reporting requirements

Commission's preliminary view

The Commission's preliminary view is that the thresholds for reporting low reliability feeders should be revised so that they reflect the reliability currently experienced by the worst served 5 per cent of customers. The Commission's preliminary view is that feeders with low reliability with respect to MAIFI should also be reported. The proposed thresholds are provided in Table 8.4.
Additionally, given the expenditure proposed to improve the quality of supply so that the distributors comply with the Electricity Distribution Code, the Commission is also of the view that zone substations and feeders which do not

> *comply with the Electricity Distribution Code, with respect to quality of supply, should also be reported.*
>
> *Where a zone substation (for quality) or feeder (for reliability or quality) is reported, the distributor will provide comments regarding its plans for that zone substation or feeder.*

The EUCV supports increasing performance measures where such will lead to an overall better picture of network performance both now and into the medium term future.

A supplier which would consistently sell a product or service which had a 5% failure or poor performance rate would not continue as a viable commercial enterprise for long. To stay in business a much higher performance rate is required.

The ESCoV reasons and position is supported, but there is an expectation that performance measurement must extend deeper in to the network over time.

9 GROWTH FORECASTS

9.1 Approach and methodology

However, what the independent verification was intended to provide was confidence that, whatever process or method the distributors used to develop their forecasts, the method, assumptions and input data were reasonable and unbiased. In the absence of satisfactorily independent verifications and given the extent of the inconsistencies that exist between the distributors' forecasts and NIEIR's forecasts, history and the VENCorp forecasts, the Commission has felt compelled to undertake a more detailed review of the distributors' forecasts than originally anticipated. MMA is assisting the Commission with its review.

EUCV supports the ESCoV reasons and position. The EUCV will comment regarding the outcome of the MMA report when it is produced.

9.2 Consistency of the assumptions

Commission's preliminary view

The Commission remains of the view that basing peak demand forecasts on a high economic growth scenario and a 10 per cent POE is likely to overstate the forecasts. However, the Commission will continue to examine this issue, in consultation with its consultants.

EUCV supports the ESCoV reasons and position. The EUCV believes that to continue to base growth on a 10% POE will not only result in significant costs, but will, over time, result in a network significantly oversized for the needs. The fact that the DBs significantly under-invested capex ever since 1996, indicates that the DBs themselves do not consider the 10% POE growth to be an appropriate basis for assessing growth in demand.

9.3 Consistency between forecast and historical data

Commission's preliminary view

The Commission remains of the view that the historical trend in growth, while not completely determinative of the future, is an appropriate starting point from which to formulate a decision on the distributors' growth forecasts and that it is therefore appropriate to require variations impacting on the trend to be explained.

The Commission, and its consultants, will be considering forecasts of macroeconomic variables in the assessment of the distributors' growth forecasts. The forecasts of macroeconomic variables will reflect expected economic conditions in the 2006-10 regulatory period.

EUCV supports the ESCoV reasons and position.

9.4 Other issues

The Commission has not yet formulated a final view on the consistency of the input data, the consistency of the distributors' forecasts with the VENCorp forecasts and the consistency between the distributors' templates and the NIEIR forecasts. The Commission will await the advice of its consultants prior to making a decision on these issues.

EUCV supports the ESCoV reasons and position. The EUCV will comment regarding the outcome of the MMA report when it is produced.

9.5 Process going forward

MMA issued an information request in December 2004 to collect more data to assist with this analysis. During February 2005, the Commission and its consultants met with the distributors to discuss the data collected and to clarify some of the issues raised in this chapter. MMA's report is expected to be finalised in late March 2005 and will be published on the Commission's website for stakeholder comment.

MMA's report, the Commission's own analysis, the distributors' actual data for 2004 and stakeholder submissions to the Position Paper and to MMA's report will inform the Commission in drafting its decision with respect to the distributors' growth forecasts.

EUCV supports the ESCoV reasons and position. The EUCV will comment regarding the outcome of the MMA report when it is produced.

10 COST OF CAPITAL FINANCING

10.1 Return of capital (regulatory depreciation)

Commission's preliminary view

The Commission is of the view that the use of the straight-line (inflation indexed) method for determining the rate of depreciation continues to be appropriate for the 2006-10 regulatory period. However, the Commission will be seeking responses from the distributors in relation to specific issues associated with their application of this approach.

EUCV supports the ESCoV reasons and position.

It is of concern that the DBs are seeking to vary the approach used now for 10 years relating to the rate of depreciation. It is well known that base line profits can be distorted by using varying approaches to rates of depreciation and as regulatory certainty is a consistent cry from DBs (except when they want to increase profitability and/or revenue) then it is considered that maintenance of the same regulatory approach should be used.

10.2 Return on capital (weighted average cost of capital)

10.2.2 Commission's preliminary view

The Commission is of the view that continuing to employ the CAPM for the estimation of WACC and its input parameters remains the most appropriate means to establish a rate of return in the current regulatory environment. As noted above, the CAPM has been used extensively by regulators in Australia and the United Kingdom, the Australian financial community, and the distributors when deriving their cost of capital estimates.

There is continuing doubt as to whether CAPM is the most appropriate method for developing a rate of return to apply to the DBs. Indeed the ESCoV notes that it has a less than full belief in it[31] and when it is considered that it was developed as a tool for assessing investment in the stock market (CAPM is an attempt to understand the frequently incomprehensible moves observed in the market) there is considerable concern for its continued use. The EUCV has consistently maintained that the CAPM should be used to develop a rate of return but that the output should be benchmarked against the actual returns achieved by competitive enterprises

Notwithstanding the detriments the CAPM does continue to be the method of choice used extensively by regulators. If ESCoV intends to use CAPM then it should ensure that the values for the inputs reflect the current state of the market,

[31] Position paper page 168

and that the calculated WACC also is in keeping with returns earned in a competitive environment.

It is of concern that the ESCoV continues to observe that "many of its inputs reflect a degree of conservatism"[32]. What the ESCoV has not done in the past is to assess the cumulative affect of all of the conservative elements it inserts into the CAPM. While EUCV is of the view that perhaps one of the inputs could well reflect conservatism, for all of them to do so has a compounding effect and so results in the award of a excessively high WACC, and not consistent with the returns earned by competitive enterprises.

10.3 Adjustment for rural risk

10.3.2 Commission's preliminary view

Based on the information reviewed, the Commission's view is that considerable uncertainty exists regarding whether rural distributors are exposed to any additional systematic risk as compared to the urban distributors. Further, the Commission is not convinced that any changes in relation to the rural risk premium have occurred since the 2001 Electricity Distribution Price Determination.

EUCV supports the ESCoV reasons and position.

10.4 Debt raising costs

Under the benchmark approach adopted by the Commission for determining the cost of debt, the Commission accepts that efficient debt raising costs should also be recognised as a legitimate cost. As these costs are related directly to debt raising, the Commission intends to include a margin to the cost of debt of 5 basis points, rather than separately identifying the costs in operating expenditure. This is consistent with the value determined in the 2002 Review of Gas Access Arrangements.

There is an essential inconsistency from the DBs relating to the cost of debt.

On the one hand they state that the debt should reflect the cost of debt relating to the life of the investment ie some 40-50 years. On this basis they would raise debt for this period and then never have to raise it again.

On the other hand they then say that they need debt raising costs to be included in the revenue as debt raising is a continuing process, that they have a need to continually roll over debt in order to minimize the overall cost of the debt to them. The EUCV tends to believe that the treasury function does in fact continue to roll

[32] Position paper page 168

debt over on a consistent basis, as this is the most cost effective way to manage debt.

The EUCV also notes that the base rate used by the ESCoV and the DBs is the 10 year bond rate which is used as the notional “risk free” rate. Thus in any debt raising program in any five year period there should be only a “half of a debt raising cost” for the whole of the debt amount as notionally the debt has been raised once and for a10 year period, whereas the regulatory period is only 5 years.

The EUCV believes that the amount needed for debt raising (whether by way of a premium added to the base rate, or by costs included in opex) should reflect the basis on which the debt element of the WACC is structured. If the 10 year bond rate is used, then there should be debt raising costs appropriate to the term of the debt – which is for a 10 year period. As the ORG permitted debt raising costs based on a 10 year bond rate in 2000, then there is no reason for the ESCoV to add another premium for this period, on the assumption that the debt was raised initially for 10 years.

Any new debt raised (for example that needed for new investment) would be entitled to incur a debt raising cost but as a once off cost every 10 years if the 10 year bond rate is used as the basis fro setting debt in the WACC.

10.5 Equity raising costs

10.5.2 Commission’s preliminary view

When the Commission forms a view on the distributors’ expenditure requirements it will undertake further analysis to identify whether an equity injection is required to maintain a 60 per cent gearing.

There is an essential inconsistency from the DBs relating to the cost of equity.

On the one hand they say that they need equity raising costs to be included in the revenue as equity raising is a continuing process. In the same way that debt was based on a 10 year bond rate, the equity element of the WACC uses the same basis. The equity premium calculated uses the 10 year bond rate, so there is a degree of consistency in this practice.

On the other hand they also state that the equity should reflect the cost of equity relating to the life of the investment ie some 40-50 years. On this basis they would raise equity for this period and then never have to raise it again. The EUCV is of the view that equity injection occurs infrequently and only when there is a need for new investment. This then does not support the view that equity raising costs (either by adding a premium to the rate or by allowing an amount on the opex) should be reimbursed any more than once.

If the ESCoV accepts that equity is assumed to be raised every 10 years (as implied by the usage of the 10 year bond rate), then it must be assumed that the equity that was notionally injected in 2000 has not been re-raised and will not be so until the next regulatory period. On this basis there is no reason to provide for equity raising costs at the 2005 review.

Following this argument, any new equity raised (for example that needed for new investment) would be entitled to incur an equity raising cost but as a once off cost every 10 years if the 10 year bond rate is used as the basis fro setting equity in the WACC.

10.6 Taxation

10.6.1 Tax depreciation

On review of the distributors' price-service proposals, the Commission identified a small number of inconsistencies that must be addressed.

The EUCV supports consistency across all DBs.

11 PRICE CONTROLS

> *The Commission noted this issue in its Issues Paper. Given the stage that the price review is currently at, the Commission expects that stakeholder consultations on the distributors' Tariff Strategy Reports would have already commenced or, at the very least, be scheduled for commencement shortly.*

These discussions have not yet commenced as of late April.

11.1 Reporting requirements and timing

> **Commission's preliminary view**
> *The Commission's preliminary view is that the Tariff Strategy and Annual Tariff Reports should be consistent with the templates set out in the Issues Paper.*
>
> *The Commission is of the view that the 60 business day time frame for the submission of the Tariff Strategy Report, Annual Tariff Report and the annual network tariff proposals should be retained. An indicative timetable is presented in Figure 11.1.*
>
> *In retaining the 60 business day time frame, the June CPI would replace the use of the September CPI.*

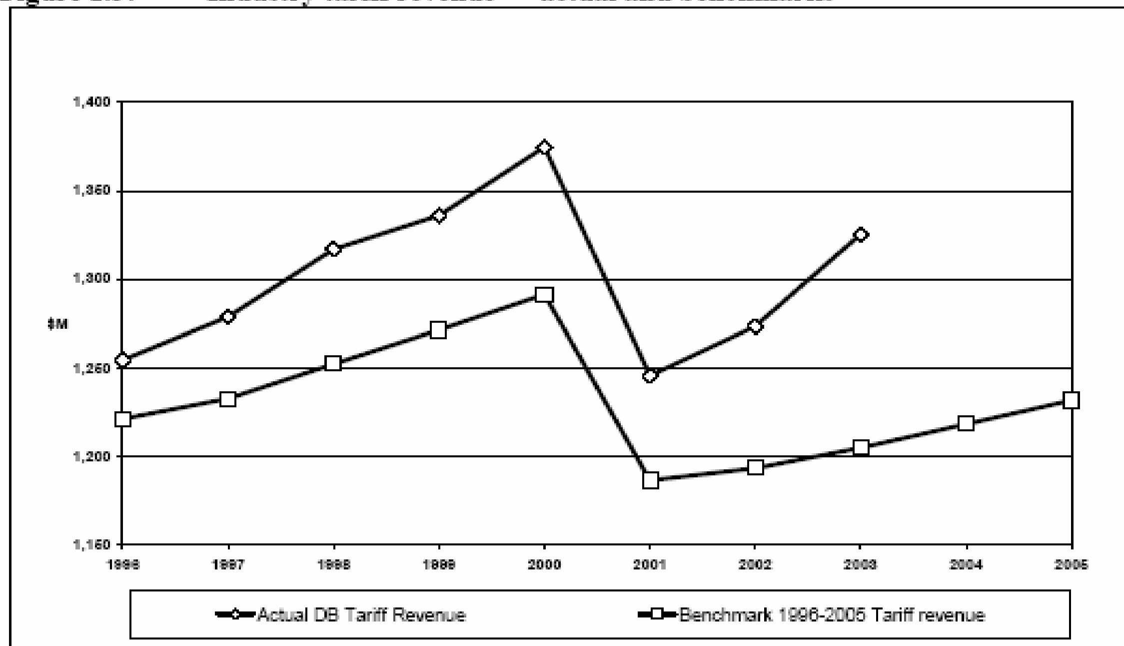
EUCV supports the ESCoV reasons and position.

11.2 Tariff proposals

> *As noted above, the Commission is not responsible for the individual tariffs and tariff structures that the distributors choose to introduce. The Commission sets an overarching price control that applies to the average price of a basket of tariffs and a set of side-constraints that attempt to place some economic discipline upon the distributors to develop tariffs that reflect the true cost of a customer's use of the network. Distributors are free to introduce, abolish or change the structure of their tariffs provided they comply with the overarching price control.*

The EUCV is very concerned that the ESCoV does not consider itself responsible for ensuring the tariffs are equitable, but only match the overarching price control. As identified in section 1 there was an significant over-recovery of revenue through the tariff allocation as the following figure (graph 8) shows[33].

[33] Position paper figure 1.5



Graph 8

This demonstrates that by re-balancing (read: manipulating) tariffs, the DBs can and did increase their revenue. The Electricity Code requires there be cost reflective allocation of costs to each customer class, but as there has been a significant over-recovery, then some customers must have been over-charged for the service provided. The ESCoV has an obligation to ensure there is cost reflectivity in the development of the individual tariffs to meet this most basic requirement of the NEC.

> *However, as noted above, the Commission has concluded that there would be benefit in developing a structured framework and process for increasing the transparency of the distributors' tariffs and the basis for changes to their tariffs over time (see Section 11.1). Such transparency would include clear articulation of the cost allocation methodology used in developing individual tariffs. In association with the PICG, the Commission has therefore been developing a template for the preparation and publication by the distributors of a Tariff Strategy Report.*

EUCV supports the ESCoV reasons and position, and as a result will cooperate with the ESCoV to assist in the development of a cost reflective allocation methodology**.**

11.3 Re-balancing constraints

11.3.1 Distribution tariff re-balancing constraints

Commission's preliminary view

The Commission will increase the distribution re-balancing constraint where the need for an adjustment is supported by the distributors' Tariff Strategy Reports. Distributors should indicate in their Tariff Strategy Reports which tariffs they intend to re-balance over the regulatory period, how the re-balancing will achieve the objectives of the distributors' tariff strategy and the level of rebalancing required. In doing so, the distributors need to indicate how they have allocated costs and current revenue between tariffs to demonstrate how much and in which direction the nominated tariff(s) will need to move over the regulatory period.

To provide greater transparency to stakeholders whilst still affording distributors their current flexibility in structuring their tariffs, the Commission will enhance the tariff approval model to provide quantitative and visual analysis of the annual movements in tariff and tariff components.

Furthermore, distributors will be required to relate component changes back to the objectives and directions set out in their Tariff Strategy Report.

The DBs have demonstrated that they can and do use rebalancing to increase revenue – this view is supported by the over-recovery of revenue achieved by the DBs in every year since 1996 except for the first year of the current period when the revenue was reset[34]. This was achieved with the current constraints on rebalancing. Of concern is that by widening the constraints, this will enable an even greater ability to use this mechanism to increase the revenue, which of course must come from consumers.

The ESCoV has a responsibility to ensure there is no unreasonable or excessive recovery of revenue over and above the forecast revenue stream. The actual results show that the regulator so far has been unable to reduce any over recovery to a level commensurate with growth. It should be remembered that the decision to use a regulatory price cap rather than a revenue cap is intended to encourage the growth of network usage by the DBs, and not as a medium to recover unearned income.

Bearing these comments in mind, there are two mechanisms the DBs can use to over recover revenue – to set the tariffs to do so initially, and then have the maximum facility to recast tariffs to maximize revenue.

The EUCV considers that a decision to permit greater flexibility of tariff recasting, and the transparency required to verify cost reflectivity, must go

[34] See Position paper figure 1.5

together. Notwithstanding this the EUCV does not support the ability of the DBs to have unfettered ability to vary tariffs without good reason.

The ESCoV should not increase the re-balancing constraint, although the constraint might be lifted if the DB can demonstrate that the rebalancing will not result in increased revenue as calculated using the DB Tariff Strategy Report and methodology provided for increased transparency of the process.

11.3.2 Transmission tariff re-balancing constraint

Commission's preliminary view

The Commission's preliminary view is to retain the transmission re-balancing constraint at CPI+2 per cent but allow the distributors to apply for increases in the constraint on an annual basis.

EUCV supports the ESCoV reasons and position.

11.4 Tariff re-assignment

Commission's preliminary view

The Commission is proposing to allow distributors to mandate the re-assignment of customers where distributors have installed an interval meter. Such re-assignment would occur where an interval meter has been installed and/or a change in a distribution customer's load and/or connection characteristics has occurred.

Whilst the principle of tariff re-assignment is supported, the ESCoV must be assured that the use of such enforced re-assignment does not result in an increase in overall revenue.

The Commission remains of the view that some form of consultation with customers is required prior to any re-assignment occurring.

The Commission recognises that successful implementation of the interval meter rollout ruling will require a whole of industry approach to the provision of information, education and notification of customers with regard to impacts, benefits and how customers can respond. The Commission will take a lead role in this process, consulting with all stakeholders including distributors, retailers, customers and government departments.

The Commission is proposing to establish, at the conclusion of this price review, a working group comprising representatives of the Commission, distributors, retailers, end-user representatives and relevant Victorian departments to develop transitional arrangements for the rollout of interval meters.

Among other things, this group would be responsible for developing the transitional arrangements that should accompany the rollout of interval meters and the mandatory reassignment of customers to interval meter tariffs. While the details of the transitional arrangements are for the working group to establish, the arrangements should at least cover (but not be limited to) the following aspects:

- *the appropriate communication and education campaign for each customer group;*
- *the customer groups and/or customer sizes the transitional arrangements should apply to and a date before which no re-assignment will occur so as to allow time for the development of the transitional arrangements;*
- *a period of notice that begins with the mail out of an information package;*
- *the development of an information package that:*
    - *explains to customers why the changes are occurring;*
    - *includes a hypothetical bill demonstrating what impact the introduction of interval meter tariffs will have upon the average household or business bill;*
    - *contains information about how changes in usage patterns can impact upon a bill; and*
    - *advice on how customers can obtain more information on interval meters tariffs.*

EUCV supports the ESCoV reasons and position.

11.5 Pricing principles

Commission's preliminary view

The Commission's preliminary view is that the pricing principles should consist of the following:

- *Tariffs for each customer should generate revenue in excess of the avoidable cost to service the customer.*
- *Tariffs for each customer should generate revenue less than the cost of providing the service on a stand-alone basis to the customer.*
- *Tariffs for each customer should signal the impact of additional (peak) usage on future investment costs.*

These pricing principles are supported as far as they go, but there are additional principles that must be added. These are:-

- Revenue recovered from tariffs must not exceed the revenue expected from providing the service as assessed by the ESCoV in its review, after making adjustment for actual growth

- Tariffs should recover revenue which is as close to "cost reflective" as possible, and
- Tariffs should make due recognition of the benefits of using shared assets

11.6 Pass through provisions

Commission's preliminary view

The Commission's preliminary view is to retain the existing pass through provisions for tax related events but not provide for the pass throughs of costs arising from a change in tax on a third party, from the financial failure of a retailer or from other non-tax events.

EUCV supports the ESCoV reasons and position.

The Victorian Tariff Order (Clause 6.3.1) still contains provisions for a price determination to be reopened if a distributor is materially adversely affected by the price determination as a result of an event beyond its control which was not contemplated at the time the price determination was made and, on balance, the benefits of revoking the price determination outweigh the detriment to the participants in the Victorian electricity supply industry resulting from the revocation of the determination. This clause provides some protection to distributors if there is a major unforeseen event which significantly increases the costs they face.

This provision is seen as one sided and makes no requirement for the DB to request a re-opening if there is an event which would result in a windfall benefit to the DB.

11.7 Pass through of licence fees

Commission's preliminary view

The Commission is of the view that an F-factor be incorporated into the price control formula to allow for the recovery of licence fees imposed by the Commission and/or the Australian Energy Regulator. The F-factor would equal the sum of the licence fees imposed by the Commission and the Australian Energy Regulator.

To ensure that any re-balancing that distributors wish to do within the parameters set out by the constraint is not limited by any increase in licence fees, the Commission is also of the view that the F-factor should be added to the current CPI+2 per cent re-balancing constraint.

EUCV supports the ESCoV reasons and position, providing that this adjustment results only if there is an increase in the total fees payable, as the current approach to the allowed opex is that a trend will used to set opex and this

trend approach already includes for fees currently payable to the ESCoV. If there is a decrease in total fees payable then the F-factor should include for negative amounts.

12 METERING

12.2 Number of meters to be installed

12.2.2 Commission's preliminary view

ECG is currently assessing the distributors' forecasts of meter volumes and will report on their findings shortly.

Additionally the Commission will facilitate a meeting shortly between distributors and retailers to further discuss the implementation of the interval meter rollout.

EUCV will assess the impact on its constituency of this preliminary view when the consultant report is provided.

12.3 Metering services costs

Commission's preliminary view

ECG is currently assessing the distributors' forecasts of meter provision costs and will report on its findings shortly.

The Commission is still considering its view regarding the recovery of costs associated with the replacement of meter board replacement and asbestos board removal. However, a separate charge will be levied where a customer specifically requests that an interval meter be installed after hours and it will continue to be the responsibility of the owner of the premises to ensure that the wiring of the premises is safe and the electrical connection is legal.

In relation to the depreciation period for interval meters, the Commission considers a depreciation period no shorter than ten years to be appropriate.

Finally, the Commission requires the distributors to provide information regarding:

- *the meter installation costs that are included in each of their connection charges;*
- *revised connection charges which exclude the costs associated with installing a meter; and*
- *the additional installation costs associated with new meters that are to be included in the metering price control for each meter type.*

EUCV will assess the impact on its constituency of this preliminary view when the consultant report is provided.

12.3.2 Metering data services

Commission's preliminary view

ECG is currently assessing the distributors' forecasts of metering data service costs and will report on its findings shortly.

In relation to the depreciation period for the IT capital expenditure, the Commission considers a depreciation period no shorter than five years to be appropriate.

EUCV will assess the impact on its constituency of this preliminary view when the consultant report is provided.

12.3.3 Indirect costs

Commission's preliminary view

ECG will be assessing the reasonableness of the incremental indirect costs incurred due to the increased activity in metering over the 2006-10 regulatory period. The Commission will ensure the allocation of indirect costs to the DUoS price control, metering price control and excluded services is undertaken on a consistent basis and does not result in the over recovery of these costs.

EUCV will assess the impact on its constituency of this preliminary view when the consultant report is provided.

12.4 Incentive mechanism

12.4.2 Commission's preliminary view

The tariff basket control formula for metering charges will take the form:
($CPI - X_M + M$). The metering incentive mechanism (M) will have two components – an efficiency component and a volume component.
The efficiency component will operate in the same way as the efficiency carryover mechanism.

The growth adjustment for the efficiency component will be based on the volume and unit costs for each type of meter (single phase off peak meter, three phase direct connected meter etc). The efficiency component will be adjusted where a distributor's revenue requirement is based on a specific type of meter (for example, two element), but the distributor installs a different type of meter (for example, one element). The adjustment will be based on the volume of meters concerned and the difference in the unit costs between the two different types.

The volume component will operate such that where the cumulative value of meters installed in year t is more than 5 per cent greater (or lesser) than the forecast cumulative value of meters, the revenue will be increased (or decreased) in year t+2 based on the difference between the actual and forecast cumulative

volume of interval meters installed up to year t, the agreed unit costs for each meter type, and the time value of money.

The distributors will be required to report audited meter volumes as part of their regulatory accounting statements from 2006. The Regulatory Accounting Guideline will be updated accordingly.

The EUCV has no comment on this issue, other than these costs should be ring fenced from the DUoS revenue.

12.5 Metering service charges

12.5.2 Commission's preliminary view

The distributors have provided the metering service charges for customers with annual consumption less than 160 MWh and a manually read meter in a disaggregated form as required by the Commission. The Commission will analyse the charges in more detail after ECG's report on the costs and volumes have been received. The Commission will require the distributors to resubmit their metering templates on the basis that the revenue from the metering service charges should be approximately the same as the building blocks revenue required in 2010. This implies that there is likely to be a significant increase in the metering charges from year to year.

However this increase will be offset, in part, by any changes to the DUoS charges over the same period.

United Energy has not yet provided excluded service charges for metering services for customers with annual consumption greater than 160 MWh and a manually read meter. The Commission requires this information to be provided by the end of March 2005.

The Commission also requires the distributors to further consider the introduction of exit fees where a customer or retailer chooses to remove a meter.

The EUCV has no comment on this issue, other than these costs should be ring fenced from the DUoS revenue.

12.6 Other issues

12.6.2 Commission's preliminary view

The Commission's preliminary view is that the expenditure for "ripple control" technology proposed by CitiPower and Powercor in their enhanced offers will not be provided for in the revenue requirement.

> *In relation to the depreciation of existing accumulation meters, the Commission's preliminary view is that these meters should be depreciated over a period of no less than 15 years. The Commission expects the distributors to resubmit their templates on this basis.*

The EUCV has no comment on this issue, other than these costs should be ring fenced from the DUoS revenue.

13 EXCLUDED SERVICES

13.2 Policies and definitions

13.2.1 Commission's preliminary view

The distributors should resubmit their definitions of existing excluded services by 31 March 2005. The Commission will review the information provided to assess the extent to which it provides greater clarity of existing excluded service charges. The Commission expects that the definitions will clearly outline each excluded service offered, and significantly improve the information currently made available to stakeholders.

EUCV supports the ESCoV reasons and position.

13.3 Revisions to current excluded service charges

13.3.2 Commission's preliminary view

The Commission continues to invite distributors to provide supporting information for variations to excluded service charges as outlined in its Final Framework and Approach. The Commission does not consider that indexation, or rebalancing where required, should occur unless it is shown to be appropriate. To enable the Commission to effectively assess a revised statement of charges, a distributor will be required to submit the following information outlined in its Final Framework and Approach:

- *The charges (and associated terms and conditions) that the distributor proposes for the excluded service.*
- *Information that demonstrates compliance of the proposed excluded service charge with the following requirements set out in clause 5.6.2 of Guideline No. 14:*
  - *Costs of service provision: a distributor's charge and terms and conditions for an excluded service must be based on the costs incurred by the distributor in providing the excluded service;*
  - *Cost allocation: in respect of the costs incurred by a distributor in providing an excluded service:*
    - *those costs must not include costs in respect of which the distributor is remunerated under the distributor's distribution tariff; and*
    - *those costs must only include an appropriate allocation of any shared or common costs incurred by the distributor in providing the excluded service and in providing any other goods or services, whether in the conduct of the distributor's business as a distributor or any other business;*
  - *Cost differentials: a distributor's charge and terms and conditions for an excluded service must be the same for all customers unless*

there is a material difference in the costs of providing the excluded service to different customers or classes of customers. Different charges and terms and conditions for different customers or classes of customers must only be attributable to differences in:

- *the volume or quantity of the excluded service provided;*
- *the places to or from which the excluded service is provided;*
- *the time of day at which the excluded service is provided;*
- *the performance characteristics at which the excluded service is provided; or*
- *any other difference in the costs of providing the excluded service; and*

- *Simplicity: charges and terms and conditions for excluded services should be simple and easily comprehensible.*

- *Reported and expected costs of providing the excluded service for the next five years.*
- *The reported historic and current demand for the excluded service, demand forecasts, and the method that was used to determine those forecasts, for the excluded service over the next five years.*
- *Information on the allocation of costs between prescribed and excluded services, and between each excluded service, and the method that was used to determine this allocation.*

EUCV supports the ESCoV reasons and position.

13.4 Allocation of costs to excluded services

13.4.2 Commission's preliminary view

The Commission's technical consultants have been asked to consider the issue of the allocation of both metering data services costs and shared costs to excluded services in their assessment of the volume and expenditure forecasts associated with metering. The Commission will make available on its website this report when it is available.

Given that the allocation of costs is an issue that encompasses three separate price controls (DUoS, metering and excluded services) and that the reasonableness of the costs associated with these controls is still being assessed, the Commission at this stage is unable to resolve the cost allocation issue. However, the Commission will continue to carefully assess whether the allocation of shared costs to DUoS, metering and excluded services is reasonable, given the reclassification of metering as a prescribed service for a substantial portion of the distributors' total customer base.

In continuing its review, the Commission will require TXU and AGLE to indicate why the allocation of shared costs to excluded services should exhibit an upward

trend in the 2006-10 regulatory period, despite the reclassification of metering data services as a prescribed service for a substantial number of customers.

EUCV supports the ESCoV reasons and position.

13.5 Other Activities

13.5.2 Commission's preliminary view

For the 2006-10 regulatory period the Commission will treat as a customer contribution fifty per cent of the reported revenues less reported cost derived from Other Activities. Distribution customers will then share the benefits of unregulated revenues, derived from the use of regulated infrastructure, in the 2011 regulatory period. This will occur because, in rolling the regulated asset base forward in 2011, distributors will not receive the return on, nor the return of, fifty per cent of reported revenues less reported cost derived from Other Activities in the 2006-10 regulatory period.

Throughout the 2006-10 regulatory period, in addition to the reporting of unregulated revenues and costs allocated to Other Activities48, distributors will also be required to report the corresponding customer contribution (equalling to fifty per cent of reported revenues less reported costs from "Other Activities") as a separate line item in their annual regulatory accounts. The Regulatory Accounting Guideline will be amended to reflect this change.

Treating as a customer contribution fifty per cent of the reported revenues less reported costs derived from Other Activities represents a relatively unobtrusive method to deal with the small quantum of unregulated revenues reported to date. However, should the quantum of unregulated revenue become material during the 2006-10 regulatory period, the Commission will review its approach for the next regulatory period.

EUCV supports the ESCoV reasons and position, but only whilst the amount of revenue from "other activities" remains small. If during the current period the revenue from these activities becomes significant, then the revenue share to consumers should be made earlier than 2011.