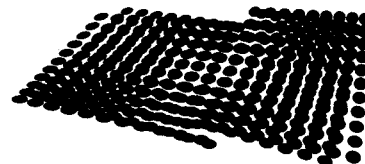


25 September 2001

Dr Tom Parry
Chairman
Independent Pricing and Regulatory Tribunal
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Paul A Broad
Managing Director

Dear Dr Parry

Form of regulation to apply from 1 July 2004

The pure revenue cap adopted by the Tribunal for the current regulatory period has failed to produce the desirable economic outcomes espoused by the Tribunal and contained in the National Electricity Code. Indeed EnergyAustralia has observed sub-market rates of return on investments, negative net cash flows: and the frustration of demand management initiatives] due to the perverse incentives arising from the pure revenue cap.

EnergyAustralia's concerns with the outcomes of the pure revenue cap as adopted by the Tribunal are compounded by the fact that such outcomes could have been predicted at the commencement of the regulatory period, if the sensitivity of the pure revenue cap to variations in demand above forecast levels had been considered. Therefore, in moving forward EnergyAustralia believes that the form of regulation adopted for the next regulatory period must be robust in being able to manage greater degrees of possible growth scenarios] regardless of their probability.

The attached submission details some of EnergyAustralia's experiences with the pure revenue cap. The paper is supplementary to the joint submission that EnergyAustralia has made on behalf of Country Energy and Australian Inland Energy and Water.

EnergyAustralia also understands that the individual submission provided by Integral Energy is consistent with the views expressed by the other NSW DNSPs in their joint submission.

If you have any queries regarding any of the attached documents please do not hesitate to contact myself or Mr Jon Hocking on 9269 2054.

Yours sincerely

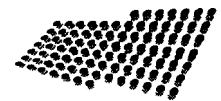
A handwritten signature in black ink, which appears to read "Paula Broad". The signature is written in a cursive, flowing style.

(PAULA. BROAD)
Managing Director

**Form of Regulation to Apply to NSW
Electricity Distribution Network Service
Providers**

**EnergyAustralia's Supplementary
Submission on IPART's Discussion
Paper (DP48)**

25 September 2001



EnergyAustralia welcomes this opportunity to assist the Tribunal in its considerations of the various forms of regulation available to it for the next regulatory reset due to occur in 2004. This supplementary submission sets out EnergyAustralia's experiences with the pure revenue cap, and the associated administrative procedures, in particular the unders and overs account.

In providing this submission EnergyAustralia does not wish to dwell on the difficulties encountered during the administration of the current determination. Rather EnergyAustralia is attempting to quantify the impact of the choice of the form of regulation, its administrative procedures, and significant variances in actual volumes from forecasts.

EnergyAustralia would like to commend the submission made by Integral to the Tribunal and recommend that the joint DNSP, Integral, and EnergyAustralia submissions should be read in conjunction. Although the experiences that each business has faced during the current regulatory period differ, EnergyAustralia understands that we are all of the view that the Tribunal should adopt the weighted average price cap.

EnergyAustralia's experience with the pure revenue cap

Since the last determination when IPART chose to change the form of regulation, EnergyAustralia has been faced with the pure revenue cap that has been exceptionally difficult to apply from both an administrative and a financial standpoint. With the adoption of the pure revenue cap all capacity for the financing of higher than forecast capital expenditure was lost. Indeed this would appear to have been compounded by the fact that the growth rates used by the Tribunal were not revised to take account of the changes in the regulatory framework.

Moreover the DNSPs did not receive any additional compensation for the increased regulatory risks faced by them under the new form of regulation. There were no adjustments either in the calculation of the cost of capital, or in the allowed cash flows of the businesses to illustrate any expectation by the Tribunal that the pure revenue cap placed any additional regulatory risks on the DNSPs.

Hence, when the estimates of growth provided proved to be incorrect, as indeed is the nature of forecasts, EnergyAustralia's network business has been unable to achieve its allowable rate of return on capital invested. Further, pressures on EnergyAustralia's cash flows have become unacceptable. These cash flow pressures have arisen as EnergyAustralia aims to maintain network reliability and discharges its legal obligation to connect new customers by investing in new infrastructure. To ensure that the taxpayers of NSW are not disadvantaged by these developments, EnergyAustralia has sought to maintain the appropriate risk adjusted returns paid to its shareholder.

These issues have made the administration of the current determination very difficult for both EnergyAustralia and the Tribunal, as there are no mechanisms available for either party to manage the significantly higher than anticipated volumes. The lack of such flexibility is a concern particularly as a divergence of actual volumes from forecast is easily foreseeable, although the magnitude of such variance will always be inherently uncertain. Indeed, the CPI-X framework by its very construction recognises the fundamental uncertainty of economic forecasting and manages the risk of actual inflation varying from forecasts within the regulatory framework.

Whilst the financial performance of EnergyAustralia has suffered under the pure revenue cap such that it has been unable to achieve the regulated return on investment, the reconciling actual and allowable revenues which is required under any form of revenue cap has also been problematic. Indeed the application of the unders and overs mechanism has resulted in allowable revenues in the latter stages of the current determination being reduced at the same time as the costs of providing the network services are increasing.

The disconnect between revenues and costs that can occur in situations where volume growth is materially higher than forecast causes problems not only during the regulatory period, but also for

the transition between determinations. The potential problems arising from the cash shortages of businesses during regulatory periods and the subsequent price shocks at the transition between determinations can not be overstated.

EnergyAustralia's anticipated capital expenditure program

EnergyAustralia estimates that for the 2001/02 financial year it will need to invest \$93 million in capital projects above that recognised in the Worley report in order for EnergyAustralia to meet demand and reliability requirements. The total capital expenditure that EnergyAustralia anticipates that it will invest above that allowed for in the Worley report for the current determination period is approximately \$391 million.

The revenue requirement for this adjusted level of expenditure is obviously materially greater than that allowed for in the Tribunal's December 1999 determination. The additional revenue necessary to support the additional capital expenditure for 2001/02 is in the order of \$23 million, which increases to a shortfall of approximately \$40 million in 2003/04, based on the WACC and other assumptions of the December 1999 determination.

The total shortfall in allowable revenues necessary to fund additional capital expenditure over the current regulatory period, based on current estimates, is \$113 million. The return on capital component of this foregone revenue is \$75 million, which if capitalised and rolled forward to the end of the regulatory period would result in a total increase in the regulatory asset base of \$472 million, or 11.3 per cent.

The implication for prices resulting from the once-off inclusion of the additional assets and return of additional depreciation and operational expenditure over the period of the next determination would be a price increase in the order of 9.0 per cent, based on current estimates of growth. It should be noted that the assumed growth over the remainder of the regulatory period is conservative, particularly in light of the growth experienced by EnergyAustralia during 2000/01.

Subject to the application of an appropriate prudence test for capital expenditure, which EnergyAustralia is eager to work with the Tribunal to develop, EnergyAustralia does not see any valid reason why taxpayers should be required to fund the higher than anticipated capital expenditure requirements of the distribution businesses placed upon it by customer demands on the network.

The impact that the increased capital expenditure program has had on the operations of EnergyAustralia has been significant. Indeed the impact has been so material in relation to the cash flows of the business that, whilst maintaining appropriate distributions to our shareholder, EnergyAustralia is currently facing negative net cash flows. Whilst EnergyAustralia does not believe that such an outcome was ever the intension of the Tribunal in its adoption the pure revenue cap, it has been the effect.

Mitigation of the problems

Given these experiences EnergyAustralia can not over state its desire for the Tribunal to adopt a form of regulation that enables volume variations to be adjusted for within the regulatory period.

Moreover with the benefit of hindsight it becomes clear that the of the available forms of regulation the one that would have been best able to manage the circumstances that arose in EnergyAustralia's distribution area is the weighted average price cap.

Indeed the weighted average price cap would have ensured both a revenue stream close to that required by EnergyAustralia given the additional capital expenditure, and would have maintained a balanced pricing trajectory without the anticipated price volatility that is described above.

Therefore EnergyAustralia believes that the weighted average price cap would have achieved efficient pricing, pricing stability, revenues commensurate with the capital invested in the network infrastructure, and would have been much simpler to administer through the elimination of the unders and overs account and the redrafting of the Tribunal's rules.

Transitional arrangements

The problems associated with the existing regulatory arrangements will not be immediately resolved by merely adopting the weighted average price cap. Rather, there will need to be a carefully considered transition to any new form of regulation to ensure that both the pre-existing difficulties associated with the pure revenue cap are rectified, but also that the benefits of the new forms of regulation are not compromised by the management of these difficulties.

EnergyAustralia submits that the most appropriate manner in which to ensure that the economic benefits of the new form of regulation is to make a FO step change. In particular EnergyAustralia believes that the building blocks components should be reset so that the initial prices arising from the new form of regulation will reflect the 'true' economic cost of providing network services based upon the best available information at that point in time. Moreover, EnergyAustralia would encourage the Tribunal to examine the feasibility of easing side constraints where necessary to enable the DNSPs to set the most economically efficient prices, given the form of regulation that is ultimately adopted.

The application of these recommendations will maintain the integrity of the new form of regulation, and does not perpetuate the problems associated with the current form of regulation. However, EnergyAustralia recognises that these recommendations do not address all of the issues and indeed it will still need to return the balance of its unders and overs account to customers that exists at the end of the current regulatory period.

In addressing the issue of the final balances of the unders and overs account there would appear to be several options available to the Tribunal. However it must be recognised that the effectiveness of each of these mechanisms will be largely dependent upon the manner in which the Tribunal conducts its review and administers its determinations. Therefore, rather than open the debate at this stage, EnergyAustralia would like to reserve the option of approaching the Tribunal with its preferred approach to returning the balance to customers when the principles of the Tribunal's regulatory framework become clearer.

Demand management and concurrent regulation

EnergyAustralia's experiences with the policies adopted as part of the pure revenue cap framework demonstrate that they create perverse signals for demand management. Whilst the pure revenue cap will always encourage the DNSPs to pursue demand management options as they will only face reduced profits from increases in consumption, the reverse is signalled to customers. Under the pure revenue cap, as demand grows the price per unit decreases which provides a pricing signal to customers that they can afford to consume more.

Assuming that demand for electricity is not totally inelastic, customers will respond to this pricing signal, which is in direct opposition to the pricing outcomes that would be expected from an examination of the changes in the long-run marginal costs associated with the increased infrastructure necessary to cope with the increased load.

In addition to its support for the general arguments raised in the joint DNSP submission EnergyAustralia would like to remind the Tribunal that it is currently regulated by both IPART and the ACCC. As such, EnergyAustralia can see significant benefits from the achievement of regulatory consistency in the assessments of both economic and environmental prudence.

In particular, EnergyAustralia believes that the Tribunal should adopt the regulatory test developed by the ACCC as a means of ensuring that externalities are appropriately incorporated in the assessment of demand management options. EnergyAustralia believes that this would enable EnergyAustralia to establish and maintain a single process for the approval of all capital expenditure, regardless of the regulatory jurisdiction under which the specific assets fall.

Conclusions

In summary EnergyAustralia believes that the Tribunal should:

- give consideration as to the transition to the new form of regulation that it adopts, and the impact that such a transition is likely to have on both the short and long-term effectiveness of the new form of regulation;
- not attempt to utilise the form of regulation as the mechanism for ensuring the pursuit of appropriate *end user energy efficiency* initiatives, and consider whether the regulatory test developed by the ACCC is a more appropriate means of ensuring appropriate consideration to alternative technologies and *end user energy efficiency* options;
- consider the development of a set of Principles for Distribution Regulation;
- adopt the weighted average price cap as the preferred form of regulation; and
- discuss the procedures and policies it proposes to adopt as part of the form of regulation in detail as part its draft decision of the form of regulation to apply for the next determination.