

NSW Distribution reset – Framework & Approach

We have published our Preliminary Framework and Approach (Preliminary F&A) in advance of our distribution determination for NSW electricity distributors Ausgrid, Endeavour Energy and Essential Energy. We welcome stakeholder feedback. Once finalised, the F&A will establish key parameters for our assessment of the network businesses' regulatory proposals, due to be submitted to us in January 2018.

Our role and the regulated network businesses

The Australian Energy Regulator (AER) is the economic regulator for transmission and distribution electricity and gas network businesses across Australia (excluding Western Australia).

The high cost of energy networks can make it efficient to have a single supplier of network services in a particular geographic area, leading to a natural monopoly industry structure. The networks are regulated to manage the risk of monopoly pricing, where a business can charge higher prices or provide poorer services compared with the situation in a competitive market.

Ausgrid, Endeavour Energy and Essential Energy operate monopoly electricity distribution networks in New South Wales (NSW). The networks comprise the poles, wires and transformers used for transporting electricity across urban and rural population centres to homes and businesses.

We make regulatory decisions on the revenues the NSW network businesses can recover from their customers. We determine their revenue by an assessment of their efficient costs and forecasts. Our assessment is based on regulatory proposals submitted by the network businesses in advance of a five year regulatory control period, in this case beginning 1 July 2019.

The regulatory framework we administer is based on an incentive regime. We set a network business' allowed revenue for a period (typically five years) based on the best available information, rigorous assessment and consideration of consumers' views. Network businesses are then provided with incentives to outperform the revenue we determine. Those savings are passed to customers through lower network bills.

What is the Framework and Approach?

The Framework and Approach (F&A) is the first step in our process to determine efficient prices for electricity distribution services. The F&A determines, amongst other things, which services we will regulate and the broad nature of the regulatory arrangements, including incentive schemes that will apply to the network business. The F&A also facilitates

early consultation with consumers and other stakeholders and assists electricity distribution businesses prepare their regulatory proposals.

An F&A stays in place until it is replaced. There have been a number of changes to the regulatory environment since we published our last NSW distribution F&A. Changes to the National Electricity Rules (NER) in November 2012 introduced new incentive schemes and allow us to adopt improved approaches to assessing expenditure forecast by the network service providers. The Power of Choice reforms also introduced changes to metering contestability. Further, we are currently developing a new demand management incentive scheme (DMIS) and have recently published a national ring-fencing guideline. For these reasons we consider it prudent to review the current F&A paper.

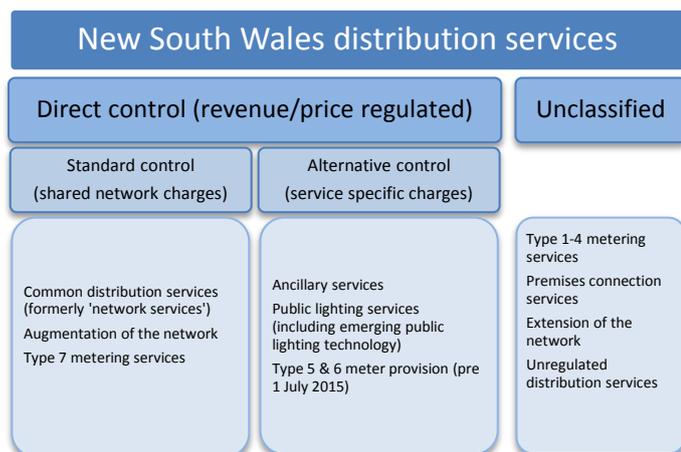
Classification of distribution services

We regulate a variety of services provided by the NSW network businesses. Where there is considerable scope to take advantage of market power, our regulation is more prescriptive. Less prescriptive regulation is required where prospect of competition exists. In some situations we may remove regulation altogether.

Our preliminary view is that the classification of some NSW distribution services will change for the 2019–24 regulatory control period. Specifically, we propose to classify emergency recoverable works as standard control services so that it can be provided by the distributor without triggering any ring-fencing requirements. In particular, it would not be a suitable service for ring-fencing given distributors are required to perform works to maintain or repair the shared network to ensure a safe and reliable electricity supply. We also propose to clarify service descriptions so they better align with the services provided.

Our preliminary service classifications are set out in Figure 1 below.

Figure 1 AER preliminary service classification



Control mechanisms

Our determinations impose controls on direct control service prices and/or their revenues. We may only accept or approve control mechanisms in a distributor's regulatory proposal if they are consistent with our final F&A. In deciding control mechanism forms, we must select one or more from those listed in the NER. These include price schedules, caps on the prices of individual services, weighted average price caps, revenue caps, average revenue caps and hybrid control mechanisms.

Our preliminary position on the form of control mechanisms for the NSW network businesses are:

- standard control services— revenue cap
- alternative control services— caps on the prices of individual services.

We consider this approach will provide cost reflective prices for customers.

Incentive schemes

Incentive schemes encourage network businesses to manage their networks in a safe, reliable manner that serves the long term interests of consumers. They provide network businesses with incentives to only incur efficient costs and to meet or exceed service quality targets. Our preliminary position is to apply each of the available incentive schemes to each of the NSW network businesses:

- Service Target Performance Incentive Scheme
- Efficiency Benefit Sharing Scheme
- Capital Expenditure Sharing Scheme
- Demand Management Incentive Scheme

Expenditure Forecast Assessment Guideline

Our Expenditure Forecast Assessment Guideline is based on a reporting framework allowing us to compare the relative efficiencies of distributors. Our preliminary position is to apply the guideline, including its information requirements, to the NSW network businesses in the upcoming regulatory control period.

Our expenditure assessment guideline outlines a suite of

assessment/analytical tools and techniques to assist our review of the NSW network businesses' regulatory proposals. We intend to apply the assessment/analytical tools set out in the guideline and any other appropriate tools for assessing expenditure forecasts.

Depreciation

We provide an allowance for network businesses to recover the cost of their investments. The rate at which they recover the cost of their investments is determined by their depreciation profile. We have a choice of using forecast or actual depreciation. We have chosen to apply forecast depreciation in combination with the CESS as this will maintain the incentive for the NSW distributors to pursue capex efficiencies.

Dual function assets

Some high voltage distribution assets are of use to customers outside of the distribution network. These are dual function assets that support the transmission of electricity at high voltages across Australia and not just within a distribution network. One aspect of our decision is to determine whether customers within the network should pay for these assets or whether the costs should be recovered from only those customers that benefit from their use.

Ausgrid and Endeavour Energy operate dual function assets. Essential Energy does not. Our preliminary position is to apply transmission pricing rules to Ausgrid's dual function assets because doing otherwise would significantly impact Ausgrid's customers. We propose to apply distribution pricing rules to Endeavour Energy's dual function assets because, due to the nature of those assets, applying transmission pricing rules would not change their cost recovery—Endeavour Energy customers would still finance those assets.

For more information:

More information can be found on our website: www.aer.gov.au

