

Replacement of framework and approach 2021−25

AusNet, CitiPower, Powercor, Jemena, and United Energy

June 2018

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Inquiries about this publication should be addressed to:

Australian Energy Regulator  
GPO Box 520  
Melbourne Vic 3001

Tel: 1300 585165

Email: [AERInquiry@aer.gov.au](mailto:AERInquiry@aer.gov.au)

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# Introduction

The Framework and approach (F&A) is the first step in a process to determine efficient prices for electricity distribution and transmission services. The F&A determines, amongst other things, which distribution services the Australian Energy Regulator (AER) will regulate and certain aspects of a regulatory determination set out under the National Electricity Rules (the Rules). It facilitates early public consultation on the pricing mechanism for regulated services (for distribution businesses) and the incentive schemes that will encourage efficient network expenditure (for distribution and transmission businesses).

These are important aspects of the regulatory process and have a significant bearing on the regulatory proposals that AusNet Services, CitiPower, Powercor, Jemena Electricity Networks, and United Energy are required to submit to us by 31 July 2019.

## Why is the F&A important for consumers?

The F&A is important because it provides an opportunity for interested parties, including consumers, to have a say in which distribution services we should regulate and how much control we have over determining the prices for network services. Our intended approach on service classification will settle the ring-fencing obligations for particular services for a regulatory control period.[[1]](#footnote-2)

The F&A also sets out information around incentive schemes that will apply to network service providers to encourage efficient investment and performance.

The sorts of issues we will consider in the F&A include:

* whether there is the possibility of increased competition in the provision of some distribution services traditionally provided only by network service providers. This might happen if, for example, we were satisfied there were no significant barriers to competitive provision of a particular service. In this event, we may decide not to regulate that service, leaving prices to be set by the market.
* whether the provision of distribution services should take place on a fee for service basis or as a service for which there is minimal oversight by us. For example, we may determine that a distribution business may bundle the costs for a particular service into a generic electricity supply service (standard control service). Alternatively, we may decide that charging for a service on a user-pays basis is more appropriate (alternative control service). Finally, we may allow consumers and network service providers negotiate the price of a service (negotiated distribution service) and only intervene if the parties cannot reach an agreement.
* whether incentive schemes will apply to distribution and transmission businesses, for example, to service quality, improvements in network reliability or capital and operating expenditure. The purpose of incentive schemes is to encourage network service providers to manage their business in a safe, reliable manner that serves the long term interests of consumers. The schemes provide network service providers with incentives to only incur efficient costs and to meet or exceed service quality targets. In some instances, network service providers may incur a financial penalty if they fail to meet set targets.

We consider that consumers should be actively involved in the F&A process as the decisions made, particularly relating to classification of distribution services and pricing, will apply for a five year period before they are reviewed.

Diagram 1 provides an overview of where the F&A sits in the Victoria reset processes for the regulatory control period of 1 January 2021 to 31 December 2025. Stakeholder consultation occurs throughout the process.

Diagram 1: Reset process

## Our decision

For the 2021–25 regulatory control period we consider it prudent to undertake a more comprehensive review of the Victoria F&A papers. A number of significant regulatory changes have been introduced (or are likely to be introduced by end-2018) that are relevant to the Victoria F&A. Changes to the Rules in November 2012 introduced new incentive schemes and make it possible for us to adopt improved approaches to the assessment of the expenditure forecast by the network service providers.[[2]](#footnote-3) We developed a new demand management incentive scheme (DMIS) [[3]](#footnote-4) and have published a national Electricity Distribution Ring-fencing Guideline.[[4]](#footnote-5) The Power of Choice reform also introduced changes to metering contestability.[[5]](#footnote-6) These changes do not apply to Victoria at present, as the Victorian Government deferred metering competition in Victoria through an Order-In-Council.[[6]](#footnote-7) The AEMC's Contestability of Energy Service final rule requires that we develop a distribution service classification guideline, which will publish in September 2018.[[7]](#footnote-8) In mid-2018 we will publish a final decision on a review of the Service Target Performance Incentive Scheme (STIPS).[[8]](#footnote-9) In December 2017 the COAG Energy Council submitted a rule change request to the AEMC, which would give the AER responsibility for setting the value of customer reliability (VCR) on an ongoing basis. In May 2018, the AEMC commenced consultation on this rule change request.[[9]](#footnote-10)

In addition to these changes, AusNet Services is undertaking a Customer Forum trial under the New Reg Model. Under the New Reg Model AusNet trial, a Customer Forum is tasked with seeking to agree on aspects of the regulatory proposal in advance of lodging that proposal with the AER. Members of the Customer Forum have been selected to credibly represent perspectives of all AusNet Services' customers. This trial may impact aspects of AusNet Services' reset process, including the F&A.[[10]](#footnote-11)

This decision sets out our reasons to replace the current F&A papers for the next regulatory control period. Appendix A lists the specific matters we will include in the F&A papers. We will also consider any other relevant matters appropriate or convenient for us to address in the F&A papers.[[11]](#footnote-12)

The F&A papers for the Victorian distributors were published on 24 October 2014.[[12]](#footnote-13) In accordance with the Rules, we intend to publish replacement F&A papers by 31 January 2019.[[13]](#footnote-14) Consultation on the replacement F&A papers will commence with publication of a discussion paper for the Victorian distributors in August 2018.

Before reaching this decision to replace Victorian distributors' F&A papers, we issued a notice under the Rules,[[14]](#footnote-15) inviting submissions on whether it is necessary or desirable to amend or replace the current F&A papers for network service providers. Submissions closed on 7 June 2018 and we received no submissions.

CitiPower/Powercor/United Energy, Jemena Electricity Networks, and AusNet Services each submitted requests to us to address a number of issues in their respective F&A papers that we are required to consider.[[15]](#footnote-16) This is because the Rules include a provision that permits a network service provider to specify certain issues that must be addressed in its F&A.[[16]](#footnote-17) A copy of each service providers' request is published on our website alongside this decision.[[17]](#footnote-18)

Reasons for our decision follow.

# Our reasons

This section sets out our reasons for deciding to replace the Victoria F&A papers for the next regulatory control period of 1 January 2021 to 31 December 2025. The sections below correspond to the various components of the F&A.

## Distribution service classification

We consider it necessary to replace the Victoria F&A papers with respect to the classification of distribution services.[[18]](#footnote-19) The Rules require us to determine which services provided by network businesses will be subject to regulation as well as the manner in which we will regulate those services.[[19]](#footnote-20) That is, whether we will directly control prices through to deciding not to regulate a particular service. We make these decisions by assessing a range of factors to determine whether there is competition or potential for competition for the provision of that service.

We consider it timely to consider distribution service classification in Victoria. We have recently released our Electricity Distribution Ring-fencing Guideline, which requires DNSPs to separate their services based on the classification. The Australian Energy Market Commission has also recently issued a rule change relating to service classification, which applies to all distribution businesses. In accordance with this rule change, we are developing a service classification guideline in 2018, with a Draft Guideline being published for consultation in June.[[20]](#footnote-21)

The service providers also requested a review of service classifications to ensure the service descriptions better reflect the services offered. This review will also provide improved clarity given that service classification will set ring-fencing obligations for the regulatory control period.[[21]](#footnote-22)

## Form of control

For distribution services classified as direct control services, we must determine the price or revenue controls (or some other hybrid arrangement) for each service or group of services. The form of control may be, for example, a cap on revenue or a cap on prices charged by the network service providers. The Rules set out assessment criteria we must consider.[[22]](#footnote-23) We may also apply additional criteria in considering the form of control we will apply (as we have done elsewhere).[[23]](#footnote-24) Our assessment is particularly important as we have limited discretion to amend the form of control in our final determination.[[24]](#footnote-25) For these reasons, we will review the form of control applicable to each of the Victorian distributors in our F&A.

The Rules also require us to set out the formulae that give effect to the control mechanisms we will apply.[[25]](#footnote-26) The control mechanisms are the formulae we will use to calculate service prices. We expect to classify some services differently. Again, we have limited discretion to alter the control mechanism formulae listed in the F&A at the time of the determination unless we consider a material change in circumstances justifies departing from those formulae.[[26]](#footnote-27)

## Application of incentive schemes

We have developed several mechanisms that provide incentives for network service providers to invest efficiently and therefore be more likely to operate in the long term interests of consumers. These schemes include the service target performance incentive scheme, efficiency benefit sharing scheme, capital expenditure sharing scheme, demand management incentive scheme, and embedded generation connection incentive scheme. The overall objectives of the schemes are to:[[27]](#footnote-28)

* incentivise network service providers to spend more efficiently on capital and operating expenditure
* reduce the risk of consumers paying for unnecessary capital expenditure
* share efficient improvements and losses between network service providers and consumers
* encourage appropriate levels of service quality
* maintain network reliability as appropriate.

A number of incentive schemes already apply to the network service providers. However, since our last determination, there have been updated versions of some schemes released. We now have a new demand management incentive scheme (DMIS), which network service providers would prefer applied to them for the 2021-2025 regulatory control period. AusNet Services notes that they are discussing incentive schemes with the Customer Forum established under the NewReg Model (including the EBSS, CESS, and DMIS/DMIA) and that it is possible that they may seek to change the way that these schemes are applied, to reflect any agreement reached with the Customer Forum.[[28]](#footnote-29)

In light of the issues raised above, we consider that the application of all incentive schemes should be reviewed in the Victoria F&A papers.[[29]](#footnote-30)

## Other matters

Jemena Electricity Networks submitted that the AER should continue with its current approach to depreciation, that is, using forecast depreciation to establish the RAB at commencement of the 2021-25 regulatory control period.[[30]](#footnote-31) AusNet also requested that the AER indicate our approach to depreciation in our F&A, stating that the current approach to applying forecast depreciation, which is consistent with the Capital Expenditure Sharing Scheme Guideline, should apply in the 2021-25 regulatory control period.[[31]](#footnote-32)

AusNet Services submitted that the AER should specify the value of customer reliability that will apply to the 2021-25 regulatory control period in the F&A paper. In December 2017, COAG Energy Council submitted a rule change request to the AEMC, under which the AER would be responsible for setting the VCR. AusNet has noted that the VCR to be applied in the 2021-25 regulatory control period will impact planning processes and negotiations with the Customer Forum, established under the New Reg Model trial.[[32]](#footnote-33)

For the above reasons and having regard to the submissions, we consider it necessary to replace the F&As for Victorian distributors for the next regulatory control period of 1 January 2021 to 31 December 2025. We expect to issue a discussion paper in August 2018 outlining preliminary views on the matters outlined in this decision. We must then publish final F&A papers by 31 January 2018.

Appendix A – Matters to be addressed in the F&A

The replacement Victorian F&A will address the following matters:

* classification of distribution services (which services we will regulate)
* form of control mechanisms (how we will determine prices for regulated services) and the control mechanism formulae that give effect to the form of control mechanisms
* application of a range of incentive schemes that encourage things like service quality, improvements in network reliability or efficient capital and operating expenditure. This includes application of the:
* service target performance incentive scheme
* efficiency benefit sharing scheme
* capital expenditure sharing scheme
* demand management incentive scheme
* demand management innovation allowance mechanism
* embedded generation connection incentive scheme
* small-scale incentive scheme
* expenditure forecast assessment guidelines
* value of customer reliability
* whether depreciation for establishing the regulatory asset base the network service providers opening regulatory asset base for the 2026–2030 regulatory control period is to be based on actual or forecast capital expenditure.

1. AER, Ring-fencing guideline electricity distribution, October 2017. See: <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/electricity-ring-fencing-guideline-october-2017>. [↑](#footnote-ref-2)
2. Which we outline in our published guidelines. These guidelines are available at [www.aer.gov.au/Better-regulation-reform-program](http://www.aer.gov.au/Better-regulation-reform-program). [↑](#footnote-ref-3)
3. See: <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/demand-management-incentive-scheme-and-innovation-allowance-mechanism>. [↑](#footnote-ref-4)
4. AER, Ring-fencing guideline electricity distribution, October 2017. See: https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/ electricity-ring-fencing-guideline-october-2017. [↑](#footnote-ref-5)
5. See: <http://www.aemc.gov.au/Major-Pages/Power-of-choice>. [↑](#footnote-ref-6)
6. Victorian Government Order-In-Council, No. S 346, 12 October 2017. [↑](#footnote-ref-7)
7. AER, Distribution Service Classification Guidelines and Asset Exemption Guidelines, <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/distribution-service-classification-guidelines-and-asset-exemption-guidelines> [↑](#footnote-ref-8)
8. AER, Service target performance incentive scheme - 2017 amendment, <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/service-target-performance-incentive-scheme-2017-amendment> [↑](#footnote-ref-9)
9. AEMC, Establishing values of customer reliability, <https://www.aemc.gov.au/rule-changes/establishing-values-of-customer-reliability> [↑](#footnote-ref-10)
10. For more information on the AusNet trial, please see the Regulatory Innovation webpage: <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/regulatory-innovation> [↑](#footnote-ref-11)
11. NER, cll. 6.8.1(g) and 6A.10.1A(g). The AER would consult appropriately on any additional matters it wishes to include in the F&A. [↑](#footnote-ref-12)
12. See <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/united-energy-determination-2016-20/initiation> and <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/powercor-determination-2016-20/initiation> and <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/ausnet-services-sp-ausnet-determination-2016-20/initiation> and <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/jemena-determination-2016-20/initiation> and <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/citipower-determination-2016-20/initiation>. [↑](#footnote-ref-13)
13. NER, cll. 6.8.1(e) and 6A.101A(e). [↑](#footnote-ref-14)
14. NER, cll. 6.8.1(c)(2) and 6A.10.1A(c)(2). We issued this notice on 1 November 2017. [↑](#footnote-ref-15)
15. CitiPower/Powercor and United Energy, Request to replace the 2014 framework and approach paper, 30 April 2018; AusNet Services, Victorian electricity distribution determination 2021-25: Request to replace Framework and Approach, 30 April 2018; Jemena Electricity Networks, Request for a replacement Framework and Approach, 30 April 2018. [↑](#footnote-ref-16)
16. Service provider written requests were submitted in accordance with NER, cll. 6.8.1(c)(1) and 6A.10.1A(c)(1). [↑](#footnote-ref-17)
17. As required under NER, cll. 6.8.1(c)(3)(ii) and 6A.10.1A(c)(3)(ii). [↑](#footnote-ref-18)
18. NER, cl. 6.8.1(b)(2)(i). [↑](#footnote-ref-19)
19. NER, cll. 6.2.1 and 6.2.2 [↑](#footnote-ref-20)
20. See http://www.aemc.gov.au/Rule-Changes/Contestability-of-energy-services. [↑](#footnote-ref-21)
21. CitiPower/Powercor and United Energy, Request to replace the 2014 framework and approach paper, 30 April 2018, p. 1; AusNet Services, Victorian electricity distribution determination 2021-25: Request to replace Framework and Approach, 30 April 2018, p. 1; Jemena Electricity Networks, Request for a replacement Framework and Approach, 30 April 2018, p. 1; AER, Ring-fencing guideline electricity distribution, October 2017. [↑](#footnote-ref-22)
22. NER, cl. 6.2.5. [↑](#footnote-ref-23)
23. In the current Victoria F&A processes, we applied three additional criteria in our form of control mechanism assessment. We consider it prudent to continue applying these criteria to Victoria for 2021−25. [↑](#footnote-ref-24)
24. NER, cll. 6.8.1(b)(1)(i) and 6.12.3(c) and (c1). [↑](#footnote-ref-25)
25. NER, cl. 6.8.1(b)(2)(ii). [↑](#footnote-ref-26)
26. NER, cl. 6.12.3(c1). [↑](#footnote-ref-27)
27. AER, Electricity distribution network service providers, Service target performance incentive schemes, June 2008, p. 2; AER, Better Regulation, Draft expenditure incentives, 9 August 2013, AER, Demand management incentive scheme, December 2017, AER, Demand management innovation allowance mechanism, December 2017. [↑](#footnote-ref-28)
28. AusNet Services, Victorian electricity distribution determination 2021-25: Request to replace Framework and Approach, 30 April 2018, p. 5. [↑](#footnote-ref-29)
29. NER, cll. 6.8.1(b)(2)(iii)-(viii). [↑](#footnote-ref-30)
30. Jemena Electricity Networks, Request for a replacement Framework and Approach, 30 April 2018, p. 9. [↑](#footnote-ref-31)
31. AusNet Services, Victorian electricity distribution determination 2021-25: Request to replace Framework and Approach, 30 April 2018, p. 6. [↑](#footnote-ref-32)
32. AusNet Services, Victorian electricity distribution determination 2021-25: Request to replace Framework and Approach, 30 April 2018, p. 5. [↑](#footnote-ref-33)