Better Regulation

Explanatory Statement

Shared Asset Guideline

November 2013

AUSTRALIAN ENERGY REGULATOR

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Inquiries about this document should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001
Tel: (03) 9290 1444
Fax: (03) 9290 1457
Email: AERInquiry@aer.gov.au

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Shortened forms

This explanatory statement uses the following definitions:

Term	Definition
AEMC	Australian Energy Market Commission
annual revenue requirement	an amount representing revenue for a distributor, for each regulatory year of a regulatory control period, calculated in accordance with Part C of Chapter 6 of the NER. The equivalent for a transmission network service provider is the maximum allowed revenue calculated for a regulatory year of a regulatory control period in accordance with rule 6A.3
consumer	For this guideline we use the term 'consumer'. This term is consistent with the National Electricity and National Gas Objectives. It is also reflected in the National Electricity Rules, which refer to 'electricity consumers'. We acknowledge 'consumer' and 'customer' have distinct meanings and it is valid to make the distinction in some cases. We also acknowledge these terms are used interchangeably.
cost reduction	shared asset cost reduction a reduction in the regulated annual revenue, as established by clauses6.4.4 and 6A.5.5 of the NER
cost reduction method	as set out in section 6 of these guidelines
distributor	Distribution Network Service Provider, as set out in the NER
material	for the purposes of the application of these guidelines, 'material' is as set out by section 4.2 of these guidelines
NER	National Electricity Rules as defined in the National Electricity Law.
network service provider / service provider	distribution network service provider and/or transmission network service provider as defined by the NER
relevant regulatory control period	an upcoming regulatory control period comprising one or more relevant regulatory years
relevant regulatory year	a regulatory year of an upcoming regulatory control period in which total shared asset unregulated revenues are material
return of capital	depreciation calculated in accordance with the relevant distribution or transmission determination
return on capital	the return on capital calculated in accordance with the relevant distribution or transmission determination
RIN	regulatory information notice

shared asset guideline, guideline	Shared Asset Guideline
shared asset standard control revenues	return on and return of capital, as determined under chapter 6 of the NER
shared asset unregulated revenues	revenues paid to a distributor for unregulated services provided using the distributor's shared assets
smoothed annual revenue requirements	amount of revenue to be raised in each year of the regulatory control period (usually five years) smoothed to minimise fluctuations from one year to the next
TNSP	transmission network service provider, as set out in the NER

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Summary

This explanatory statement accompanies our Shared Asset Guideline (guideline) which sets out how electricity consumers[1] will share in the benefits of using assets paid for by electricity consumers to also provide other, unregulated, services. It forms part of our Better Regulation program of work which delivers an improved regulatory framework focused on the long term interests of consumers.

The November 2012 changes to the National Electricity Rules (NER) recognised that distribution and transmission electricity network service providers (service providers) sometimes use regulated assets to earn unregulated revenue streams. The NER now define assets used in this way as 'shared assets'. Specifically, a shared asset is any asset used to provide regulated standard control (distribution) or regulated prescribed transmission (transmission) services as well as unregulated services.

An example of a shared asset might be a power pole, paid for by electricity consumers, supporting both power lines and fibre optic cable for internet services. Electricity supply is a standard control service which we regulate, but we do not regulate internet services. In this case, the power pole is a shared asset. By charging a third party to use the pole to provide internet services, a service provider earns additional, unregulated, revenues. Through these unregulated revenues, service providers could potentially recover the cost of the poles more than once as the poles are already being paid for in full by electricity consumers.

Under the shared asset mechanism, electricity consumers who funded shared assets through their electricity bills can now share the benefits of unregulated activities (that is, the additional revenues). Consumer benefits will come in the form of lower regulatory asset costs that we determine under a mechanism principally established in the NER. Electricity prices reflect the cost of assets used to supply electricity. Reducing the cost of shared assets will help contain or reduce electricity prices. By reducing shared asset costs, we aim to ensure electricity consumers will pay less for regulated assets where these assets are also used to provide unregulated services.

The revised NER establish a high level framework to make shared asset cost reductions. We must publish a guideline on our intended approach which provides further details on how such a mechanism will work—that is, our steps for making cost reductions. However, there is flexibility in the way the mechanism will operate under the NER. While there is no requirement to include a detailed method to determine cost reductions in the guideline, for transparency we have chosen to include a detailed method in the guideline.

This explanatory statement should be read in conjunction with our guideline, which sets out how we propose to reduce consumer costs for shared assets. This explanatory statement sets out our reasons for the approach to cost reductions detailed in the guideline. We previously released a draft guideline for stakeholder consideration, itself with an accompanying explanatory statement. These are available on our website.[2] Our final guideline is largely consistent with the draft guideline. Changes relate to:

- a more simplified method of determining consumer benefits

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1 For this guideline we use the term 'consumer'. This term is consistent with the National Electricity and National Gas Objectives. It is also reflected in the National Electricity Rules, which refer to 'electricity consumers'. We acknowledge 'consumer' and 'consumer' have distinct meanings and it is valid to make the distinction in some cases. We also acknowledge these terms are used interchangeably.

2 AER, or www.AER.gov.au

- dealing with unregulated services that use shared assets only marginally.

The guideline sets out that, for each service provider we regulate, we will:

- at the time of a regulatory determination, make shared asset cost reductions in advance for each year unregulated revenues earned from shared assets are expected to exceed 1 per cent of regulated revenues from standard control (or prescribed transmission) services
- determine cost reductions using the method set out in the guideline
- reduce standard control (or prescribed transmission) service revenues by an amount equal to the cost reductions we determine
- encourage service providers to submit proposed cost reductions calculated in accordance with the guideline
- consider proposed cost reductions calculated using alternative methods only if the result leaves consumers no worse off than under the method set out in the guideline
- require minimum annual reporting and more comprehensive reporting with regulatory proposals.

In determining cost reductions, we will take into account evidence of consumers benefitting from assets upgraded or replaced by third parties. We will accept as the upper limit on potential cost reductions a service provider's reasonable estimate of the regulated returns it earns from its shared assets.

1 Introduction

The AER is Australia's independent national energy market regulator. We perform our role in accordance with the objectives set out in the National Electricity and Gas Laws which focus us on promoting the long term interests of consumers.

In 2012, the Australian Energy Market Commission (AEMC) changed the rules governing how we determine the total amount of revenue each electricity and gas network business can earn. The Council of Australian Governments also agreed to consumer focused reforms to energy markets in late 2012.

The Better Regulation program we initiated is part of this evolution of the regulatory regime. It includes:

- seven new guidelines outlining our approach to network regulation under the new regulatory framework
- a consumer reference group (CRG) to help consumers engage and contribute to our guideline development work
- an ongoing Consumer Challenge Panel (CCP) (appointed 1 July 2013) to assist us incorporate consumer interests in revenue determination processes.

National electricity and gas objectives

The objective of the National Electricity and Gas Laws is to promote efficient investment in, and efficient operation and use of, energy services for the long term interests of consumers of energy with respect to—

(a) price, quality, safety, reliability and security of supply of energy; and

(b) the reliability, safety and security of the national energy systems.

1.1 What problem does the guideline address?

In some circumstances, it is possible for an electricity network service provider to invest in an asset and require electricity consumers to pay for the asset in full and also use that asset to earn additional revenues from other consumers. This creates the problem of potential cost over recovery.

There are already measures in place to help prevent this problem. These measures include regulatory instruments called Cost Allocation Methods and audit requirements for regulatory reporting statements. These sorts of measures are discussed later in this document and are particularly aimed at ensuring electricity customers do not pay for the costs of providing other services. It seems, however, that existing measures do not go far enough when asset costs have not been allocated to different services from the outset or use of the asset has changed.

It is unlikely the circumstances that lead to cost over recovery have occurred in a significant way in the past. However, it is apparent that there may be more opportunities in the future to use assets for purposes not originally envisaged when the assets were first established. These include using power poles to hold high speed fibre cables or locating electric car recharging stations on or near to electricity distribution transformers.

In light of these issues, the NER has been revised to better accommodate the existence of what are referred to as 'shared assets'.

1.2 Shared assets

The NER describe shared assets as those used by distribution and transmission electricity supply businesses (service providers) to provide both regulated and unregulated services. By charging for unregulated services, service providers may recover asset costs more than once.

The NER define shared assets as providing both unregulated services and particular categories of regulated electricity supply services:[3]

- for distribution—standard control services[4]
- for transmission—prescribed transmission services.[5]

So, any asset used to provide unregulated services and standard control or prescribed transmission services is a shared asset. It need not be fixed (such as power poles), and it may be mobile (such as vehicles), or non-physical (such as radio frequency spectrum). But this definition of a shared asset is not complete without an understanding of its relationship to cost allocation.

When a service provider establishes (builds or buys) an asset it determines the proportion of the asset use for regulated purposes and that for other purposes and allocates the costs accordingly. Done correctly, cost allocation means the price of regulated services properly reflects the cost of assets providing these services. In this case there is no shared asset as the asset has been properly allocated to the different services it is used for. However, this allocation generally is done only once, when an asset is first established.[6]

A shared asset, on the other hand, arises when the use of a regulated asset changes after its initial cost allocation. While the asset may still provide all the services that it provided when installed, it may now also provide unregulated services. Alternatively, unregulated revenues may vary compared with the asset's initial cost allocation.

1.3 Rule change

The NER now permit us to reduce regulated revenues where electricity supply businesses earn unregulated revenues with the same shared assets. The NER refer to this as a 'cost reduction', because we will reduce asset costs for electricity consumers. The guideline sets out our proposed approach to making cost reductions, within the framework established by the NER. We propose to include in the guideline a detailed method we intend to use to determine cost reductions.[7]

1.4 Limits to the shared asset guideline

As set out in the guideline, our approach to determining cost reductions is constrained in a number of ways. Under the NER, we may make cost reductions:

- of an amount that we consider reasonable to reflect asset costs recovered through charging for unregulated services
- based on the use of the shared assets
- that are no greater than the depreciated regulatory value of the shared assets
- as part of our distribution and transmission regulatory determinations, usually every five years

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[3] Standard control and prescribed services represent core electricity supply activities. These form the majority of distribution and transmission services respectively, and earn the bulk of revenues accruing to network owners. Appendix A discusses service classifications.

[4] NER, cl. 6.4.4(a).

[5] NER, cl. 6A.5.5.

[6] Appendix B describes cost allocation in more detail.

[7] Under the NER, the guidelines must set out our proposed approach, or high level steps, to determine cost reductions. We may or may not include in the guidelines a detailed method for determining cost reductions.

- that are forward looking and therefore based on forecasts.

On the above issues, our approach, set out in the guideline, is already determined. We may not, for example, make cost reductions worth more than the depreciated regulatory value of the shared assets in question. And we cannot determine cost reductions within a regulatory period. Changes to these arrangements require the NER to change first.

1.5 Guideline development

In developing the guideline, we undertook a comprehensive stakeholder consultation process, beginning in December 2012. At that time we published an issues paper on the Better Regulation work program and held a nationwide stakeholder forum (via our videoconference facilities) to detail our approach to guideline development. Throughout 2013 we emailed stakeholder alerts on key developments in the guideline development process.

Also beginning in December 2012 we established an internal Consumer Reference Group (CRG) to facilitate effective engagement with consumer groups throughout the guideline development process.

- The CRG held its first meeting in February 2013.
- The full CRG held meetings throughout 2013, chaired by the AER Chairman.
- CRG meetings included guideline briefings and discussions with AER staff.
- The shared assets CRG subgroup met with AER staff in addition to the full CRG meetings.

In March 2013 we published an issues paper on the shared asset guideline. We received 16 written submissions in response.

Due to limited stakeholder interest in a broader public forum, we offered bilateral meetings to interested stakeholders. A number of stakeholders took advantage of this offer.[8] In response to our bilateral discussions, we received a further four written submissions.

In July 2013 we published a draft shared asset guideline and explanatory statement setting out reasons for our proposed approach. We received 13 written submissions in response.

We held a further round of bilateral discussions with interested stakeholders prior to finalising the guideline.

1.6 Treatment of submissions

Appendix C summarises submissions we received in response to our draft shared asset guideline. Our explanatory statement released with the draft shared asset guideline included a summary of submissions we received in response our issues paper. We have not reproduced that summary here.[9]

Throughout this explanatory statement we reference submissions when relevant to the text. When several submissions made a similar point, we do not reference every relevant submission. Rather, we note a representative sample. We have taken all submissions received into account when finalising

8 While the Energy Networks Association (ENA) was only one of many stakeholders we engaged with bilaterally, we considered that awareness of our discussions with the ENA would be helpful to other stakeholders. As such, notes of our ENA meetings were made available on our website.

9 Our draft shared asset guideline explanatory statement is available on our website.

the guideline. Submissions from individual stakeholders on both the issues paper and draft guideline tended to be quite consistent.

All written submissions we received throughout the guideline development process are available on our website, excepting one confidential attachment. A submission on our draft guideline from Networks NSW included a confidential attachment which is not available for public viewing. Because comments made by our Consumer Reference Group (CRG) members in our discussions with them are reflected in their written submissions, we have not included a separate summary of those comments.

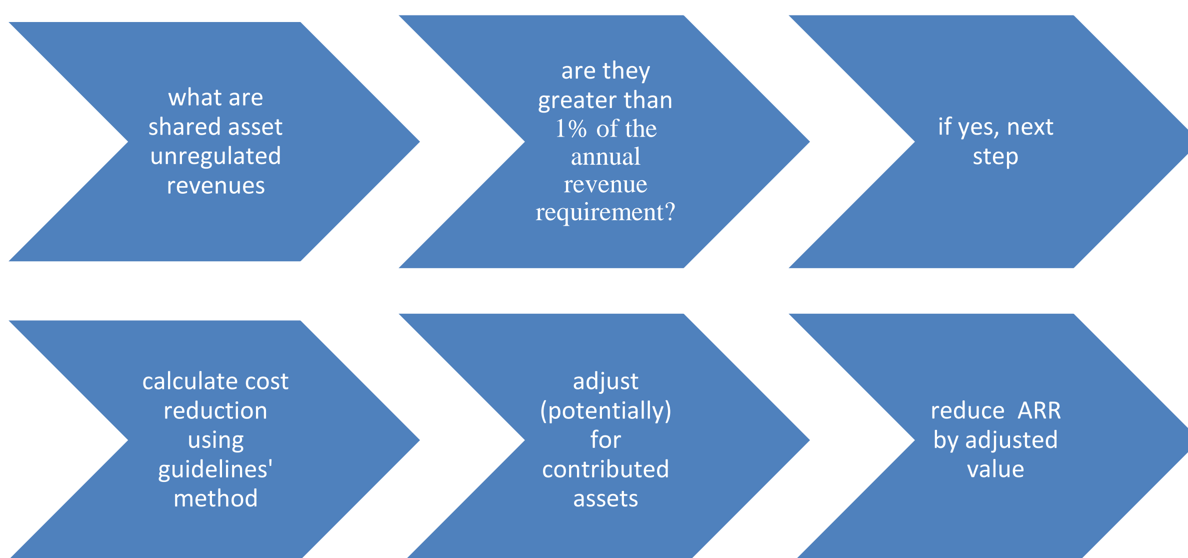
1.7 Structure of this explanatory statement

This explanatory statement takes the following structure:

- Chapter 2 explains our approach to when cost reductions are made.
- Chapter 3 explains our method for determining cost reductions.
- Chapter 4 describes why cost reductions will not account for the incremental costs that service providers incur from using shared assets to provide unregulated services.
- Chapter 5 explains service provider information reporting.
- Appendix A details the NER service classification framework.
- Appendix B describes the relationship between shared assets and the NER cost allocation framework.
- Appendix C lists submissions on our draft guideline.

Figure 1 illustrates our steps to making a cost reduction, as set out in our guideline.

Figure 1: Cost reduction process



If a service provider earns from its shared assets unregulated revenues equal to less than one per cent of its annual revenue requirement, no further action is required.[10] In this scenario, there will be no cost reduction for this service provider for the relevant regulatory year.

But where unregulated revenues are greater than one per cent of a service provider's revenue requirement, a cost reduction would occur. By reducing a service provider's annual revenue requirement, tariffs paid by consumers for standard control (or prescribed transmission) services will be lower than otherwise. Because standard control (or prescribed transmission) services are consumed by most electricity consumers, lower tariffs for these services mean lower electricity prices for most consumers.

10 A service provider's annual revenue requirement is the revenue it earns from standard control or prescribed transmission services in a given year. This generally equates to around 80 per cent of a service provider's total annual revenue.

2 Our approach to making cost reductions

This chapter sets out our reasons for our approach, or high level steps, to making cost reductions. Our approach includes making cost reductions using forecast revenues and services, defining materiality and allowing service providers to propose cost reductions. We address these issues in detail below.

2.1 Cost reductions will be forward looking

2.1.1 Issue

Some submissions supported annual determination of cost reductions and ex post reconciliations for the difference between cost reductions made using forecasts and actual outcomes.[11]

2.1.2 Our approach

Consistent with our draft guideline, we will make cost reductions based on forecasts, within the distribution and transmission regulatory determinations that we undertake at the beginning of regulatory periods. We propose not to make ex post reconciliations.

2.1.3 Reasons for our approach

We will determine cost reductions within our regulatory determinations, using forecast services and revenues. This is because the NER do not permit annual determination of cost reductions, and the NER and AEMC do not support ex post reconciliations. This section first addresses the proposal from some stakeholders that we determine cost reductions annually. We then discuss the proposal that ex post reconciliations be used to balance actual outcomes against the forecasts used to determine cost reductions.

In respect of annually determined cost reductions, the NER specify that the AER may:[12]

> …in a distribution determination for a regulatory control period, reduce the annual revenue requirement for that Distribution Network Service Provider for a regulatory year in that regulatory control period by [an amount we consider reasonable].

A distribution determination (or a transmission determination) is our written decision on the regulatory arrangements to apply to a service provider for a period of time. That period of time is a regulatory control period—usually five years. The phrasing of this provision means that we may only determine consumer benefits as part of our regulatory determinations—every five years. The NER do not allow us to determine consumer benefits annually. To change this approach, the NER must change first.

The Energy Users Association of Australia (EUAA) submitted that it does not agree the NER prevent cost reductions being determined annually, however, it did not provide a rationale for this view.[13] Our understanding of the NER remains as set out above, that we are unable to determine cost reductions other than as part of our regulatory determinations.

On ex post reconciliations, consistent with our draft guideline, we propose not to make ex post reconciliations for the following reasons:

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[11] Energy Users Association of Australia (EUAA), Submission on draft shared asset guideline, August 2013, p.4. EUAA, Submission on shared assets, 17 May 2013, p. 1. EUAA, Submission on draft shared asset guideline, 9 August 2013, p.4.

[12] NER, cl. 6.4.4(a) for distribution and cl. 6A.5.5(a) for transmission.

[13] EUAA, *Submission on draft shared asset guideline*, August 2013, p.4.

- The NER do not specifically allow ex post reconciliations and imply real-time cost reductions.[14]
- The AEMC considers ex post reconciliations should not be necessary.
- Consumer benefits from services begun only in the preceding regulatory period will be limited, because only a short period of operation will have been possible.
- We propose to monitor the accuracy of forecasts compared with actual unregulated service and revenue outcomes, with a view to possibly changing our approach and the NER if necessary.

The NER do not mention reconciliations for the difference between forecasts and actual outcomes. Also, the phrasing of the NER seems to support a real-time approach to determining cost reductions. That is, the NER allows our cost reductions to reflect shared asset costs that a service provider 'is recovering through charging' for unregulated services. The AEMC also considers ex post reconciliations should not be necessary:[15]

> In respect of an ex post adjustment, or 'true-up', once the actual benefits in a period of a sharing arrangement are known, the Commission considered in the draft rule determination that this should not be necessary. First, if the sharing arrangements are set on the basis of a contract the revenue received should be relatively easy to predict. Second, the revenue received will be only one factor to consider in setting the cost reduction for consumers, which must be based on the cost of assets shared. Third, to the extent revenues received through the sharing arrangements change, the cost reduction can be adjusted at the next regulatory determination for the next regulatory period.

The NER permit cost reductions to reflect unregulated services that have not yet commenced at the time of our determination. If we have sufficient certainty about related unregulated revenue, we may make cost reductions to account for forecast revenues from services not yet begun. In this case, we will make the cost reduction for the next regulatory period, consistent with our proposed method set out in the draft guidelines.

Submissions from consumer groups tended to support ex post reconciliations while service providers tended to support use of forecasts only. Service providers submitted that not having ex post reconciliations is straightforward, while consumers groups see them as a failsafe mechanism to ensure they receive appropriate benefits. Consistent with our approach to the draft guideline, we continue to give weight to the AEMC's views that ex post reconciliations should not be necessary. However, we retain an open mind about changing our approach in future should it become necessary.

As discussed in our explanatory statement for our draft guideline, we propose to carefully monitor actual unregulated services and revenue outcomes compared with the forecasts used to determine cost reductions. If we find a significant difference that would limit benefits to consumers, then we will seek to change our approach. If an unregulated service begins during the regulatory period and preceding our first consideration of that service in a regulatory determination, then we propose no ex post reconciliation would occur. Rather, we will permit service providers to retain their full regulated revenues for the few years that the new unregulated service operated. In the AEMC's view, benefit sharing with consumers should begin from the first full regulatory period in which the unregulated service is operated:[16]

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[14] NER, cl. 6.4.4(a).
[15] AEMC, *Final position paper, November 2012*, p. 166.
[16] AEMC, *Final position paper*, p. 165.

> There would be no reconciliation or 'ex post adjustment' in respect of any sharing arrangement that was put in place during the middle of a regulatory period; the cost reduction would only start from the beginning of the next regulatory period.

This approach received initial support from at least one consumer group submission. The Major Energy Users submitted that we will, by not reducing regulated revenue in response to an unregulated service that begins in a regulatory period, create an incentive for service providers to seek unregulated revenue streams.[17] In response to our draft guideline, the Major Energy Users refined its position by proposing a relationship between use of ex post reconciliations and the consumer benefit sharing proportion. It suggested that the consumer benefit sharing proportion should be increased if ex post reconciliations are not applied.[18] However, we consider the two issues are separate. Our considerations in setting the benefit sharing proportion do not relate to the presence, or otherwise, of ex post reconciliations. We have considered the benefit sharing proportion as a separate issue.

2.2 Service providers may propose cost reductions

The NER states we may make a reasonable adjustment to a service provider's annual revenue requirement to account for a shared asset. It does not state a service provider should include such an adjustment in its regulatory proposal.

2.2.1 Issue

In general, service providers propose regulatory arrangements and we either approve or substitute with our own arrangements as we consider necessary.[19] We think this approach should be reflected in arriving at particular shared asset mechanism for a given service provider.

2.2.2 Our approach

As set out in the guideline, we intend to accept any reasonable cost reduction a service provider submits with its regulatory proposal. Proposed cost reductions should be calculated using the method set out in the guideline (our method), or leave consumers no worse off if calculated under another method.

2.2.3 Reasons for our approach

We consider service providers should be permitted to propose shared asset cost reductions for the following reasons:

- It is consistent with the approach established by the NER more generally.
- It is likely to minimise costs for service providers and us, with benefits for electricity consumers and taxpayers.
- We will accept proposed cost reductions only if we consider they are reasonable.
- If we consider a proposed cost reduction is not reasonable, or a cost reduction is not proposed for a year for which we think one should be proposed, we will substitute our own cost reduction.

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[17] Major Energy Users (MEU), *MEU response to shared asset guidelines for electricity distribution and transmission*, May 2013, p. 15. And *MEU comments on the draft guideline*, September 2013, p. 15.

[18] MEU, *MEU comments on the draft guideline*, September 2013, p.14.

[19] NER, clauses. 6.8.2 and 6.12 for distribution; clauses 6A.10.1 and 6A.12 for transmission.

Allowing service providers to propose cost reductions is no less appropriate than for other elements of a regulatory proposal. While the shared asset provisions make no mention of service providers proposing cost reductions, we consider it unlikely that the AEMC would wish to rule out this option. The guideline sets out our expectations around proposed cost reductions, to clarify and formalise what is already possible under the NER.

Service providers are more familiar than we are with their asset management practices. As such, they may be better able to efficiently estimate some costs and revenues. We will retain our authority to determine whether proposed cost reductions are reasonable.

We consider our proposed method leads to reasonable cost reductions and thus meets the NER requirements and appropriately shares benefits with consumers. But we cannot assert that we would not consider proposed cost reductions calculated using an alternative method. The shared asset guidelines are not binding on us or anyone else.[20]

However, we have broad authority to make cost reductions that we consider reasonable. Service providers have an incentive to minimise cost reductions. If they use an alternative method to calculate a proposed cost reduction, then we will assess the reasonableness of that reduction against our own method. We would generally not consider the proposed cost reduction reasonable if it leaves consumers worse off than under our method. So, when proposing a cost reduction calculated using an alternative method, service providers must demonstrate to us that it leaves consumers no worse off than under our method. We expect a service provider to set out for us both the alternative method used and an equivalent cost reduction calculated using our method. Service providers should present outcomes under both methods to demonstrate the relative benefits for consumers. Otherwise, we may not be able to accept the proposed cost reduction prepared using an alternative method.

In our shared assets issues paper, we did not discuss the possibility of allowing service providers to submit cost reduction proposals. Our draft guideline was the first opportunity stakeholders had to respond to this proposal. Consumer group submissions did not address this issue, but on similar issues expressed a preference for the AER to undertake all calculations rather than allowing service providers to make proposals.

We understand consumer groups may have reservations about service providers proposing elements of cost reduction calculations. However, we retain our authority to approve or not approve service provider proposals and to substitute our own calculations if necessary.

2.3 Defining material unregulated use of shared assets

2.3.1 Issue

Under the NER, we must have regard to the shared asset principles when making a cost reduction. One of the principles is that a cost reduction should be made if use of shared assets for unregulated services is material. However, the NER do not define materiality in this context.

2.3.2 Our approach

The guideline sets out a materiality definition based on unregulated revenue relative to regulated revenue. Materiality is defined as a service provider's expected annual unregulated revenue earned

[20] NER, cl. 6.2.8(c).

with shared assets being at least one per cent of its expected revenue from standard control (or prescribed transmission) services.[21]

2.3.3 Reasons for our approach

Consistent with our approach to the draft guideline, we include a proposed materiality definition in the guideline for the following reasons:

- The NER require us to take into account materiality when we make cost reductions.
- It will help to protect electricity consumers and taxpayers from higher costs.
- It will provide certainty for service providers and electricity consumers.

Also consistent with the draft guideline, we propose the approach to determining materiality set out in the guideline for the following reasons:

- Using relative revenues as a benchmark for asset use is simple, transparent and directly related to cost reductions.
- Assessing materiality in aggregate, rather than by service, is fair to electricity consumers and avoids the complexities of defining individual services.
- The one per cent threshold is consistent with the NER materiality definition for cost pass through applications.[22]

In addition to the above, we note that when unregulated revenues earned with shared assets are lower than the one per cent threshold, potential consumer benefits are very small. Against these benefits we must weigh the administrative costs to service providers (and ourselves) of administering cost reductions.

Why include a materiality definition in the guidelines

Under the NER, we must take into account the principle that a cost reduction should be applied where the shared asset use for unregulated services is material. In line with this, we would generally consider cost reductions should not apply when unregulated services are not material. The normal meaning of material is 'significant or important'. However, this definition presents challenges in a regulatory context. Most obviously, interpretations of importance may vary greatly among different parties to a single event. Electricity consumers may consider any potential change that could lower or constrain electricity prices to be important. Alternatively, service providers may consider any existing unregulated revenue streams to be important to them but insignificant to electricity consumers.

We think establishing a materiality definition and incorporating it in our guideline gives service providers and consumers certainty. This will help business planning and investment, with flow-on benefits for consumers. We also think that there are likely to be cost advantages for consumers and service providers from establishing a materiality threshold. This is because very small cost reductions could result in consumers paying more for electricity rather than less. That is, consumers pay for the costs incurred by service providers in submitting regulator proposals. This is because service providers recover their administrative costs from their consumers. We consider a materiality threshold will benefit all parties.

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[21] A service provider's annual revenue from standard control or prescribed transmission revenue is otherwise referred to as its annual revenue requirement.

[22] NER, chapter 10—glossary, definition of 'materially'.

Submissions generally supported establishing a materiality definition to mitigate risk of undue administrative costs for limited consumer benefits. Only one submission on our issues paper supported having no materiality threshold at all.[23] Service provider submissions on the draft guideline were generally supportive of the one per cent threshold, though some continued to propose its application to individual services rather than in aggregate.[24] Consumer group submissions on both the issues paper and draft guideline were largely opposed to the one per cent threshold, suggesting it may leave consumer benefits unrealised at levels below the threshold. Consumer groups tended to propose use of absolute values or service provider transaction costs to define material use.

Why use relative revenues to determine material use of shared assets

Consistent with our reasoning set out in the explanatory statement for the draft guideline, we think using revenue as a benchmark for material use of shared assets for unregulated services has several advantages over other approaches. First, revenue is easily measurable and therefore transparent. Second, revenues are readily aggregated across multiple services. And finally, revenue relates directly to the cost reduction method and therefore to reducing asset costs for electricity consumers. The NER state that:[25]

> ..the AER may, in a distribution determination for a regulatory control period, reduce the annual revenue requirement … by such amount as it considers reasonable to reflect such part of the costs of that asset as the [service provider] is recovering through charging for [unregulated services].

That is, our cost reductions must reflect asset costs recovered via unregulated revenues. We consider this supports use of relative revenues to assess the materiality of shared asset use for unregulated services. Unregulated revenues are the best indication of the extent of asset cost recovery achieved by service providers through charging for unregulated services. It follows that the relative size of the two revenue streams is a reasonable indication of relative asset cost recovery. This approach also calibrates cost reductions to the potential customer benefits—discussed further in the next section.

We propose to measure materiality in aggregate, across all of a service provider's unregulated services provided using shared assets. We think this is reasonable. Applying a materiality definition separately to individual services would have the effect of diluting its impact. Such an approach would be equivalent to applying a higher materiality threshold in aggregate. Therefore, it would erode the possibility of benefit sharing with consumers in proportion to the number of individual services to which a threshold would apply.

An aggregated materiality threshold is also the simplest approach. Per service assessment would give rise to difficulties in defining specific services. For example, were telecommunications services to be provided in several different discrete parts of an electricity supply network, would that be a single service or several? Similarly, were multiple telecommunications providers to use a single network, would that be a single service or several? Aggregating unregulated revenues earned by shared assets across all unregulated services provided with shared assets avoids such definitional difficulties.

Consumer submissions favoured materiality assessment in aggregate, as we propose.[26] Service provider submissions, however, tended to favour a per service approach to assessing materiality.[27] It

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[23] Southern Sydney Regional Organisation of Councils (SSROC), *Better Regulation - Shared Assets Guideline Submission*, 17 May, p.4.

[24] ActewAGL, *Response to AER draft shared asset guidelines*, September 2013, p.2.

[25] NER, cl. 6.4.4(a) for distribution and cl. 6A.5.5 for transmission.

[26] EUAA, 17 May 2013, p. 1. Major Energy Users (MEU), *Response to shared asset guidelines for electricity distribution and transmission*, May 2013, p. 7. EUAA,

was not clear from service provider submissions how the definitional issues were to be addressed, nor how such an approach would be in the interests of consumers. For both reasons, we consider our proposed approach is more reasonable than that proposed by service providers.

Why one per cent

The guideline's materiality threshold, one per cent of a service provider's annual standard control (or prescribed transmission) revenues, provides clarity, transparency and calibrates administrative effort to potential consumer benefits. As a fixed proportion, it will be well understood by all stakeholders. It is also equivalent to the only materiality definition already established in the NER—for cost pass throughs. This provides consistency within the regulatory framework. To recover an additional cost, so to gain a benefit, service providers must show that a cost meets the one per cent threshold and similarly with reductions in costs that are passed through to consumers under the pass-through provisions. And to share unregulated service benefits with electricity consumers, so to lose something, relevant revenues should meet the same threshold.

Consumer group submissions which favoured including a materiality definition in the guideline suggested lower thresholds than our proposed one per cent.[28] For example, the EUAA proposed an absolute dollar value, such as $2 million.[29] However, we remain of the view that one per cent is reasonable in the context of consumer benefits to be realised under the NER. That is, when shared asset unregulated revenues are very low compared to regulated revenues, consumer benefits will be very small. This would be the case across electricity networks of different sizes and revenue levels. This is because the per consumer costs of network services are proportional to network size.

When unregulated revenues available to be shared with consumers are less than one per cent of a service provider's regulated revenue, consumer benefits would be insignificant, if not trivial, relative to their total electricity bills. For example, a typical NSW household currently faces an annual electricity bill of over $2,000. For such a household, we estimate a cost reduction based on unregulated revenue equal to the one per cent threshold would provide a reduction in its annual electricity bill of less than $1.[30] This is equivalent to a fraction of one per cent of the household's annual electricity bill. When shared asset unregulated revenues are lower than the one per cent threshold, potential consumer benefits are even smaller.

In response to our draft guideline, the MEU proposed cost reductions be made whenever unregulated revenues earned by shared assets grow larger than the service provider's cost of complying with the guideline, including its transaction costs.[31] It argued this approach would be more consistent with the phrasing of the NER' shared asset provisions. The MEU also submitted that our proposed use of the materiality definition already used for cost pass throughs was not supported by the NER. Rather, that the NER requires the ordinary meaning of 'material' to be used unless in relation to cost pass throughs.

The MEU's proposal that transaction costs could be used to define materiality would give rise to an information problem. In this context, transaction costs are the costs incurred by a service provider in collecting and reporting to us the information we require to make cost reductions. We think the MEU has not appreciated the range of possible costs which service providers may report. Further, that in

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27 Energy Networks Association (ENA), *AER shared asset guidelines for electricity distribution and transmission - response to issues paper*, May 2013, p.10.
28 EUAA, 17 May 2013, p. 1. MEU, May 2013, p. 7.
29 EUAA, August 2013, p. 4.
30 Using the method set out in the guideline.
31 MEU, Comments on the draft guideline, September 2013, p.7.

assessing reported transaction costs in the context of our regulatory determinations, we would have little to no information available to allow us to verify such reported costs. Potentially, service providers may report relatively large transaction costs to reduce scope for consumer benefits.

We do not agree with the MEU's suggestion that specifying a threshold for materiality in the context of shared assets is not supported by the NER. While the NER definition of 'material' in a broader context (excluding for cost pass throughs) specifies its ordinary meaning,[32] the NER shared asset provisions provide us with flexibility.[33] We are required to make a guideline setting out our proposed approach. Rather than being inconsistent with the Rules, establishing a clear and transparent materiality definition gives effect to the shared asset provisions of the NER.

We note that the MEU did not propose that the guideline set out a definition of 'material' consistent with its ordinary meaning. Rather, the MEU seeks to substitute its preferred definition in place of ours. While we understand consumer group misgivings about the one per cent threshold, for the reasons discussed above we think it provides advantages compared to other approaches. Consistency with the cost pass through definition is not our goal, but we think it is a positive outcome, given the one per cent threshold provides the other advantages we are seeking in terms of clarity, transparency and balancing administrative cost with consumer benefits.

[32] NER, chapter 10, Glossary, definition of 'materially'.
[33] NER, cl. 6.4.4.

3 Cost reduction method

3.1 Issue

In the previous chapter we discussed our approach, or high level steps, to making cost reductions. In addition to our approach, under the NER the guideline may or may not detail a method to apply.[34] Such a method would determine the cost reduction to apply in a given circumstance. It would complement, but be more detailed than, our approach. For example, a method might include formulae.

3.2 Our approach

The guideline sets out the method we will use to determine cost reductions. Our method involves:

- reducing service provider regulated revenues by 10 per cent of the value of unregulated revenues earned by shared assets
- a secondary control step, to ensure cost reductions do not exceed the regulated returns to service providers from their shared assets—as required by the NER

We will also take into account network assets contributed by third parties that benefit consumers and are additional to unregulated revenues.

3.3 Reasons for our approach

The guideline sets out our method to determine cost reductions because we consider this will enhance transparency and certainty. We suspect potential consumer benefits under the guideline may be limited, so our method is straightforward to keep administrative costs to a minimum. Importantly though, our method will reduce electricity consumer costs when unregulated use of shared assets is material.

Why include a method in the guideline

We think setting out our proposed method in the guideline provides certainty, improves investment confidence and may lower administrative costs. Establishing a single method consolidates these advantages. Were we to establish a range of methods applicable in different circumstances, or at the choice of service providers, the additional uncertainty may undermine any associated benefits.

We think the benefits of including a method in the guideline outweigh the potential benefits from retaining greater flexibility to apply different methods in different circumstances. Consumers, service providers and other stakeholders can be confident we will approve reasonable cost reductions prepared under the method set out in the guideline. It may also reduce the perceived need for service providers to submit additional material in support of their proposal, such as consultant reports and other input from independent experts. And having a ready-made method available may avoid the costs of service providers developing their own methods.

Submissions on our draft guideline supported inclusion of a method, though service providers tended to seek flexibility to use their own method rather than be restricted to the guideline method.[35] We consider such an approach, if not constrained, would be equivalent to not setting out a method in the

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[34] NER, cl. 6.4.4(d) for distribution and cl.6A.5.5(d) for transmission.

[35] ENA, *Response to the AER draft shared asset guidelines*, September 2013, p. 5.

guideline. Therefore, we retain our view that service providers should propose cost reductions calculated using the guideline method, or show that consumers are no worse off under the method used.

The control step

Under the NER, consumer benefits from the shared asset mechanism are capped at the standard control (or prescribed transmission) revenues earned by a service provider from its shared assets.[36] That is, cost reductions may not reduce regulated revenues by more than the relevant shared assets earn from providing standard control services. Under the control step of our cost reduction method, we have also capped consumer benefits at this value. Consistent with the NER, our method does not transfer to consumers a portion of unregulated revenue streams without limit.

Under the guideline, service providers may estimate the standard control revenues they earn from shared assets. By allowing service providers flexibility to estimate this value, we aim to avoid administrative costs that may be incurred under a more prescriptive approach. We recognise service providers are more familiar with their own asset management practices than we are. As such, they will be more aware of the most efficient ways to estimate regulated returns from specific assets and thereby avoid undue administrative costs.

We have clear expectations for the information to be submitted by service providers in support of their proposed upper limit for cost reductions. Service providers must set out how they have estimated regulated returns under the control step and justify that approach. If we think a service provider's approach to estimating the control step is not reasonable, we may substitute our own estimate using average asset lives and revenues for relevant asset classes.

The EUAA submitted that it is opposed to allowing service providers to estimate the control step value.[37] The EUAA prefers that we undertake this calculation ourselves. In response, we again note that allowing service providers to submit proposed calculations is consistent with the regulatory proposal structure the NER establishes more generally.

Why use relative revenues to determine the value of cost reductions

The method set out in our guideline bases cost reductions on the unregulated revenues a service provider earns from use of shared assets compared to its regulated standard control (or prescribed transmission) revenues. This is consistent with our proposed materiality definition. It is also consistent with the nature of the NER, which establishes our authority to reduce regulated revenues in terms of asset costs recovered through charging for unregulated services.

Under our method, we will reduce a service provider's regulated revenues from assets providing standard control (or prescribed transmission) services by a fixed 10 per cent of the value of unregulated revenues earned with shared assets.[38] We consider that setting a fixed proportion further enhances transparency and certainty for both service providers and consumers.[39] Alternative approaches, such as making cost reductions of varying proportions depending on the circumstances, would provide less certainty than the guideline approach.

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[36] In the case of transmission, 'prescribed transmission services' are relevant, rather than distribution standard control services.

[37] EUAA, August 2013, p. 5.

[38] Asset related regulated revenues equal a service provider's return on and of capital for its regulatory asset base (RAB). That is, revenues earned through charging for regulated services to compensate service providers for asset depreciation (return of capital) and to provide a rate of return on capital.

[39] We discuss our proposed benefit sharing proportion in detail in chapter 6 of this paper.

The method set out in the draft guideline incorporated a set of calculations that would result in cost reductions of around 10 per cent of the value of unregulated revenues earned by shared assets. We initially proposed those calculations to better reflect the example methods described by the AEMC.[40] However, while these are reasonable approaches, the draft guideline calculations would lead to slightly inconsistent cost reductions across determinations. Establishing a fixed proportion gives better effect to our intent.

Our method provides transparency and certainty but is consistent with our limitations as an economic regulator. That is, we are not regulating the revenues of unregulated services. For clarity, we note that the AEMC stated in its final position paper on the NER:[41]

> With respect to determining the appropriate portion of costs for the purposes of a shared assets cost adjustment, the AEMC considered in the draft rule determination the most obvious approach is for the AER to base this on the relative use of the asset for the provision of the different kind of services such as the technical use or physical use. Another possible way could include using the ratio between the proportion of revenue from the asset for standard control services and the proportion of revenue from the asset for other than for standard control services over the current regulatory period. However, this should not be taken as precluding the AER from considering other possible bases for sharing the costs of the asset.

We consider our cost reduction method is equivalent to basing cost reductions on the ratio of unregulated to regulated revenues, as proposed by the AEMC. We note also that the AEMC does not rule out other possible bases for cost reductions.

The AEMC's proposal that cost reductions could be based on physical asset use incurs the same problems as physical use to determine materiality. That is, it raises a number of difficult questions. How would relative use be measured? What physical metrics should be used? How would such measures be aggregated across services and asset types? Our preferred method, based on comparing unregulated revenues to regulated revenues, is transparent and readily aggregated across services and assets.

Precision versus administrative costs

Our cost reduction method is straightforward to keep administrative costs to a minimum. Under our method, service providers need not track individual asset or physical use for regulated and unregulated services. This is intentional. We recognise though that this simplicity is only achieved at the cost of some degree of precision. We think this is consistent with the shared asset provisions and the scale of potential benefit sharing with consumers.

The cost of establishing a more precise, but more onerous, method may outweigh the potential benefits for consumers. A more detailed method may cause service providers to incur higher staffing and information technology costs to track individual asset use and to estimate the unregulated revenue earned by each shared asset. Service providers would pass on those costs to electricity consumers. In the context of very large asset bases, we consider such detailed asset management may not be practicable. And where consumer benefit sharing per shared asset may be limited, the costs of a more detailed method would likely undermine the potential benefits.

3.3.1 Services that use shared assets only marginally

Submissions from service providers suggested the guideline should include a range of methods to determine cost reductions. This in part reflected the different degrees of shared asset use across

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41 AEMC, *Final position paper*, November 2012, p. 168.

different unregulated services.[42] For example, unregulated telecommunications services using distribution power poles rely heavily on shared assets. That is, we consider all unregulated revenues earned by a service provider from that unregulated service are for use of shared assets. However, there may be other circumstances, such as where an unregulated maintenance service run by a service provider may primarily use unregulated assets and use shared assets in an insignificant way.

There are different ways to address this issue. Potentially, we could establish a threshold for regulated asset use by an unregulated service. Under this approach, services that use regulated assets below the threshold could be excluded from consideration under the guideline. However, we consider the best way to address this issue is by focussing on the unregulated revenue stream derived from an unregulated service.

Revenue apportionment

To reflect unregulated services making insignificant use of regulated assets, we will allow service providers to reduce unregulated revenues to which the shared asset mechanism will apply. That is, service providers may apportion an unregulated revenue stream in such circumstances. Revenue apportionment means reducing proportionally a revenue stream earned from an unregulated service to reflect the extent to which the service relies on shared assets.

For example, for a service that relies on regulated assets only 5 per cent of the time, only 5 per cent of the revenues earned from that service may be relevant to the shared asset mechanism. This includes both the materiality threshold and cost reduction method.

We will only accept revenue apportionment for unregulated services making insignificant use of shared assets. We will exercise our judgement in respect of any revenue apportionment proposed by service providers. We will not accept apportionment proposed by a service provider to incrementally reduce the unregulated revenues to which the shared asset mechanism will apply. Service providers should note that our starting assumption is that all revenues earned from an unregulated service that uses shared assets will be relevant to the shared asset mechanism.

When reporting to us, service providers should set out the basis on which they have proposed to apportion any revenues and their reasons for doing so.

3.3.2 Contributed assets

The guideline allows service providers to present evidence of electricity consumers benefitting from assets contributed by third parties, such as telecommunications providers. We propose to take such evidence into account when determining cost reductions. A third party, for example, may replace distribution power poles, because the original poles were too short or too weak to support additional telecommunications cables. In this example, the contributed assets would be in addition to unregulated revenues paid to the owner of the power poles by the telecommunications provider. If service providers demonstrate benefits accrue to consumer from contributed assets, we may reduce the size of a cost reduction. Any such reductions will be in proportion to the scale of the demonstrated consumer benefits from asset upgrades or replacements.

[42] ENA, May 2013, p. 5. Citipower, Powercor, SA Power Networks, 17 May 2013, p. 2.

4 The use of incremental costs and profit sharing

4.1 Issue

Service providers describe 'incremental costs' as the additional costs they incur in providing unregulated services with existing shared assets. Service providers and consumer groups submitted that cost reductions should account for the incremental costs of providing unregulated services.[43] That is, service providers should share with consumers only their profits from unregulated services provided with shared assets—profit sharing.

4.2 Our approach

The guideline does not adopt a profit sharing approach. However, in determining cost reductions we can see a need to balance consumer benefits with the need to retain incentives for the provision of unregulated services. We intend to achieve this balance by sharing with consumers a reasonable proportion of the unregulated revenues earned with shared assets.

4.3 Reasons for our approach

Profit sharing would be inconsistent with the NER and would see commercial risk move from service providers to consumers. We consider the method set out in the guideline is preferable because it:

- is consistent with the NER
- retains reasonable incentives for shared assets to be used for unregulated services
- leaves commercial risk with service providers who can manage that risk.

We set out below our reasons for the guideline's approach.

Profit sharing and the NER

The NER shared asset principles state:[44]

> a shared asset cost reduction should not be dependent on the [service provider] deriving a positive commercial outcome from the use of the asset other than for [standard control or prescribed transmission services]

Clearly, the profitability of an unregulated service for a service provider should not be the sole basis for cost reductions. Rather than focussing on profit, we should make cost reductions if use of assets for unregulated services is material. In this way, a cost reduction is an acknowledgement that regulated assets are being used, in a material way, for unregulated services for which additional revenue is earned by the service provider. However, cost reductions are not dependant on whether a profit is being earned by the service provider.

Service providers submitted that the NER restricts cost reductions to only sharing unregulated revenues above their incremental costs. Also, that retention of incentives for unregulated services should take priority over all other considerations. These arguments are based on another shared

[43] ENA, May 2013, p. 6. Jemena, May 2013, p. 5. MEU, September 2013, p. 11. EUAA, August 2013, p. 3.

[44] NER, cl. 6.4.4(c)(2).

asset principle, that service providers should be encouraged to provide unregulated services with regulated assets:[45]

> the [service provider] should be encouraged to use assets that provide [standard control or prescribed transmission] services for the provision of other kinds of services where that use is efficient and does not materially prejudice the provision of those services

While we agree reasonable incentives should be retained for service providers to use regulated assets for unregulated services, we do not agree this principle is more important than others nor that it can only be satisfied through a profit-based approach. The NER is explicit in asserting that we should not make cost reductions only if there are positive commercial returns. Cost reductions should not depend on asset owners deriving a profit from the other services they choose to provide with assets paid for by electricity consumers. Rather, consumers should receive a benefit when standard control (or prescribed transmission) assets are used materially for unregulated services.

Consumer groups proposed profit sharing for different reasons to service providers. They suggest that allowing service providers to recover their incremental costs means the remaining unregulated revenues (profits) can all be used to reduce costs for consumers.[46] Again however, the shared asset principles do not generally support that approach. We are also mindful that the scale of benefit sharing under an incremental cost approach may not be what consumer groups expect. Service providers may submit incremental costs which we, or consumer groups, would consider higher than reasonable. Were this to occur, we would necessarily have to estimate efficient costs for the unregulated services they relate to. This gives rise to a further issue.

We think it may not be straightforward for us to examine the efficient cost of services we do not regulate. The AEMC has commented that we should not be regulating the revenues of unregulated services, as this is not permitted under the NER.[47] Rather, the shared asset provisions simply allow us to reduce asset costs faced by electricity consumers in response to costs service providers recover through unregulated revenues. We think going beyond this role, to assess the efficient cost of unregulated services, is likely to be beyond the scope of our powers.

Commercial risk properly sits with service providers

The AEMC has commented that a profit sharing approach would misallocate commercial risk of a decision to use regulated assets to provide unregulated services:[48] [49]

> The Commission did not accept … the principle that the [service provider] should only have to pass on the benefit of a shared asset if it receives a net profit as a result, which was proposed by NSPs to recognise the associated risks of the NSP with sharing arrangements. In general, the NSP should bear the risk so it takes this into account when deciding whether to enter a sharing arrangement, as the Commission considered the NSP to be the party best able to assess and manage this risk.

We agree. Whether unregulated revenues earned with shared assets are sufficient to cover the incremental costs incurred by service providers is an issue for service providers, not electricity consumers. A profit sharing approach to determining cost reductions would see commercial risk sit with electricity consumers. That is, were unregulated revenues earned by service providers larger than their incremental costs, both service providers and consumers would benefit. But were

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45 NER, cl. 6.4.4(c)(1).

46 MEU, September 2013, p. 9. EUAA, August 2013, p. 3.

47 AEMC, *Final Position Paper - National Electricity Amendment Rule 2012*, November 2012, p. 164.

48 AEMC, November 2012, p. 168.

49 NSP is an abbreviation of 'network service provider'.

unregulated revenues lower than the incremental costs, consumers would continue to finance the full cost of regulated assets.

An equivalent scenario to the incremental cost proposal is a retailer proposing to pay rent to a landlord only if the retailer makes a profit. In such a scenario, the landlord would be taking on commercial risk incurred by the retailer. The landlord, however, would have no capacity to manage that risk. Similarly, electricity consumers are not in a position to make decisions about the use of assets they have paid for to provide other services.

Retaining incentives for unregulated services to be provided

To retain incentives for unregulated service use of standard control and prescribed transmission assets, we think asset owners should have opportunity to retain a reasonable portion of unregulated revenues. In developing the guideline, we have given weight to each of the shared asset principles. That is, we have balanced the provision of incentives for unregulated services with the requirement that cost reductions not be dependent on profit.

We consider that the guideline's method, to reduce regulated revenues by 10 per cent of the value of unregulated revenues earned with shared assets, strikes a reasonable balance. Indeed, retaining a reasonable incentive for ongoing provision of unregulated services is key to the ongoing sharing of benefits with consumers. For standard control and prescribed transmission consumers, service provider retention of some of the unregulated revenues promotes lower regulated prices in the longer term. For the broader community, such an approach facilitates ongoing provision, or development, of unregulated services.

While the sharing amount of 10 per cent may be seen as relatively modest, at this time we do not have a large body of evidence on the incremental costs to service providers from unregulated services. As unregulated services, these have been out of scope until the recent rule change which gave rise to the guideline. We have therefore developed the guideline with limited information and as a result we have taken a more conservative approach. As part of the guideline development process we sought information on service provider incremental costs.

A confidential report jointly submitted by the New South Wales' distribution service providers (Ausgrid, Endeavour Energy and Essential Energy) supports our view that incremental costs may be significant. The report details a range of incremental costs arising from third party telecommunications cables using the service providers' networks. This gives weight to our view that unregulated services are likely to create incremental costs. The submitted costs also illustrate that reported incremental costs under a profit sharing approach would require careful assessment. At least some submitted cost items or their values may be arguable. On balance, we think the confidential report is sufficiently robust to support our view that incremental costs may be significant. In such a case a profit sharing approach would lead to little or no cost reductions to customers stemming from the use of shared assets.

When considering the benefit sharing proportion, we also considered the potential size of unregulated revenue streams compared to potential service provider incremental costs. We note that the *Telecommunications Act 1997* gives telecommunications providers significant powers to access energy network infrastructure with or without the agreement of network owners. We think this gives telecommunications providers significant countervailing power when negotiating commercial terms of access with network owners. If telecommunications providers use the *Telecommunications Act 1997* to access energy infrastructure without a commercial agreement with network owners, what

compensation would be provided is uncertain.[50] Potentially, it could be limited to recovery of network owner incremental costs. In this case, the shared asset mechanism may leave network owners with relatively small or zero profits at best or even in a negative financial position. Larger benefit sharing proportions in such a situation would have larger negative impacts and would not provide sufficient incentives for unregulated use of shared assets.

We have not included in the guideline an exception for circumstances such as those described above. We have done this deliberately. We think service providers should be treated equally under the shared asset mechanism and we note that energy networks already support a range of other telecommunications services such as pay TV and telephone lines. We think this indicates the potential for commercial terms to be agreed. Also, establishing an exception for such circumstances would in effect establish a de facto profit sharing mechanism.

We have taken into account the societal benefits provided by unregulated services using electricity network assets. Services, for example, such as telephony, internet and other telecommunications products have significant value to the community more broadly. Electricity infrastructure is a least cost mode of delivery for many of these services. In sharing the benefits of unregulated revenue streams with electricity consumers, we seek to retain reasonable conditions for the ongoing use of network assets to continue to produce these other benefits.

Consumer groups seek larger benefit sharing proportions because they think service provider incremental costs are likely to be insignificant.[51] We acknowledge that the 10 per cent benefit sharing proportion is cautious. However, given the guideline's application to a range of different unregulated services and circumstances, we think caution is appropriate. If we find in our monitoring of this mechanism that the 10 per cent benefit sharing ratio does not lead to reasonable cost reductions for consumers, given the extent of unregulated revenues being generated, we would seek to review this approach.

[50] There is no case history available.
[51] EUAA, August 2013, p. 3.

5 Information reporting

5.1 Issue

To inform our shared asset cost reductions, we require information about a service provider's revenue, unregulated services and future expectations. However, there is a cost to service providers arising from any information request. Depending on the information requested, administrative costs may be significant and erode consumer benefits from shared asset cost reductions.

5.2 Our approach

The guideline sets out minimum annual reporting requirements and more comprehensive requirements for regulatory proposals where cost reductions are in scope. We propose to give effect to these requirements through annual and regulatory proposal regulatory information notices (RIN) and similar information reporting mechanisms.

5.3 Reasons for our approach

We consider our proposed approach balances the administrative costs faced by service providers and the interests of consumers. The nature of the shared asset mechanism, established principally in the NER, is such that a degree of information about unregulated services is necessary. We consider that the information we propose to request is a minimum necessary to reasonably ensure compliance with the NER.

The guideline requires detailed reporting only when the cost reduction threshold is met. However, we propose to maintain awareness of unregulated services and revenues through limited annual reporting requirements. Maintaining awareness of actual unregulated services and revenues will prepare us for subsequent distribution and transmission regulatory determinations. Moreover, we intend to monitor the accuracy of the service and revenue forecasts we will rely on to determine cost reductions. Should actual services and revenues considerably diverge from forecasts, we will consider amending our approach to determining cost reductions.

Because regulatory determinations occur only every five years, information reporting only with regulatory determinations implies significant lead times before we would have evidence to support guideline changes. Annual reporting of actual outcomes will allow us to form judgements on guideline changes in more efficient timeframes. We consider the limited regulatory burden associated with our proposed annual reporting requirements is reasonable in the circumstances.

Consumer group submissions on our draft guideline did not comment specifically on its information reporting requirements. However, in their comments on other aspects of the draft guideline, consumer groups sought comprehensive reporting by service providers of their costs of providing unregulated services.[52] In some cases, consumer groups emphasised making reported information public.[53] In contrast, service provider submissions emphasised the sensitivity of information relating to contracts for unregulated services.[54] Having considered all submissions, we think the guideline's reporting requirements balance our need for information to inform our cost reductions, the regulatory burden faced by service providers and our role as regulator under the NER.

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52 EUAA, August 2013, p. 3.
53 Uniting Care Australia, September 2013, p. 5.
54 Citipower/Powercor/SA Power Networks, September 2013, p. 4.

A Service classifications

This appendix summarises the service classification frameworks central to the NER shared asset definitions. We undertake service classification during our five yearly revenue determinations. By classifying services, we group them and apply different forms of economic regulation, or no regulation.[55] The NER provide slightly different classification categories for the distribution and transmission sectors. As a result, the two sectors have slightly different shared asset definitions.

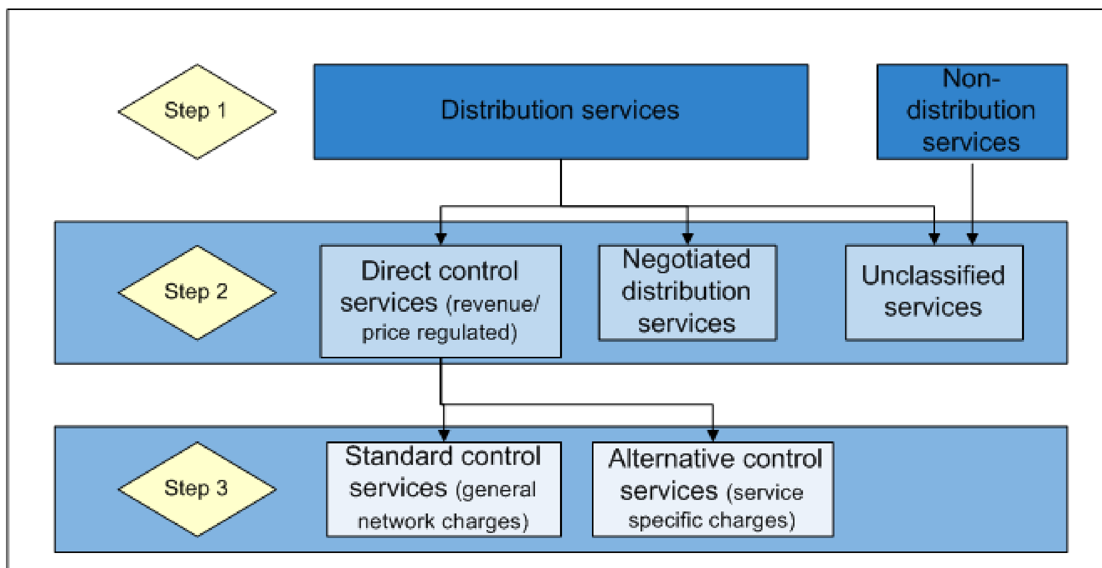
Service classifications—distribution

Distribution service classifications that provide the most prescriptive regulation are standard control and alternative control. These services are collectively known as direct control services, because we directly determine consumer prices for them. Direct control services tend to be subject to monopolistic power, so may not be provided by others.[56] Within this classification, standard control services are generally provided for a broad consumer base and alternative control services are relatively ad hoc (such as a request to move a power pole) or potentially competitive (such as meter reading).

The remaining distribution classification is negotiated services, for which service providers and consumers negotiate prices under a framework established by the NER.[57]

Finally, some services provided by electricity distribution network assets are not classified—unregulated services. These may be unregulated distribution services or unrelated to electricity distribution. Figure A1 sets out the NER process for classifying distribution services.[58]

Figure A1: Distribution service classification process



[55] We determine service classifications by the degree of competition for service supply. We classify services to a more strict form of economic regulation when competition to supply those services is less. When greater service supply competition exists, we classify to a less strict form of regulation.

[56] Direct control services are frequently restricted to licensed network service providers, so legal barriers prevent effective supply competition.

[57] Reflecting a degree of supply competition.

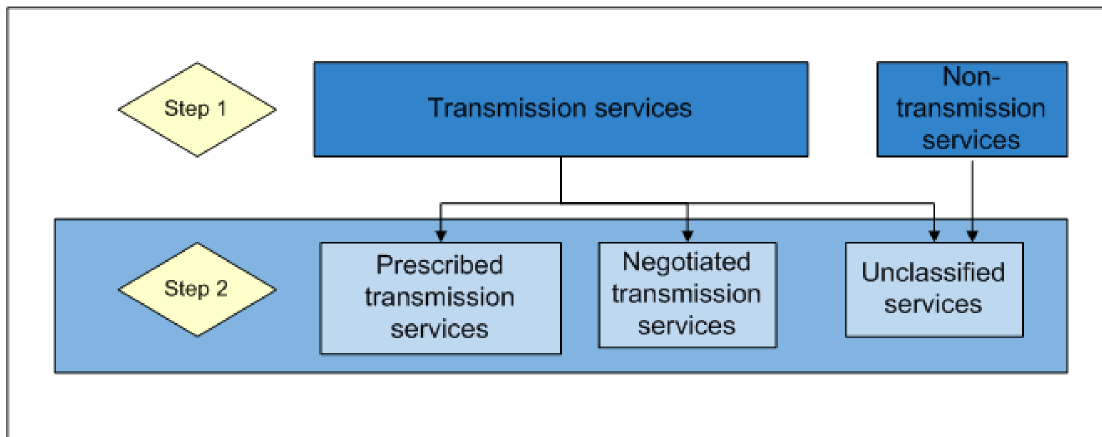
[58] Comprising three steps. First, we confirm whether a service is a distribution service. We then determine the appropriate level of regulation: strict, less strict or none. And, finally, when direct control is appropriate, we classify services as either standard control or direct control.

Service classification—transmission

For transmission, a single direct control classification is available—prescribed transmission services. We generally classify transmission services for the broad consumer base as prescribed transmission services. These services provide electricity to transmission consumers, so are central to a service provider's monopoly power. The only other transmission classification available is negotiated services. Negotiated service prices for transmission, as for distribution, are subject to a negotiation framework established by the NER.

Also as for distribution, electricity transmission assets may provide some services that are not classified at all— unregulated services. These may be unregulated transmission services or unrelated to electricity supply. Figure A2 sets out the NER process for classifying transmission services.

Figure A2: Transmission service classification process



B Cost allocation and shared assets

If the allocation of costs between regulated and unregulated services was correct, why would a shared asset mechanism be required? The answer is that it would not. However, as the intended use of an asset may change, there is a need for a shared asset mechanism.

What is cost allocation?

We determine regulated electricity service prices or revenues based on costs that the distributor or transmission service provider incurs to provide services which are classified into service types. We must, therefore, understand which costs relate to specific service classifications. The NER facilitate this understanding by requiring each electricity supply business to establish a cost allocation method (CAM), setting out its approach to cost allocation.[59] The CAM links costs incurred by service providers to service classifications. Appendix A provides further background on service classifications.

Routine power line maintenance, for example, supports core electricity supply services, so CAMs link asset costs such as maintenance trucks to standard control services. This cost allocation allows the electricity supply business to recover its maintenance costs, through regulated prices, from across its consumer base. The cost allocation 'driver' in this case—the metric used to allocate truck costs to services—might be time spent on maintaining power lines. The service provider records time spent by each maintenance truck on line maintenance and allocates the truck's costs to standard control services in the same proportion.

The NER require CAMs to reflect the cost allocation principles in the NER.[60] These principles mandate that costs be allocated only once. CAMs should prevent double-dip cost recovery by preventing the same cost from being allocated to multiple service classifications. For consumers of regulated electricity supply services, cost allocation should ensure they pay only costs related to service supply. This cost includes asset costs. Cost allocation should exclude assets providing other types of service from the standard control and prescribed transmission service regulatory asset bases.

A fleet of maintenance vehicles, for example, may do both routine line maintenance and ad hoc pole relocation jobs, which is not a standard control service. The service provider may negotiate the price of the latter service with consumers who require that service. As above, let's assume the service provider's CAM uses time spent on jobs to allocate truck costs to the standard control and other service classifications respectively. In this way, the standard control asset base should reflect only costs that the service provider incurs in providing standard control services. CAMs also guide cost allocation to any unclassified, or unregulated, services.

When a single asset provides two types of service, the cost allocation framework requires asset owners to apportion values to the relevant service classifications. For a vehicle providing both electricity supply services and unregulated services, the standard control asset base would include some of the vehicle's asset value but exclude a proportion that reflects the unregulated services.

Limitations of cost allocation

Unless service classifications change, cost allocation largely occurs only once. That is, once asset costs/values are allocated to a service classification, they remain part of the asset base for that

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[59] The NER require CAMs to be publicly available on network service providers' websites.

[60] NER, clauses 6.15.2 and 6A.19.2.

service classification. Asset cost allocation generally only changes if the services provided by that asset are re-classified. This semi-permanent cost allocation does not reflect new or growing unregulated revenue streams. Standard control assets may earn additional unregulated revenues without distributors removing any asset value from the standard control asset base or changing their cost allocation.

For this reason, the cost allocation approach will not affect what standard control service consumers pay for that service, even if asset owners earn additional revenues from those assets. Therefore, asset owners may earn two revenue streams from a shared asset: one regulated revenue stream and another unregulated. They thus may recover the cost of standard control (or prescribed transmission) assets more than once.

How shared asset reductions address cost allocation's limitations

The NER shared asset mechanism deals with unregulated revenues in a way that cost allocation does not permit. Cost allocation deals with costs, while shared asset cost reductions can deal with unregulated service revenues. Shared asset cost reductions also mitigate the risk of asset owners recovering the cost of assets more than once, from both consumers of regulated electricity supply services and consumers of unregulated services. If asset owners earn additional unregulated revenue streams from assets previously allocated to the standard control (or prescribed transmission) asset base, then we can adjust regulated revenues to reflect the new avenue for asset cost recovery.

C Summary of submissions

We received 13 submissions in response to our draft shared asset guideline. These are summarised below, by issue. All submissions summarised here may be read in full on the AER website.

Table C1: Summary of submissions on the draft shared asset guideline

Issue	Stakeholder	Summary
Materiality	ActewAGL	Supportive of 1% but should be applied on a per service basis.
	Ausgrid / Endeavour / Essential	Supportive but seeks clarity on the formula to be adopted.
	Energy Networks Association	ENA members support the draft guideline 1% threshold as simple, cost effective and transparent.
	Energex	NA
	Ergon Energy	NA
	EUAA	Does not support 1%. Significant variability in service provider size means 1% equals different values for different businesses. Proposes materiality threshold of $2 million p.a.
	Jemena	Supports 1%.
	Major Energy Users	1% is too high and advantageous to service providers. The AER has misinterpreted the AEMC's intention—that consumer benefits should simply outweigh administrative costs.
	NBN Co	Supports 1%.
	Origin	NA
	SP Ausnet	NA
	SA Power / Citipower / Powercor	NA
	UnitingCare	A materiality threshold should not be applicable. If there must be a materiality threshold, use the draft guideline 1% or $1 million, whichever is reached first.
Cost reduction method	ActewAGL	Broadly supportive of the draft guideline approach and method as simple and transparent. Alternative methods should be permitted, without limitation. Add to guideline a description of the revenue apportionment permitted when unregulated services make little use of regulated assets. While not recommending changes to the draft guideline method to account for incremental costs, proposes that service providers should be able to include incremental costs in their own alternative methods.
	Ausgrid / Endeavour / Essential	Broadly supportive as simple and proportionate. The method should not apply if unregulated revenue is compensation rather than a commercial charge for asset use. Refers to Schedule 3 of the Telco Act as limiting service provider bargaining power. Service providers should be able to use different methods. For some services, incremental costs are high compared to revenues. No profit

	to share.
Energy Networks Association	Broadly supportive of the draft guideline approach and method as simple and transparent. Alternative methods should be permitted, without limitation. Add to guideline a description of the revenue apportionment permitted when unregulated services make little use of regulated assets. While not recommending changes to the draft guideline method to account for incremental costs, proposes that service providers should be able to include incremental costs in their own alternative methods.
Energex	Notes the draft guideline method is simple and minimises administrative costs. Service providers should be able to use their own method, without limitation, if they consider it more accurately reflects their circumstances. The guideline method should only be a default.
Ergon Energy	Supportive in principle. Requests greater clarity on 'return on capital', 'return of capital' and 'shared asset unregulated revenues' as used in the AER method and control step. Guideline should detail apportionment approach. Service providers should be able to use alternative methods, without limitation, potentially including incremental costs.
EUAA	Supports profit sharing. There is no NER requirement for cost reductions to be determined at the beginning of regulatory periods. The AER should determine cost reductions annually to avoid forecasting errors. On the cap, the AER should estimate prescribed revenues earned by service providers from shared assets, not allow service providers to estimate it. The AER should lead a rule change to remove the cap restriction on consumer benefit sharing.
Jemena	Draft guideline is pragmatic, provides certainty and clarity. Minimises administrative costs. Welcomes AER recognition of the value of third party contributed assets.
Major Energy Users	Supports profit sharing. Service providers should not be required to share with consumers more than the profit they generate from unregulated services. Making service providers share revenues without consideration for their costs would be inequitable to service providers. The AEMC final decision requires the AER to ensure that NSPs are prudent in deciding when to use regulated assets for unregulated services, so there must be a profit from such services and the AER must assess related costs. AER should verify service provider reported cost information. By not assessing unregulated service costs, the AER would increase service provider and consumer risk. Review guideline operation after two years.
NBN Co	Supports recognition of contributed assets. Supports AER taking into account NSP incremental costs to reduce the value of cost reductions.
Origin	NA
SP Ausnet	Broadly supportive, as pragmatic, simple and achieves an appropriate balance between consumer benefits and unregulated service incentives. Unregulated revenue may be earned from a mix of regulated and unregulated assets and need to cover costs. The revenue-only method is best suited to a pure rent scenario. However, the guideline has been developed amidst complexities and the NER are somewhat inconsistent. The AER's approach is about right. Service providers should be able to use their own methods.
SA Power / Citipower / Powercor	Broadly supportive. Add to guideline a description of the revenue apportionment permitted when unregulated services make little use of regulated assets. Proposes a revenue apportionment method, based on identifying unregulated revenue relevant to specific asset classes (e.g. buildings, IT, vehicles).
UnitingCare	In the longer term, service providers should be required to undertake a

		'negotiated settlements' process with consumers.
Benefit sharing proportion	ActewAGL	NA
	Ausgrid / Endeavour / Essential	Supportive. Larger proportions would limit serviced provider ability to recover costs.
	Energy Networks Association	The draft guideline 10% is at the upper limit of possibilities while retaining incentives for unregulated services. Larger sharing % will endanger electricity consumer benefits and broader societal benefits.
	Energex	10% will impact the viability of some unregulated services.
	Ergon Energy	NA
	EUAA	The draft guideline method will typically see reductions in consumer costs of 9% of the value of unregulated revenue streams earned with shared assets. This is in favour of service providers at consumer's expense. But service provider incremental costs could be significant, in which case the EUAA's concerns evaporate. While the NER say cost reductions should not rely on service provider 'positive commercial outcomes', this does not relate to commercial outcomes in general. AER should release its legal advice on this and seek a rule change if necessary.
	Jemena	Draft guideline 10% strikes reasonable balance.
	Major Energy Users	Service provider profits from unregulated services should be split 50-50. The MEU accepts that service providers will likely incur costs in generating unregulated revenue and there may be some risk that revenues will not exceed costs. Consumers also bear risk. The draft guideline 10% assumes 80% of unregulated revenue is to meet additional costs—probably wrong. Service providers should be setting fees for unregulated services between their marginal cost and the third party's stand-alone cost. MEU agrees there are societal benefits from unregulated services, but these would not be impacted by higher or lower sharing proportions. Because no ex post true-up will apply, consumers should get 70%. If this doesn't occur, benefits should be assessed annually. Proposes a sliding scale of sharing proportions, depending on level of unregulated revenues.
	NBN Co	Supports 10%, but applied only to revenues above 1%.
	Origin	NA
	SP Ausnet	10% benefit sharing is about right, given the range of different services to which the guideline will apply. Some services will have large costs compared to revenues and some otherwise.
	SA Power / Citipower / Powercor	10% is the upper limit in light of the shared asset principle that incentives for unregulated services should be retained. Larger proportions will endanger benefits for service providers and electricity consumers.
	UnitingCare	Not convinced 10% is a fair share for consumers. In principle, consumers should receive 50% of the benefit earned from shared assets. In the absence of data, apply the guideline 10% and review in 3 years.
Reporting	ActewAGL	NA

	Ausgrid / Endeavour / Essential	Revenue and volume forecasts would be uncertain. Seeks clarity on reporting mechanisms the AER will use. Draft guideline notes RINs and 'other appropriate mechanisms'. Some information will be c-in-c.
	Energy Networks Association	Supports reporting requirements set out in the draft guideline. All contract details should be treated confidentially, as these relate to unregulated services.
	Energex	NA
	Ergon Energy	NA
	EUAA	AER should require service providers to report their additional costs.
	Jemena	Draft guideline reporting requirements are reasonable.
	Major Energy Users	The AER should request unregulated service contract and cost information from service providers. AER should ask service providers for their transaction costs of processing shared asset cost reductions. This will determine the materiality threshold.
	NBN Co	Service providers should be able to report their incremental costs from unregulated services.
	Origin	Supports transparent reporting, including asset descriptions & key contract details. If c-in-c prevents reporting, service providers should be barred from entering into such service agreements.
	SP Ausnet	Service providers should not be expected to report speculative unregulated revenue streams. This may mean no benefits are shared with consumers from a new unregulated service until the next re-set.
	SA Power / Citipower / Powercor	All contract related reporting should be treated by the AER as c-in-c.
	UnitingCare	Service providers should report revenue and cost information. Preferably publicly.
Other emphasis	ActewAGL	Not supportive of annual reporting. Where shared assets earn no revenue, under legacy arrangements, there should be no reporting requirement. All reported contractual information should have blanket c-in-c status from the AER.
	Ausgrid / Endeavour / Essential	Seeks clarity on application of the shared asset mechanism if services are transitioning to a new classification, or if unregulated revenues include fees for ancillary services, such as design.
	Energy Networks Association	NA
	Energex	NA
	Ergon Energy	NA
	EUAA	NA

	Jemena	
	Major Energy Users	AER should review operation of the shared asset mechanism after 2 years of operation.
	NBN Co	There are societal benefits from unregulated services provided with electricity supply assets, which are a least cost delivery mode for many services.
	Origin	NA
	SP Ausnet	Certainty is very important for NSPs and investors. Including a detailed method in the guideline is important for clarity. Should define clearly what will be treated as shared asset revenue. Set out in the guideline details of how apportionment will work. Clarify what would be a change in asset use from its CAM treatment.
	SA Power / Citipower / Powercor	NA
	UnitingCare	The guideline should apply for 3 years before a review at the end of calendar year 2016. AER should build a public data set of costs and revenues. The AER should explore a 'negotiated settlements' approach to sharing benefits with electricity consumers.