Ref: LZ:JC

30 May 2002

Dr Tom Parry
Chairman
Independent Pricing and Regulatory Tribunal of NSW
Level 2, 44 Market Street
PO Box Q290
QVB Post Office NSW 1230

Dear Dr Parry

Draft Notice – Economic Regulatory Arrangements

Country Energy welcomes the opportunity to comment on the Tribunal's *"Draft Notice under Clause 6.10.3 of the National Electricity Code – Economic Regulatory Arrangements"*. Please accept this letter as Country Energy's written submission to the report.

Proposed Weighted Average Price Cap for Distribution Tariffs

Country Energy is supportive of the proposal to introduce a weighted average tariff basket form of price control as it meets the requirement for efficient pricing and facilitates a closer alignment of price and cost structures than the current revenue regulation. The tariff basket approach has a number of other advantages including the use of known rather than forecast variables and thereby removes the need to incorporate complex correction factors.

In our previous submissions to the form of regulation review, we stated our support for both the tariff basket and the hybrid form of control and requested the Tribunal to provide detail on the specific formulation of the proposed price control in the draft notice. It is noted however that the Tribunal has not set out a concrete formulation of the price control but has provided some general information on the factors that may give effect to the tariff basket approach. Specific comments have been provided below in relation to both the service quality incentive mechanism and the benefit sharing mechanism, factors that the Tribunal has proposed to integrate into the price control formula. Country Energy recognises the many benefits that can be derived from the tariff basket and in recognition of these benefits, Country Energy will continue to work closely with the Tribunal in relation to the above issues and to finalise the price control mechanism.

The report is silent on the key regulatory principles to be applied in the determination of limits on price movements, the introduction of new network prices and the proposed approach to the derivation of the X factor(s), which we believe are integral components of the economic regulatory arrangements.

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The introduction of the tariff basket approach to price control will only be meaningful if there is sufficient scope in the side constraint controls to allow flexibility in network price setting. Country Energy believes that the current limitations on price movements may be overly restrictive. In our previous submissions we made the comment that Country Energy's current network price structures do not reflect underlying cost structures and changes are required to provide greater flexibility to enable distributors to develop more efficient and cost reflective price structures. To the extent that the tariff basket form of regulation needs to support a cost reflective pricing approach, the existing side constraints need to be relaxed.

Additionally, it is important that re-balancing constraints are revised to ensure that they do not in the future prevent a distributor from earning their allowable network revenue requirement and that they do not obstruct the construction of new efficient network prices or restructuring of prices. We urge the Tribunal to give due consideration to the provision of adequate flexibility for distributors to introduce a range of new network prices or structures as part of the introduction of the new price control. Country Energy recognises that significant work and consultation may need to be performed to address this complex issue.

In the absence of freedom to set cost reflective network prices, Country Energy will bear additional residual risk as cost structures fail to align with revenue structures, and the potential for bypass is increased. Such risk would need to be reflected in the cost of capital. This risk, and other areas of risks, will be addressed in detail in our submission to the 2004 price review.

Additionally, Country Energy has some concern with the absence of detail relating to the methodology to be used to derive the X factor(s). The choice of approach may have significant bearing on revenue and earnings risk. We firmly believe that this calculation must take account of the distributors current price structures and the changes proposed to prices, in accordance with published medium term network pricing strategies, rather than the application of assumed price structures.

Country Energy urges the Tribunal to commence consultation on the specific formulation and parameters of the control mechanism immediately following its formal notification of the form of regulation (expected to be 30 June 2002), and for this subsequent review to be completed before the distributors submit their pricing proposals. This will provide greater understanding of how the selected formulation would be applied in practice and integrated into pricing proposals. Country Energy is willing to actively participate in the development of an acceptable formulation.

Service Quality Incentive Mechanism

Country Energy has demonstrated its commitment to providing excellence in customer service and to develop continuous improvement in supply reliability in satisfying the needs of the users of our rural network. This commitment has been demonstrated by the

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significant increase in customer satisfaction levels, which has increased during the last year since the formation of Country Energy from 75% to 82%.

Country Energy believes that there is insufficient justification for the introduction of a service quality incentive mechanism into the proposed price control for average reliability performance and for the introduction of minimum standards. There is little evidence to date in other jurisdictions to demonstrate that the introduction of an incentive scheme in the price control or minimum standards will improve reliability in rural electricity distribution. Country Energy submits that it is neither necessary nor appropriate to introduce such mechanisms in relation to reliability of supply.

The Tribunal has commenced a review of minimum and average performance standards as part of the 2004 network price review. Country Energy believes the introduction of mandatory minimum service standards should be considered at the next price reset beyond 2004 and then only in accordance with the principle that the likely costs must be balanced against any perceived benefit. Any reconsideration of current service standards or the introduction of minimum standards would need to be based on rigorous evaluation of costs and benefits. It is likely that any consequential benefit would be disproportionate to the cost of implementation and administration. In consideration of the potential cost of introducing new systems and modifications to existing systems, together with the cost of collecting, processing and maintaining the necessary data to apply minimum standards, it is evident that such a proposal must only proceed if there is clear and sound justification.

Furthermore, given an ageing network infrastructure, Country Energy considers that substantial costs will be incurred in maintaining current standards through an extensive replacement/refurbishment and maintenance program over the next regulatory period, apart from any attempt to move these standards to an even higher level. For rural systems there will always be customers with poorer performance due simply to the long radial nature of many of our supply systems and uncontrollable events such as storms and lightning that impact on the network, and it is not possible to eliminate these without huge capital investments. However, Country Energy will continue to evaluate service standards as part of the willingness to pay customer research. The development of our submission to the upcoming 2004 price review will reflect this research and any proposed change that may incorporate this research would be subject to a cost-benefit analysis.

Country Energy does not believe that the current regulatory framework in NSW and the available information systems have matured sufficiently to accommodate an incentive based regulation of price controls and the introduction of a penalties and rewards system. The establishment of minimum standards requires sound historic data. In our opinion, there is at present insufficient data to develop rigorous minimum reliability targets or benchmarks for the coming regulatory period. This could create potential problems where arbitrary or unreasonable standards are imposed without due consideration for regulated pricing levels and the differing operating environments faced by the distributors and in areas of the state where data collection is immature.

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Minimum standards are a future possibility once systems are in place to collect reliable and consistent data and are sufficiently robust to monitor individual customer performance. The Tribunal could undertake a more comprehensive service quality review and the possible progression to minimum standards at the next regulatory reset beyond 2004 when more comprehensive information on performance is expected to be available. The information from these systems could then be required for the modelling and setting of the guaranteed payment thresholds.

In the interim, Country Energy supports the continuation of aggregate reliability performance targets that are no worse on average over the next regulatory period than the average aggregate reliability performance expected at the end of the current regulatory period and that appropriate exclusions are allowed for upstream incidents and events beyond the control of the distributor. Additionally, at this review, we believe the option of introducing minimum standards should be left to the discretion of the individual electricity distributor. This would leave the option of individual electricity distributors pursuing minimum standards where it is believed that they might enhance customer service and improve overall service efficiency, and allow distributors to develop direct experience with their implementation. This would provide comfort to the Tribunal that the distributors are driving service level improvements.

Country Energy supports the premise that public disclosure of reliability performance provides a very effective discipline on the distributors to maintain and improve on service levels for poorer performing parts of the network. Country Energy believes that the current comparative reporting of service quality to the Ministry of Energy and Utilities is a simple but very effective form of regulation. However the disclosure of information should be limited to information that is useful and meaningful to customers. Country Energy therefore recommends that as part of the upcoming review, that the most appropriate mechanism for service quality incentives should be the continuation of comparative performance reporting in the short term over the next regulatory period. The current guaranteed service levels and licence conditions, and other voluntary minimum standards would supplement this arrangement.

In addition, Country Energy believes that there is a need to determine what priority and value customers may place on the development of service standards. The willingness to pay evidence will provide increased focus on service quality improvement information for distributors and allow them to recognise those areas of the network or customer segments where increased expenditures is necessary. This expenditure would be integrated into the building blocks, matched with customers' preparedness to pay and therefore have the greatest impact.

Country Energy believes that the development of the framework must be the subject of meaningful consultation involving customers, distributors, industry stakeholders, regulators and must recognise the practicalities and reliability information limitations associated with operating rural electricity networks. Country Energy therefore welcomes the formation of a consultative group on network service standards to facilitate consideration of service quality issues in the context of the 2004 review.

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Notwithstanding the above, if minimum service standards are established by the Tribunal a conservative approach should be adopted, particularly in terms of the thresholds of performance in relation to service and reliability. Country Energy believes that any incentive framework introduced by the Tribunal must preserve the economic value of the individual distributor. For example the expected costs of any performance penalty payments and the costs associated with the establishment and on-going management and maintenance of recording and payment systems associated with the minimum standards process must be recognised in the distributors revenue requirement and provided for in full. Irrespective, a clear distinction between the features of incentive regulation and penalty based regulation should be maintained in the 2004 pricing review.

Transmission Tariffs

Country Energy agrees with the Tribunal's proposal to introduce a correction factor for transmission charges. There must also be flexibility in re-balancing controls. Separate limits on price movements for the transmission component of the network price is required to ensure full recover of transmission costs.

Miscellaneous Charges and Monopoly Fees

Country Energy recommends the formation of a consultative group on miscellaneous charges and monopoly fees to facilitate the consideration and development of a comprehensive list of "ancillary services" provided by the distributors and the setting of prices thereof.

Proposed Approaches to Setting Volume Forecasts

The Tribunal has indicated a requirement for distributors during the 2004 review to provide forecasts for, amongst other things, consumption, peak demand and customer numbers for low, medium and high growth scenarios. Demand forecasts will be used by the Tribunal to derive the specific building blocks, X factors and presumably to determine the appropriateness of growth related expenditure forecasts.

Country Energy supports the position that the NSW distributors should provide their own estimates of demand forecasts, together with independent verification that the forecasts are best estimates arrived at on a reasonable basis. Distributors are in the best position to know the capabilities of their existing assets and how best to develop those assets to meet the future needs of customers. If the distributors are to be held accountable for servicing customers then they must have responsibility for the development and implementation of the key service inputs of system planning and expenditure, including demand forecasts.

Country Energy proposes to adopt a formal methodology to forecast consumption, demand and new customer growth. This work will be supported by external expertise. The outcome of this analysis will be made available in our submission to the 2004 price review and will enable the Tribunal to form a view about the appropriateness of forecast growth and growth related expenditure. This approach would also enable the distributors to provide comment on the key influences that will effect volumes and expenditure requirements into the future.

It is important not to over-rely on volume forecasts based on historical trends. The Tribunal should recognise the limitations on how accurate forecasting of future demands can be using a mechanistic approach as outlined in the report.

Furthermore, Country Energy does not support the unqualified use of historical trends as a starting point in forecasting costs to be incurred in any future regulatory period. There are limitations in the use of historical spending patterns for determining future capital and operating expenditure requirements. Any assessment of future operating costs must also provide for changes in scope of activities, changes in operating and other conditions. Whilst historical data may have some limited value, it is essential that each regulatory period be considered separately in light of the services to be delivered, outcomes to be achieved (for example compliance with safety requirements and industry accepted maintenance practices) and the operating environment in which those activities are to be undertaken.

Benefit Sharing Mechanism

The success of incentive based regulation relies on a regulatory regime that delivers incentives to distributors to encourage efficient rather than inefficient behaviour.

The tariff basket form of price control provides an incentive for distributors to meet growth where it is efficient to do so. Country Energy believes that the incentive to meet efficient growth in demand present in the tariff basket form of price control must be preserved. Country Energy does not consider that the Tribunal's "benefit sharing mechanism" proposal is consistent with an incentive based regulatory regime. The Tribunal does not offer any substantive or objective evidence to support the introduction of the mechanism proposed. In order to be certain that incentives to meet efficient growth in demand are maintained under the price cap form of control, Country Energy considers that the approach should be designed to err in favour of providing incentives and opportunities for investment. Such an approach has been advocated by the Productivity Commission in its recent position paper on the national access regime.

Additionally, the tariff basket approach results in an actual revenue path which is not dependent on demand forecasts and so the need for a "benefit sharing mechanism" to correct for inaccurate volume forecasts as proposed by the Tribunal is unnecessary.

In considering the issue of a growth related adjustment, the Tribunal has introduced potential complexity in attempting to introduce a mechanism to provide adjustment for differences in forecast and actual outputs without looking at the actual costs that would be incurred during the next regulatory period. Country Energy considers that any benefit sharing mechanism implemented should be simple and should seek to maximise cost efficiency and customer benefit by ensuring that the objectives of customers and the

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distributors are aligned. A more effective approach therefore is the introduction of a "cost efficiency" sharing mechanism that provides a fair sharing of cost efficiency gains between electricity distributors and customers.

A fair apportioning of the benefits of cost efficiency gains in this manner over a number of regulatory periods is more likely to encourage the sustained uncovering of such gains to the ultimate benefit of all electricity consumers. However, given the complexities of finding a "perfect" adjustment mechanism and the likely imperfect outcome that will potentially be achieved. Higher rewards to distributors are necessary to encourage higher efficiency. Any approach that under compensates the distributor will provide an incentive not to undertake economic expansion of the network reflecting growth, defeating one of the key incentive mechanisms associated with the tariff basket form of price control.

Processes and Timetable for 2004 Review

The Tribunal has proposed a timetable to be followed as part of the formal process for the 2004 price review.

Country Energy has some concern with the indicative timetable proposed by the Tribunal. The timetable should be altered to remove the requirement for the distributors to provide their initial public submission until April 2003. At this stage of the (informal) process, Country Energy is concerned that clear and consistent guidelines will not be established with sufficient time that would enable us to make a meaningful submission by October 2002.

Country Energy may not be in a position by October 2002 to provide financial information to the level of detail that would enable purposeful consultation. It will require some time to process financial information and forecasts and it is unlikely that we will be in a position to provide firm price-service offerings and our views on a number of key issues by October 2002. Some issues, notably the service-price offerings, can only be thoroughly analysed after financial information has been processed. In many cases we expect only to provide qualitative examination of the key issues.

Country Energy would prefer to work towards an April 2003 timeline for initial submission from the distributors to ensure that we have completed all necessary analysis, verification and supporting information in accordance with the guidelines that the Tribunal is proposing to establish (following consultation with all stakeholders). The April 2003 timeframe would also allow the distributors to develop price-service proposals to better reflect users preferences and the requirements of the regulatory framework and the incorporation of any early agreed upon positions in relation to the 2004 price review. Country Energy also recommends that the Tribunal seek to consult with all stakeholders on the proposed guidelines and information template and for this to commence in July 2002 for release by December 2002.

The timetable proposed above would also enable the Tribunal to conduct early formal consultation with all stakeholders on a number of substantive issues relating to the review

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prior to the submissions by the distributors. We view this as an opportunity to participate in developing debate on key issues and the early exposure of these issues will assist users and interested parties in their understanding. Country Energy believes that the NSW distributors would be disadvantaged if some issues have not been explored prior to the formal submission for example service standards and incentive mechanisms.

It should be noted that any preliminary information provide by Country Energy will differ significantly from the more detailed information that would otherwise be developed and provided in a more formal submission in April 2003, reflecting in part:

- Integration of actual financial outcomes for the current 2001/02 financial year as provided in regulatory and financial accounts;

- Further development of the costs and experience with the operation impacts of the recent merger of Country Energy;

- Allows sufficient time for further consultation by the Tribunal on the form of regulation to finalise the details of the price control mechanism for incorporation into pricing submissions;

- The NSW electricity distributors are also facing changes in the scope of their businesses over the course of the Tribunal's review (and the next regulatory period) associated with the introduction of FRC. External uncertainties and changes in scope of the electricity distributors reinforce the need to provide more time for the distributors to make their initial submissions. The extended timetable would enable further development of the costs and experience associated with the operational impacts of FRC;

- Enables the integration of any variances in future technical maintenance standards;

- Allows the outcome of the consultation process relating to service standards, and other reviews such as undergrounding and the demand management inquiry, to be integrated into the submissions;

- Incentive regulation based upon customer value preferences is strongly preferred. Incentives through price require a good understanding of the value that the customer places on reliability and how much they are prepared to pay for increased supply quality. The development of customer willingness to pay evidence is now being established by the NSW distributors. At present this information is not available. Country Energy and the other NSW distributors are working towards providing this data to the Tribunal, but this information will not be available until late 2002;

- Time to prepare forecast volumes which need to be based on the best information available and identify the key influences that have affected and will affect the volume forecasts such as weather trends, consumption associated with new housing developments and connections, latest census information, etc.

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- The weighted average cost of capital parameters reflecting market conditions at a time closer to the 2004 reset;

- Expenditure estimates which are based on Country Energy's five year Asset Management Plan that would be more reflective of the level of expenditures necessary to meet technical standards and requirements closer to the 2004 price reset. The forecasts that would be provided in October 2002 may not be fully representative of the costs of operating, maintaining and developing a sustainable network and meeting growth over the 5 year period from June 2004.

An April 2003 timeframe will enable Country Energy to finalise a detailed capital works and expenditure program based on the needs of our customers with respect to the timely and reliable service and supply, and the state of our distribution network assets. The program will include:

- Demand related expenditure to meet new customer demand and changing needs associated with existing customers,

- Network reinforcement to maintain and to improve service levels and supply quality and reliability to customers (where willingness to pay evidence is provided), and

- Non-demand related expenditure focussed on maintaining and improving supply and service quality, reliability, safety and security. In particular, expenditure needs attributable to compliance obligations to meet industry standards for network management.

Details of these programs and supporting analysis will be made available to the Tribunal in our April 2003 submission.

- Enable the impact of the new capital contributions determination to be assessed and the net impact to be included in forecast capital expenditure; and

- Enable the Tribunal to consult on a number of key issues that warrants early and detailed consideration and to conduct a series of workshops and meetings to provide opportunities for interest parties to debate the issues and express their views prior to the submissions by the distributors.

The 2004 pricing review will also commence at a time of significant uncertainty surrounding the current framework for electricity industry regulation. In particular, there are two reviews in various stages that may have the potential to significantly affect the regulatory framework for the NSW electricity distributors. These reviews are the Productivity Commission Review of the National Access Regime and the Council of Australian Government (COAG) Review of Energy Market Directions.

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The Productivity Commission has now completed its considerations and submitted a final report to the Commonwealth Government. The Commission has emphasised the impact of regulatory uncertainty and risk on new investments in energy infrastructure, and concluded that the costs of under compensating a facility owner are significantly greater than the cost of over compensation. As the Productivity Commission notes, given the asymmetry of costs of under and over compensation of facility owners, there is a strong principle case to "err" on the side of investors. The report is likely to recommend far reaching reforms to regulatory arrangements. Country Energy considers it of key importance that the Tribunal considers an approach complementary to and consistent with the findings of the Commission during the pricing review. In addition, it would be appropriate to combine the implementation of measures to address some of the deficiencies of regulation identified by the Commission as part of the review.

COAG has initiated an energy market review, which will examine many critical issues associated with the development of appropriate regulatory frameworks and outcomes. In particular, the energy market review is tasked with examining regulatory approaches that balance incentives for new investment, demand responses and benefits to consumers. Country Energy urges the Tribunal to have regard to any findings of the COAG review of energy market directions.

Country Energy looks forward to further consultation in relation to the matters raised in this letter. If you have any questions or wish to discuss this response, please do not hesitate to contact either myself on 6338 3424 or Mr Lawrence Zulli on 6883 4547.

Yours sincerely

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General Manager Regulatory Affairs

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