Final decision

# Framework and approach paper

# Classification of services and control mechanisms

## Energex and Ergon Energy 2010–15

August 2008

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# Shortened forms

| | |
|---|---|
| ARR | annual revenue requirement |
| AER | Australian Energy Regulator |
| CAC | connection asset customer |
| CPI | consumer price index |
| DNSP | Distribution Network Service Provider |
| DUOS | distribution use of system |
| EG | embedded generator |
| FRC | full retail competition |
| ICC | individually calculated customer |
| MCE | Ministerial Council on Energy |
| NEM | National Electricity Market |
| NEL | National Electricity Law |
| NER | National Electricity Rules |
| PPS | pricing principles statement |
| PTRM | post-tax revenue model |
| QCA | Queensland Competition Authority |
| RAB | regulatory asset base |
| SAC | standard asset customer |
| WACC | weighted average cost of capital |
| WAPC | weighted average price cap |

# 1 Introduction

The Australian Energy Regulator (AER) is responsible for the economic regulation of electricity distribution services in the National Electricity Market. The AER's functions and powers are set out in the National Electricity Law and the National Electricity Rules (NER).

Under chapter 6 of the NER, the AER may classify distribution services provided by a Distribution Network Service Provider (DNSP), and must make distribution determinations for each DNSP.

There are two DNSPs that operate in Queensland which are subject to economic regulation under chapter 6 of the NER:

- Energex—whose network covers mainly urban areas in South East Queensland
- Ergon Energy (Ergon)—whose network covers regional areas throughout Queensland.

Queensland distribution networks are currently subject to economic regulation by the Queensland jurisdictional regulator, the Queensland Competition Authority (QCA). The QCA released a distribution determination in April 2005 for the current regulatory period—1 July 2005 to 30 June 2010. The QCA is responsible for administering its 2005 distribution determination.

The AER will assume responsibility for the economic regulation of Energex and Ergon on 1 July 2010, with the commencement of its first distribution determination for those businesses. The AER is required to prepare for and make a distribution determination for the Queensland DNSPs for the next regulatory control period, 1 July 2010 to 30 June 2015. To this end, the AER commenced the process of making those distribution determinations on 1 April 2008. This process will continue to take place over the final two years of the current regulatory control period.

## 1.1 Nature of framework and approach paper

The AER must prepare and publish a framework and approach paper in anticipation of every distribution determination. The AER must commence preparation of and consultation on its framework and approach at least two years prior to the end of the current regulatory control period and complete its framework and approach paper 19 months prior to the end of a regulatory control period.

The aim of the framework and approach paper is to assist the DNSP prepare its regulatory proposal by:

- stating the form (or forms) of control to be applied by the distribution determination
- setting out the AER's likely approach (and its reasons for that likely approach) in the distribution determination to:
    - the classification of distribution services

- the application to the DNSP of a service target performance incentive scheme or schemes
- the application to the DNSP of an efficiency benefit sharing scheme or schemes
- the application to the DNSP of a demand management incentive scheme or schemes
- any other matters on which the AER thinks fit to give an indication of its likely approach.[1]

## 1.2 Transitional arrangements

The NER sets out the revised arrangements for distribution regulation in chapter 6 but also includes transitional provisions in chapter 11. Clause 11.16 sets out transitional arrangements that are to apply to the Queensland DNSPs for the distribution determination that covers the regulatory control period 1 July 2010 to 30 June 2015.

Clause 11.16.6 provides that if either Energex or Ergon submit a proposal to the AER on or before 31 March 2008 on the classification of services and the form of control mechanisms to apply in the next regulatory control period, the AER is required to publish its framework and approach paper on these matters within five months of receiving the proposal. This transitional provision is unique to Queensland.

Due to the transitional arrangements, the framework and approach paper for Energex and Ergon is split into two stages:

- Framework and approach (stage 1)—classification of services and control mechanisms
- Framework and approach (stage 2)—application of schemes.

This framework and approach paper sets out the AER's classification of Energex's and Ergon's distribution services and the control mechanisms to apply to standard control services and alternative control services in the 2010–15 regulatory control period.

The AER has published a separate framework and approach paper setting its preliminary positions in relation to the application of schemes.[2] This paper and submissions on it are available on the AER's website.[3] The AER must publish its framework and approach paper in relation to these matters by 30 November 2008.

1 NER, clause 6.8.1.

2 AER, *Framework and approach paper—application of schemes Energex and Ergon Energy 2010–15*, Preliminary positions, 30 June 2008.

3 www.aer.gov.au.

## 1.3 Consultation on framework and approach paper

In order to consider common issues and for administrative simplicity the framework and approach papers for Energex and Ergon are being considered through a joint process. Where necessary, the AER has considered issues separately. The consultation process was streamlined to allow for interested parties to respond to both or either proposal as necessary.

Due to transitional provision 11.16.6 the AER must complete and publish its framework and approach paper—classification of services and control mechanisms no later than 31 August 2008. The AER's process for publishing the framework and approach paper—classification of services and form of control mechanisms is set out in table 1.1.

**Table 1.1: Process for preparation of and consultation on framework and approach paper**

| Process | Date |
|---|---|
| Receipt of proposals | 31 March 2008 |
| Consultation on proposals | 1 April – 28 April 2008 |
| Publication of framework and approach positions paper | 7 July 2008 |
| Roundtable | 22 July 2008 |
| Consultation on positions paper | 7 July – 28 July 2008 |
| Publication of framework and approach paper—classification of services and control mechanisms | 27 August 2008 |

## 1.4 Structure of final decision

This decision sets out the AER's consideration of substantive issues raised in submissions on its position paper. Except where specified, the AER will maintain the proposed positions set out in its July 2008 position paper.

The structure of this framework and approach paper is set out as follows:

- chapter 2 sets out the classification of distribution services
- chapter 3 sets out the form of the control mechanisms to be applied to direct control services

Appendix A sets out the factors in the NER the AER assessed when classifying services and deciding on the form of control mechanisms to apply to standard and alternative control services.

Appendix B sets out the AER's service groups and classifications.

# 2 Classification of services

## 2.1 Introduction

This chapter sets out the AER's likely approach on the classification of Energex's and Ergon's distribution services for the 1 July 2010 to 30 June 2015 regulatory control period.

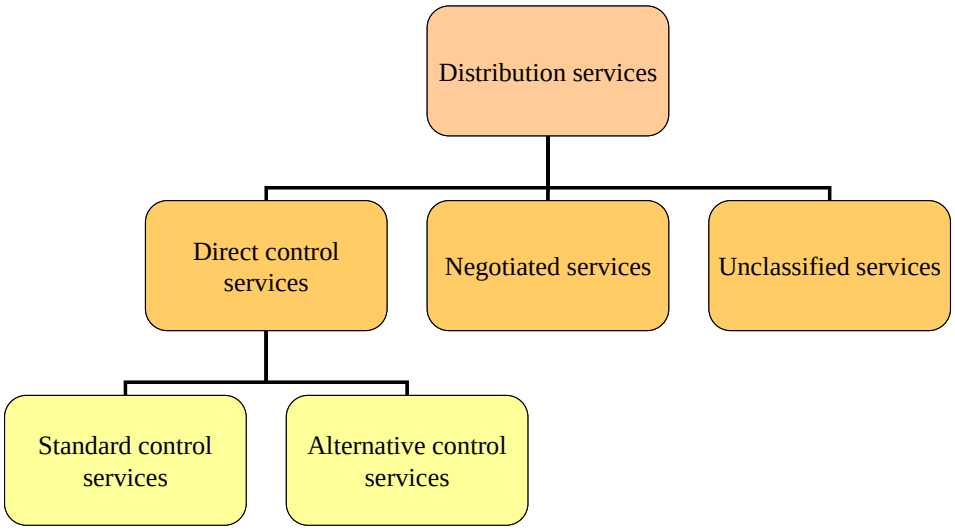
### 2.1.1 Requirements of the National Electricity Rules

Under the NER a distribution determination made by the AER must include a decision on the classification of the services to be provided by the DNSP during the course of the relevant regulatory control period.[4] The framework and approach paper must set out the AER's likely approach to the classification of distribution services in a DNSP's forthcoming distribution determination, and its reasons for that approach.[5]

The AER must have regard to the factors set out in NER clauses 6.2.1 and 6.2.2 when making its service classifications; these factors are set out in appendix A.

The distribution service classifications available under the NER are illustrated in the figure 2.1 below.

**Figure 2.1: Distribution service classifications**




### 2.1.2 Current arrangements

The QCA's approach to classifying services was set out in its determination of prescribed services.[6] The QCA adopted the following approach:

- all services performed by a DNSP that were associated with or ancillary to, access to the network for the supply of electricity were prescribed services

4 NER, clause 6.12.1(1).

5 NER, clause 6.8.1(b)(1).

6 QCA, *Electricity Distribution: Determination of Prescribed Services*, September 2000.

- DNSPs or interested parties could apply to the QCA to have a specific service treated as an excluded service where it was demonstrated that the market for such services were subject to potential—if not—actual competition.[7]

In 2007, the QCA noted DNSP concerns that there could be a significant increase in the demand for non-DUOS services and consequential increases in non-DUOS revenue due to the introduction of full retail competition. It noted that—in the context of the fixed revenue cap form of control applied under the regulatory determination—this anticipated growth could potentially result in DNSPs artificially holding DUOS prices low resulting in non-DUOS services cross subsidising DUOS services. It noted that such an outcome would be an unintended and undesirable consequence.[8]

In response to the potential inefficient pricing outcome, in August 2007 the QCA amended its determination of prescribed services. This amendment enabled the QCA to deem a service as excluded, having regard to the criteria set out in clause 6.2.4(a) of the NER (applicable at that time) and choose to apply a form of "light handed" regulation to these services, although a contestable market could not be demonstrated.[9]

Consistent with its August 2007 amendment to the prescribed services determination, in December 2007 the QCA determined that all non-DUOS services that were classified as prescribed services were to be reclassified as excluded services.[10]

### 2.1.3 Proposals

Pursuant to clause 11.16.6 of the NER, Energex and Ergon submitted classification of services and control mechanism proposals to the AER on 31 March 2008.[11]

**Energex proposal**

Energex proposed 11 distribution service groups; 10 groups classified as standard control distribution services and the remaining group classified as a negotiated distribution service. Energex's proposed distribution service groupings are shown in table 2.1.

7 ibid., p. 8.

8 QCA, *Amendment Electricity Distribution: Determination of Prescribed Services*, Final Decision, August 2007.

9 ibid., pp. 3–5.

10 QCA, *Electricity distribution: Review of excluded distribution services*, Final Decision, December 2007.

11 Energex, *Service Classification and Control Mechanisms for Distribution Services Proposal to the Australian Energy Regulator under clause 11.16.6 of the National Electricity Rule*, March 2008
Ergon, *Proposal: Service Classification and Control Mechanism*, March 2008.

**Table 2.1: Service classifications proposed by Energex**

| Group | Proposed service group title | Proposed classification |
|---|---|---|
| 1 | Network services | Standard control services |
| 2 | Connection services (excluding subtransmission connection services) | Standard control services |
| 3 | Customer services | Standard control services |
| 4 | De-energisation and re-energisation | Standard control services |
| 5 | Additions and alterations | Standard control services |
| 6 | Ancillary metering services | Standard control services |
| 7 | Supplementary services | Standard control services |
| 8 | Enhanced services | Standard control services |
| 9 | Quoted services | Standard control services |
| 10 | Temporary supply services | Standard control services |
| 11 | Subtransmission connection services | Negotiated distribution service |

Source: Energex proposal.

Additionally, Energex provided a list of services that it considered should be unregulated.[12] These services were:

- provision of electricity industry training to external parties
- pole and duct rentals for non-electricity related purposes
- provision of watchman lights
- high load escorts and coverage of low voltage mains
- provision of contestable metering services—types 1–4
- provision of contracting services to other network service providers
- non-distribution services at customer requests
- street lighting.

**Ergon proposal**

Ergon proposed 10 distribution service groups and classified all of them as standard control services. It did not propose a separate group for subtransmission connection assets. Ergon's proposed distribution service groupings are shown in table 2.2.

[12] Energex proposal, appendix B.

**Table 2.2: Service classifications proposed by Ergon**

| Group | Proposed service group title | Proposed classification |
|---|---|---|
| 1 | Network services | Standard control services |
| 2 | Connection services | Standard control services |
| 3 | Customer services | Standard control services |
| 4 | De-energisation and re-energisation | Standard control services |
| 5 | Additions and alterations | Standard control services |
| 6 | Ancillary metering services | Standard control services |
| 7 | Supplementary services | Standard control services |
| 8 | Enhanced services | Standard control services |
| 9 | Quoted services | Standard control services |
| 10 | Temporary supply services | Standard control services |

Source: Ergon proposal.

Additionally, Ergon provided a list of services that it considered should be unregulated. These services were:

- provision of watchman lights
- high load escorts and coverage of low voltage mains
- meter data agent—collecting data for metering types 1–4
- non-distribution services at customer requests
- street lighting
- unregulated services provided by Ergon group companies including:
  - ownership and operation of 33 isolated system generators
  - ownership and operation of 34 isolated system networks
  - ownership and operation of a network in the North West minerals province
  - undersea cable
  - works for Powerlink
  - sale of remote area power stations and solar PV systems
  - non-competing retail entity selling on Queensland Government notified prices

- wholesale fibre telecommunications services
- IT services supporting Energex and Ergon businesses.[13]

## 2.2 AER proposed positions

The AER considered that grouping services and applying a classification for each group in accordance with the NER was a reasonable approach to follow when classifying Energex and Ergon's distribution services.[14] Based on a review of the nature of the activity and the impact of the service the AER grouped the DNSP's distribution services as follows:

- network services
- connection services
- metering services
- quoted services
- compensable services
- unregulated services.

Based on the AER's assessment of the factors set out in the NER its proposed classification of the above distribution service groups applicable to Energex and Ergon are set out in table 2.3.[15]

**Table 2.3: AER proposed service classification for Energex and Ergon**

| Distribution service group | AER service classification |
|---|---|
| Network services | Standard control services |
| Connection services | Standard control services |
| Metering services | Standard control services |
| Quoted services | Alternative control services |
| Compensable services | Alternative control services |
| Unregulated | Unclassified |

13 SPARQ Solutions Pty Ltd is not a regulated entity but provides IT services to Energex and Ergon. The cost of providing these services will be reviewed by the AER in making its distribution determination.

14 NER, clause 6.2.1(b).

15 AER position paper, pp. 33–34.

## 2.3 Submissions

The AER received submissions commenting on its proposed positions from the following interested parties: the Electrical and Communication Association (ECA), Energex, Ergon, the Local Government Association of Queensland (LGAQ), Robin Russell and Associates (RRA), SPA Consulting (SPA), the Urban Development Institute of Australia (Queensland) (UDIA) and Vision Energy.

The main issues raised in submissions were in relation to:

- the grouping of distribution services
- the design and construction of large connection assets
- de-energisation and re-energisation services
- street lighting services
- high load escorts and the coverage of low voltage mains.

## 2.4 Issues and AER considerations

### 2.4.1 Grouping of distribution services

**AER proposed position**

In its position paper the AER grouped Energex's and Ergon's services into six groups on the basis that it allowed for a better allocation of services according to the nature of activity and the impact of the service compared to the DNSPs proposed groups.

The network, connection and metering services are the core business of a DNSP and were separated into three stand alone groups. The *other* services were categorised as quoted and compensable services and grouped accordingly.[16]

**Submissions**

Energex stated that whilst it broadly supported the proposed groupings, the separation of the services that were included in the AER's discussion on *other* services into three sub-groups would allow alignment of services that are similar in nature and the application of an appropriate control mechanism. The three sub-groups submitted were: miscellaneous fixed price services; customer requested quoted services; and compensable quoted services. It also noted that if the AER decided to classify street lighting services then a separate group should be created for that category of service. Additionally, given the AER's proposed alternative control classification of the design and construction of large connection assets Energex stated that a separate group named alternative control connection services should be established.[17]

16 Compensable services are services that are not specifically requested by a customer but arise where an external event triggers the need, for example, the replacement of a pole after a vehicle collision.

17 Energex submission, pp. 4–7.

Given that a single control mechanism is applicable to all network, connection and metering service groups, Ergon submitted that one group named standard control services is preferable to three sub-groups.[18] Ergon also submitted that four service groupings should be adopted by the AER and stated that its categorisation was not inconsistent with the AER's apparent intention in the position paper. The groupings suggested by Ergon were; standard control services and alternative control services, where alternative control services were further separated into fixed price services, quoted requested services and quoted compensable services.

**AER considerations**

Appendix A of the AER's position paper set out the proposed service groups, activity descriptions and applicable control mechanisms. Ergon sought further clarification on the services that should be in the AER's service groups. Appendix B of this decision sets out the AER's service groups, activity descriptions and classification. The activity descriptions have been expanded to provide the DNSPs with more clarity on the services that would fall within each group.

***Grouping of network, connection and metering services***

Ergon submitted that network, connection and metering services should be categorised as a single group. A decision to allocate network, connection and metering services to one group as submitted by Ergon is based only on the applicable form of control and to a large extent ignores the nature of the activities involved. The AER considers that to the extent possible, services should be grouped according to the nature of the activity as this provides users with greater transparency about the services over which regulatory control is exercised. This will also provide users with an opportunity to better understand the type of service and to map services to the type of control mechanism.

Subject to the changes noted below, the AER will maintain its individual groups for network, connection and metering services.

*Removal of de-energisation and re-energisation services from connection services*

For the reasons discussed in section 2.4.4 the AER has removed de-energisation and re-energisation services from the connection services group.

*Definition of large customer connection assets*

The AER's proposed connection services group did not include the design and construction of large connection assets because this service was classified as an alternative control service. The position paper indicated that a small customer was a customer that consumes less than 160MWh per annum but did not define a large customer for the purpose of the classification decision.

Energex stated that the AER should distinguish between large and small connections on the basis of the attributes of the physical connection to the shared network rather than on the basis of annual energy consumption.[19]

Ergon stated that the NER defines a connection service and it does not make a distinction between large and small customers. It also stated that connection services

[18] Ergon submission, pp. 6–8.

[19] Energex submission, pp.6–7.

necessarily incorporate connection assets. Therefore, it considers that the separation of connection services into a design and construction service whilst calling it a connection service is inappropriate.[20]

Ergon also stated that rather than separating large and small customers based on energy consumption it is more appropriate to differentiate them according to the nature of the connection assets. It proposed the use of the network user classes applied in its pricing principles statement (PPS) to distinguish small and large connection customers. The customer groups used by Ergon are: individually calculated customer (ICC); connection asset customer (CAC); standard asset customer (SAC); and embedded generator (EG). It submitted that the small connection customer should be consistent with the SAC.[21]

The AER agrees with Energex and Ergon that, for the purpose of this classification task, it is more appropriate to distinguish between small and large customers based on the nature of the connection asset than on energy consumption alone. Energex's network PPS also recognises customer groups similar to Ergon's.[22] Other than for SACs, connection asset costs for all other customer groups and EGs are calculated on an individual basis. For SACs the connection asset costs are based on an average for that customer group. Therefore, based on whether connection costs are individually calculated or an average, a clear demarcation between customers can be made.

For the purpose of classifying the design and construction of large connection assets for the next regulatory control period the AER considers it reasonable to adopt the DNSP's SAC as the small customer. Therefore, a large connection customer is an EG or customer other than a SAC as defined by the DNSP's in their approved PPS.

*Separate alternative control connection service group*

Energex stated that the large customer connection service is distinct from the services in the *other* services group and the costs and revenues are likely to be significant. Therefore, it proposed the establishment of a separate group named alternative control connection services.

The AER understands that Energex's proposal for the creation of a separate alternative control connection service group is due to the fact that costs and revenues associated with this service, which it submits will be significant. The AER notes that its definition of large connection assets as all EGs and customers other than SACs should result in the costs and revenues associated with this service being not as significant as envisaged by Energex under the AER's proposed position. The AER does not consider it necessary to create a separate alternative control connection services group and will continue to include the design and construction of large connection assets in the quoted services group.

***Street lighting***

Energex noted that if the AER classifies street lighting services as an alternative control services then it should establish a separate service group. Ergon stated that

20 Ergon submission, pp. 10–11.

21 ibid. pp. 22–23.

22 Energex, *Network Pricing Principles Statement 2008-09*, p. 11.

street lighting should be unregulated and did not propose a service group.[23] The AER agrees with Energex that street lighting represents a distinct stand alone service and should have its own grouping. Street lighting services will be removed from the quoted services group and made a stand alone group.

***Other services***

In its position paper, the AER grouped the DNSP's *other* services into quoted services and compensable services.

Energex and Ergon submitted that the *other* services should be grouped as: fixed price services; customer requested quoted services; and compensable quoted services. The DNSP's rationale for this grouping was that the *other* services included services where the nature and scope may or may not be known in advance and therefore depending on the type the price may be fixed or variable.

It is useful to separate services on the basis of services which can be quoted only after the specific service requirement is known and services whose nature and scope are known in advance. However, three groups of *other* services as proposed by the DNSPs are not necessary. The AER considers that separating *other* services into the following two groups will achieve the desired outcome. These groups are:

- quoted services—services for which the nature and scope cannot be known in advance irrespective of whether it is customer requested or an external event triggers the need (for example, price on application or compensable)
- fee based services—remaining services that are not provided on a quoted basis (fee for service).

**Conclusion**

The service groupings applicable to Energex and Ergon for the purpose of this classification task are:

- network services
- connection services
- metering services
- street lighting services
- quoted services
- fee based services
- unregulated services.

[23] The AER's likely classification of street lighting services is set out in section 2.4.3.

### 2.4.2 Classification of the design and construction of large connection assets

**AER proposed position**

The AER proposed to classify the design and construction of large connection assets as an alternative control service rather than as a standard control service. The AER considered that the lack of an accreditation scheme acted as a limited barrier to entry and therefore, the construction of small service connections should not be classified as an alternative control service but continue as a standard control service.[24] Therefore the design and construction of connection assets that were classified as an alternative control service only related to large customer connections and this service was included in the quoted services group.

**Submissions**

***Energex***

Energex stated that the AER had not sufficiently explained the effect of the classification on large customers or the framework necessary to implement and operate any market based system and process, however, it acknowledged the AER's rationale for the decision. It also stated that an alternative control classification would add to its administrative costs.[25]

***Ergon***

Ergon disagreed with the AER's proposed classification of design and construction of large connection assets as an alternative control service. Ergon's reasons were primarily based around the arguments that:

- the potential for competition is determined by the characteristics of the market and the non-economic regulatory framework and that competition is not determined via the classification of services

- administrative costs and other consequences associated with the changeover to an alternative control service classification have not been considered by the AER, particularly in relation to changes associated with the capital contributions policies and the ongoing policy developments of the Ministerial Council of Energy (MCE) in relation to a national approach to connections

- there is no reason to recognise that the NSW approach is more appropriate than the Queensland approach (for contributed assets, customers paying upfront, and other matters) given that both regimes are economically neutral and the AER's stated position of continuing with the current classification unless another is clearly more appropriate.[26]

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24 The AER understands that such accreditation schemes are in place in other jurisdictions of the NEM, for example in NSW. Such schemes allow third parties to competitively provide the major cost item of the connection service (materials, equipment and labour) and will assist in handling high volumes of work and also allow for the timeliness of the connection to be the responsibility of competitive providers.

25 Energex submission, p. 11.

26 Ergon submission, p. 14.

***SPA Consulting***

SPA stated that currently within Queensland there are around 10 design companies and 30 construction companies with potential for expansion if the permitted scope of work is increased. It also commented that the market was constrained particularly within the Ergon service area resulting in Queensland being disadvantaged relative to other southern states of Australia due to increased costs, reduced growth of the network and inability to reasonably forecast timing and cost of connection assets. Additionally, SPA submitted that the AER's position paper was inaccurate in terms of the types of competitive subdivision works permitted by Ergon. Ergon did not permit work to be done in subdivisions of less that six lots, rural residential, industrial, commercial or any overhead subdivisions (except for some underground projects used as trials). SPA supported the proposed alternative control classification.

SPA submitted that establishment and enforcement of technical standards should be undertaken by an independent body. It also stated that competitive works are frequently delayed due to delays in providing agreements, auditing of designs and constructed works, and the commissioning of assets.[27]

***Robin Russell and Associates***

RRA stated that the AER should promote the fundamental principle that all externally funded works should be contestable. It also had concerns about the accuracy of the types of subdivision work disclosed by Ergon as contestable and provided a list of services opened for competition by Energex and Ergon. Additionally, RRA stated that:

- an independent body should be responsible for the accreditation of consultants and contractors
- the DNSPs should contribute to the cost of developers being asked to construct assets that provide for loads above the actual requirements[28]
- delays in relation to new connection requests should be addressed, including giving consideration to making the retail entity responsible for connections.[29]

***Vision Energy***

Vision Energy endorsed RRA's submission that externally funded works should be competitive and that this would provide economic stimulus to Queensland. It noted that resources and time is currently prioritised by the DNSPs in favour of work that only the DNSP is permitted to do. Additionally, Vision Energy supported the view that accreditation of consultants and contractors should be done by an independent party and agreed with the AER's proposed classification of connection services.[30]

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27 SPA submission, pp. 2–6.

28 RRA claimed that the developers are being used to provide the DNSPs with a hedge against future load growth.

29 RRA submission, pp. 1–3.

30 Vision Energy submission, pp. 1–2.

***Electrical and Communications Association***

ECA supported the principle that users who fund electrical works should be allowed to engage accredited service providers. It also supported an independent accreditation system and the need for DNSPs to contribute to assets required from developers above the load required by regulation. Additionally, ECA noted the need to address delays associated with connection services.[31]

***Urban Development Institute of Australia (Queensland)***

The UDIA stated that as far as possible all works that are funded by developers and other parties should be made contestable and that the use of alternative providers for the design and delivery of network extensions provide a critical resource to meet development demand in a timely and cost effective manner. It stated that costs of extension should not be principally borne by the developer. Overall, the UDIA endorsed the AER's proposed position and noted that in general the industry is appreciative of the DNSP's approach to their responsibilities, however, a greater sense of priority and urgency from Ergon is warranted with substantial regulatory oversight.[32]

**AER considerations**

The AER's considerations are discussed having regard to clause 6.2.2 of the NER. Clause 6.2.2 of the NER sets out matters that the AER must have regard to when classifying a direct control service as a standard control or alternative control service.

***Requirement to classify a service of a specified kind in a particular way—clause 6.2.2(e)***

The NER does not require a distribution service provided by Energex or Ergon to be classified in a particular way.

***Presumption in favour of prior classification—clause 6.2.2(d)***

Ergon submitted that all connection services are currently prescribed services and therefore, in line with the AER's reasoning in its position paper, unless there is a persuasive reason to classify otherwise, the default classification should be a standard control service.[33]

In its position paper the AER noted that when classifying distribution services that have previously been regulated, unless a different classification is clearly more appropriate, there is a presumption of not departing from a previous classification (if the services have been previously classified); and if there has been no previous classification the classification should be consistent with the previously applicable regulatory approach.

Consistent with its position paper the AER has assessed the factors under clause 6.2.2 to determine whether a different classification is clearly more appropriate.

***Potential for development of competition—(clause 6.2.2(c)(1)***

The AER must have regard to the potential for development of competition in the relevant market and how the classification might influence that potential. The AER's

31 ECA submission, pp. 1–3.

32 UDIA submission, pp. 1–2.

33 Ergon submission, pp. 4–13.

position paper stated that there was the potential for competition to develop in the market for design and constructing of connection assets.

Submissions received from design consultants and construction contractors indicate that there are alternative providers available in Queensland to provide this service but the market was constrained due to the DNSPs limiting the entry of alternative providers to the market.

Ergon recognised that currently connection assets prior to energisation can be built by third parties and notes that it is trialling extending its subdivision related electrical works to other types of connection assets. However, Ergon considers that potential for competition is determined by the characteristics of the market and the nature of the non-economic regulatory framework. It noted that some standard control services, such as street lighting and subdivision works, are currently provided by alternative providers and therefore, competition is not delivered via the classification of service. Ergon considered that the nature of the non-economic regulatory framework determines the potential for competition and in order to introduce 'contestability' there needs to be a supporting non-economic regime to authorise parties.[34]

The AER's assessment indicates that there is a sufficient number of alternative providers in the market and if allowed to develop could lead to a competitive market for the design and construction of connection assets. As noted by Ergon, it has opened up to competition design and construction of connection assets relating to residential land subdivisions and is currently trialling this competitive approach in the provision of connection services for rural and industrial sub-divisions. This supports the AER's position that there is potential for competition to develop.

The AER considers that the underlying issue is not how or under what type of classification competition evolved. The issue is whether market characteristics and other factors indicate a potential for competition. If so, the NER require that the AER consider the influence of the classification on competition. The consequence of the type of classification is the applicable control mechanism. In circumstances where there is a potential for competition to develop, the AER considers that a control mechanism should be chosen with the aim of not restricting competition in that market. Typically, such a control mechanism would be of a limited or non-building block approach—perhaps, in the nature of a schedule of fixed prices or a price cap and would not require forecasts of expected market shares.

Further, clause 6.5.1(a) of the NER requires that the regulatory asset base (RAB) only include assets that provide standard control services.[35] Therefore, an alternative service classification will assist competition in that costs attributable to the competitive service will be directly linked to the price charged for the service, thereby, providing more transparency and if priced inefficiently could encourage competitors to enter the market.

RRA, Vision Energy and ECA submitted that the AER should promote the fundamental principle that all externally funded electrical works should be

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34 Ergon submission, pp. 13–14.

35 Transitional arrangements in clause 11.16.3 of the NER allows Energex and Ergon to retain the QCA's current treatment of the RAB in the next regulatory control period.

contestable.[36] The AER notes that the NER lists the matters that it must consider when making a classification decision. Whether assets have been externally funded or not is not a factor listed in the NER. Therefore, although the AER recognises the rationale for this submission it is not a factor that the AER must give weight to under the NER.[37]

The AER acknowledges the need for a non-economic regulatory framework that authorises third party providers which underpins 'contestability' in the market for providing design and construction of connection assets. The lack of such an accreditation scheme at this point in time in Queensland was considered a limited barrier to entry in the area of small service connections. On that basis the AER proposed that design and construction of small service connections should continue to be a standard control service. However, the AER notes that this limited barrier does not exist for large customer connection services.

Depending on the DNSP and the type of customer, design and construction of connection assets are currently provided in a competitive market up to the levels permitted by the DNSP, via service providers accredited and audited by the DNSPs. Stakeholders submitted that establishment and enforcement of technical standards should be undertaken by an independent body. The AER's position paper noted that the establishment or enforcement of technical standards that rely solely on a DNSP's approval is not generally viewed as an appropriate function for the regulated entity to undertake.[38] Stakeholders also noted delays related with connection services and requested that this issue be addressed.[39]

The AER's assessment relates to the classification of services and control mechanisms under chapter 6 of the NER – economic regulation of distribution services. Therefore, the specifics and implementation of the non-economic regulatory framework that could underpin contestability is beyond the scope of this task. The AER also notes that matters related to delays in processing connection applications are covered by chapter 5 of the NER.

***Effect on administrative cost—clause 6.2.2(c)(2)***

Energex stated that the AER had not sufficiently explained the effect of the classification on large customers or the framework necessary to implement it. It considered that an alternative control service classification would add to its administrative costs.[40]

Ergon submitted that it is administratively simpler to keep all assets in the standard control service building block without having to establish a contributed asset base resulting in two classes of assets and additional pricing categories. It noted that as

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36 RRA submission, p. 1.
Vision Energy submission, p. 1.
ECA submission, p. 1.

37 The AER understands that NSW Code of Practice, Contestable works March 1998, as revised in April 2007 provides electricity customers choice in relation to who provides a range of goods and services associated with the supply and use of electricity.

38 AER position paper, p. 21.

39 RRA submission, p. 3.
ECA submission, p. 3.

40 Energex submission, p. 11.

reflected in the Queensland DNSP's capital contribution policies, customers are not required to fully fund DNSP constructed connection assets upfront but that the AER's proposed classification would result in Ergon changing its current approach and charging large customers the full costs upfront. It also stated that a shift in this policy should not be undertaken without extensive consultation and currently the MCE is considering the development of a national approach to capital contributions.[41]

The AER understands that Ergon's concerns relate primarily to the changes that they would have to make to internal procedures in relation to pricing methodologies and related process and procedural changes particularly in relation to their capital contribution policies.

Stakeholders submitted that competition for services will provide economy wide benefits to Queensland by better allocating resources, reducing costs, increasing network development and better forecasting of construction timeframes.[42]

Both Energex's and Ergon's current capital contribution policies aim at limiting incidences of uneconomic connections and thereby reducing the potential for increased network charges resulting from new connections.[43] The DNSP's contend that this objective is achieved by applying either of the following principles:

- Requesting a capital contribution to cover the uneconomic component of the connection asset, generally calculated as the difference between costs of the assets and the expected revenue (shortfall) over the life of the assets based on average distribution prices for the relevant network price category. This is generally applied to standard asset customers.

- Including the connection asset costs in the site-specific network charges and in these circumstances customers will receive a network charge reflective of their cost of connection over the life of the asset. This is generally applied to individually calculated customers and connection asset (dedicated assets) customers.

The AER notes that the use of alternative providers could result in large connection customers agreeing to pay the costs upfront. The AER's proposed classification does not compel large connection customers to make upfront payments for connection assets. However, it notes that, if available, large customers could make a choice on payment terms based on the best price after considering all relevant factors, in particular, their cost of funds. Where third parties offer to design and construct large connection assets, customers will have a greater choice of service providers and a competitive environment will determine the efficient price for these services. This choice could extend to payment terms.

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41 Ergon submission, pp.13–14.

42 Vision Energy submission, p. 1.
SPA submission, p. 5.

43 Energex's capital contributions policy is available at:
http://www.energex.com.au/network/network_prices/pdf/Network_Pricing_Principles_Statement_2008_09.pdf
Ergon's capital contributions policy is available at:
http://www.ergon.com.au/resources/Ergon_Capital_Contribution_Methodology_April05.pdf

RRA and ECA also state that the land developers are providing a hedge against possible future load growth because of the DNSPs requesting assets that provide for loads above the actual average requirements and that the DNSPs should contribute to the costs of land subdivision electrical works.[44] The AER notes that determining the capital contributions policies applicable to DNSPs is outside the scope of this current decision.

The AER acknowledges that as a result of its likely classification the DNSPs may provide for the option of upfront as well as over time payments by customers. In this context, they may need to change internal procedures and methodologies particularly in relation to pricing. Further, it acknowledges that the Ministerial Council on Energy (MCE) is currently developing a National framework for electricity distribution networks: network planning and connection arrangements.[45] However, the DNSPs have not provided any information to demonstrate the level of cost increases that they may face due to internal procedural changes or what costs may be affected due to possible future policies. Generally, any one-off internal administrative costs to a DNSP associated with moving monopoly services towards competition would be offset by the resulting economy wide benefits of competition. Further, in this instance the level of costs is restricted to changes associated only with large connection customers. The AER's definition of large connection customer for the Queensland DNSPs classification decision does not include standard asset customers.

In response to Ergon's comments about the need to keep two separate asset bases and that it currently does not have a contributed asset base, the AER's distribution post-tax revenue model (PTRM) handbook notes that the treatment of capital contributions in the PTRM reflects a default calculation. However, the PTRM may be amended by a DNSP in consultation with the AER to allow for alternative methods for treating capital contributions under clause 6.21.2.[46] The need for a contributed asset base is not necessarily a consequence of the AER's proposed classification but depends on the methodology adopted by the DNSP to account for contributed assets. As part of the assessment of the regulatory proposal the AER will review the PTRM in accordance with the NER.

For the reasons discussed above, the AER considers that it is not appropriate to place significant weight on the DNSP's administrative costs associated with the alternative control service classification.

***Current regulatory approach—clause 6.2.2(c)(3)***

The current regulatory approach results in the design and construction of connection assets being classified as standard control service. Consistent with its proposed position the AER will apply a presumption in favour of the current regulation unless another is clearly appropriate.[47]

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44 RRA submission, pp. 2–3.
ECA submission, p. 2.

45 MCE, Bulletin No 99.

46 AER, *Electricity distribution network service providers—Post-tax revenue model handbook*, June 2008, p. 8.

47 NER, clause 6.2.2(d).

***Desirability of consistency for similar services—clause 6.2.2(c)(4)***

Ergon stated that it could see no reason for the AER to conclude that the NSW regime for procedures such as adopting a contributed asset base and customers paying connection charges upfront is superior to the Queensland regime.[48] The AER's proposed position was not intended to indicate preference for one approach over the other or to be consistent with the NSW methodology for capital contributions.

In its position paper the AER stated that presumption of consistency with current classification has to be balanced with the desirability for consistent regulatory approaches for similar services between jurisdictions. Although, these distinct objectives are not necessarily mutually exclusive, in the first round of regulatory determinations the AER will place more weight on the presumption of consistency with the current classification. The AER's classification does not result in any inconsistency within the jurisdiction.

***Extent of costs directly attributable to user—clause 6.2.2(c)(5)***

Consistent with its position paper the AER considers that the costs of designing and constructing large connection assets are directly attributable to the user.

The AER reiterates its position that it considers that services can be classified as alternative control services on the cost attribution factor alone. Therefore, this factor is given significant weight by the AER in making its classification decision.

***Any other factor—clause 6.2.2(c)(6)***

The AER does not consider there are any other relevant factors that are important in deciding on the classification of the design and construction of large connection assets services.

**Conclusion**

The AER has placed significant weight on the potential for competition to develop and how the classifications might influence this potential (clause 6.2.2(c)(1)), and that costs are directly attributable to the relevant user (clause 6.2.2(c)(5)). Based on its assessment of the factors listed in clause 6.2.2, the AER considers that a departure from the current classification is clearly more appropriate. Therefore, consistent with its position paper the design and construction of large connection assets is to be classified as an alternative control service.

### 2.4.3 Classification of street lighting services

**AER proposed position**

Energex's and Ergon's proposal to the AER stated that street lighting was not a distribution service and therefore should not be regulated.

In its position paper the AER noted that street lighting is not a defined term in the NER but that the transitional provisions of the NER applicable to the NSW/ACT distribution businesses explicitly classify street lighting as an alternative control service.[49] Given the policy intent demonstrated in the transitional rules the AER

48 Ergon submission, p. 13.

49 NER, chapter 11, appendix 1, clause 6.2.3B(b).

considered that services relating to provision, construction and maintenance of street lighting assets were a distribution service.

Having determined that this service was a distribution service and based on its assessment that there was potential for competition to develop and that costs were directly attributable to the user, the AER proposed to classify street lighting as an alternative control service and included it within the quoted services group

**Submissions**

Energex stated that it did not agree with the AER's proposed classification of street lighting as an alternative control service but acknowledged the rationale and recognised that this classification would provide a transition towards being unregulated in the future.[50]

Ergon also did not agree with the AER's proposed position that street lighting was a distribution service and maintained that it should be unregulated. It stated that the NSW/ACT transitional rules carried forward current classifications because there was insufficient time between the commencement of the new rules and commencement of the next NSW/ACT regulatory control period. Therefore, it considered that the transitional provisions did not reflect broader policy intent. It also noted that a customer's street lighting assets can be clearly demarcated from the regulated network.[51]

RRA stated that street lighting was not a core distribution function and should not be regulated.[52] SPA stated that whilst de-regulating construction of Rate 1 type street lights could be problematic there was no difficulty with designing street lights for all three rate types. SPA urged the AER to classify street lighting as an alternative control or unregulated service.[53] ECA and Vision Energy also stated that this service should not be regulated.[54]

LGAQ stated that the current regulatory approach (treatment as a prescribed service) should continue and that currently councils are entitled to take full responsibility for street lighting (Rate 3) but there has been no large scale uptake and that this demonstrates that councils are having difficulties in establishing alternative arrangements. It also noted concerns about availability of alternative providers in remote and rural areas; the lack of disclosure of current DNSP maintenance programmes; lack of specialised skills within the councils to provide the services and, if deregulated, the need to have the DNSPs as the default service provider.[55]

**AER considerations**

The key issue for the AER's consideration is whether the construction and maintenance of street lights is a distribution service as defined in the NER.

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50 Energex submission, p. 12.

51 Ergon submission, p. 19.

52 RRA submission, p. 1.

53 SPA submission, pp. 5–6.

54 ECA submission, p. 3.
Vision Energy submission, p. 2.

55 LGAQ submission, pp. 1–2.

As noted above, most stakeholders support a view that street lighting services should be unregulated. Energex and Ergon consider that it is not a distribution service whilst RRA notes that it is not a core distribution function. However, the LGAQ stated that the current regulatory arrangements for Queensland should remain.

The AER's position paper noted that street lighting services could be characterised as being closer to the definition of a customer rather than a distribution network but stated that clarity on the actual connection point would play a critical role in unbundling assets associated with such services. In response, some stakeholders have submitted that the point of supply can be clearly demarcated and can be distinguished from the rest of the regulated network. SPA noted that there are some difficulties with completely deregulating street lighting where streetlight is located on a DNSP owned pole. In addition the LGAQ noted that a majority of street lights are on the DNSP owned poles.

The AER notes that currently most of the street lights in Queensland are either provided, installed and maintained by the DNSP (Rate 1) or provided and installed by others and gifted to the DNSP who maintains them (Rate 2). For Energex and Ergon these two types of street lights equate to about 90 and 96 per cent of total street lights respectively.[56] Therefore, a high proportion of street lights are currently owned by the DNSPs. The provision, installation and maintenance of the street lights not owned by the DNSPs (Rate 3) are provided via a competitive market, whereas only the provision and installation is provided via a competitive market for Rate 2 type street lights. The AER recognises that the large majority of street lights are owned by the DNSPs and, in the absence of a functioning market, deregulating such a service could lead to inefficient outcomes.

Defining street lighting as a non-distribution service under the NER would require a new approach by many entities, including DNSPs, local councils and other street lighting users, regulatory bodies and the public. Such an interpretation would not be specific to the Queensland DNSPs but of relevance across the NEM. Some of the consequential changes resulting from defining street lighting as a non-distribution service include: identification of public lighting assets held within a DNSP's RAB; agreement with local councils and department of main roads on any asset transfer payments; establishing public lighting provider (PLP) maintenance contracts; establishing public lighting service standards access arrangements for PLP's and DNSP's to access street lighting assets and network assets owned or controlled by each other.

The LGAQ stated that in most remote and rural council areas Ergon's presence is the only practical option for delivery of this service and in order to provide street lighting services the councils will have to comply with electrical safety requirements which its staff do not currently possess.[57]

The AER considers that most of the consequential changes resulting from classifying street lighting as a non-distribution service require a policy response from the relevant authorities and a transitional plan be developed. In light of this the AER considers that it is reasonable to take the NSW/ACT transitional rules as demonstration of policy

[56] AER position paper, p. 30.

[57] LGAQ submission, p. 1.

intent. The AER does not agree with Ergon's understanding that the transitional rules were made solely to carry forward current classification in response to time constraints.[58] In this context the AER notes that the transitional rule 6.2.3B(b) did not convert all excluded services to unregulated services but made a deliberate decision to classify the currently excluded distribution service of the construction and maintenance of public lighting infrastructure as an alternative control service whilst classifying the remainder as unregulated distribution services.

Energex recognised that the proposed classification would provide a transition towards the service being unregulated in the future. The AER also notes that if a competitive market can be demonstrated in the future or if there is a policy decision to characterise street lighting as a non-distribution service, then the service could become unregulated. In the interim the alternative control service classification is intended to allow for the development of competition.

**Conclusion**

The AER affirms its proposed position that the provision, construction and maintenance of street lighting assets is a distribution service and accordingly an alternative control service classification will be applied. Street lighting services will be removed from the quoted services group and will form a standalone service group—street lighting services.

### 2.4.4 Classification of de-energisation and re-energisation

**AER proposed position**

The AER proposed that a separate distribution service group was not warranted for de-energisation and re-energisation as it considered these services to be directly related to connection services. Therefore, it included this group of services in the connection services group. Consequently, de-energisation and re-energisation services were grouped as connection services and classified as a standard control service.

**Submissions**

Energex and Ergon did not agree with the AER's proposed grouping of de-energisation and re-energisation services. Both DNSPs stated that currently these services are excluded services and that consistency with the current regulatory approach requires that they transit to an alternative control classification. Additionally, both noted that other than for safety reasons this service is generally requested by a retailer as a credit risk management tool.[59] Ergon noted that the customer for these services can be identified and costs directly attributed.[60]

**AER considerations**

The AER's position paper did not specifically consider the consequential change in classification resulting from including de-energisation and re-energisation in the connection services group. The AER's assessment is provided below.

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58 Ergon submission, p. 19.

59 Energex submission, p. 9.
Ergon submission, p. 17.

60 Ergon submission, p. 17.

***Requirement to classify a service of a specified kind in a particular way—clause 6.2.2(e)***

The NER does not require a de-energisation and re-energisation services provided by Energex or Ergon to be classified in a particular way.

***Presumption in favour of prior classification—clause 6.2.2(d)***

In its position paper the AER noted that classifying distribution services that have previously been regulated, unless a different classification is clearly more appropriate there is a presumption of not departing from a previous classification (if the services have been previously classified); and if there has been no previous classification the classification should be consistent with the previously applicable regulatory approach.

Consistent with the proposed position paper the AER will assess the factors under clause 6.2.2 to determine whether a different classification is clearly more appropriate.

***Potential for development of competition—clause 6.2.2(c)(1)***

The AER must have regard to the potential for development of competition in the relevant market and how the classification might influence that potential.

Energex and Ergon stated that there is neither competition nor the potential for competition to develop in providing de-energisation and re-energisation services. Both DNSPs stated that without legislative changes these services cannot be provided by third parties.[61]

No submissions indicate that there is competition or the potential for competition to develop in the market for de-energisation and re-energisation services in Queensland.

***Effect on administrative cost—clause 6.2.2(c)(2)***

The AER considers that the control mechanism for alternative control services should minimise the complexity and administrative burden for the AER, the DNSP and users without compromising the effectiveness of the constraint. The control mechanism proposed for de-energisation and re-energisation services is a price cap based on a non-building block approach, which generally involves low administrative costs to the AER, the DNSP and users.

***Current regulatory approach—clause 6.2.2(c)(3)***

De-energisation and re-energisation services are currently treated as excluded services.

***Desirability of consistency—clause 6.2.2(c)(4)***

In its position paper the AER stated that presumption of consistency with current classifications has to be balanced with the desirability for consistency of classifications for similar services between jurisdictions. Although, these distinct objectives are not necessarily mutually exclusive, in the first round of distribution determinations the AER placed more weight on the presumption of consistency with the current classification. The AER's classification does not result in any inconsistency within the jurisdiction.

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[61] Energex proposal, p. 63.
Ergon proposal, p. 58.

***Extent of costs directly attributable to user—clause 6.2.2(c)(5)***

The AER agrees with Energex and Ergon that the customers for these services can be identified and costs directly attributed.

In its position paper the AER stated that one of the distinguishing features of alternative control services is that the costs of providing these services can be directly attributable to the user and therefore costs do not need to be recovered via the DUOS charges. On that basis, although services neither exhibit signs of competition or potential for competition the AER considered that services can be classified as alternative control services on the cost attribution factor alone.

***Any other factor—clause 6.2.2(c)(6)***

The AER does not consider there are any other relevant factors that are important in deciding on the classification of de-energisation and re-energisation services.

**Conclusion**

Having considered the NER requirements the AER determines that de-energisation and re-energisation services should be an alternative control distribution service and should be removed from the connection services group. De-energisation and re-energisation services are included in the fee based services group.

### 2.4.5 High load escorts and coverage of low voltage mains

**AER proposed positions**

The AER proposed to classify the provision of high load escorts and coverage of low voltage mains (tiger tails) as alternative control services.[62] Energex and Ergon had proposed that these services should be unregulated. On the basis of maintaining consistency with the current regulatory approach and given that the depth of competition had not been demonstrated the AER classified these services as alternative control services.

**Submissions**

Energex stated that high load escort services are currently unregulated, not included in the QCA's excluded services lists and is also not a distribution service. It noted that consistent with the AER's decision on other unregulated services high load escorts should be unregulated. In relation to tiger tails, Energex noted that it is currently an excluded service but the existence of a competitive market demonstrates that it should not be classified.[63]

In relation to high load escorts, Ergon noted that the service has two elements. It stated that the service relating to lifting, or disconnecting and reconnecting mains to allow high load vehicles to pass is currently an excluded service but accrediting contractors, scoping the route and travelling with the vehicle was unregulated. It also

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62 High load escorts involve services associated with lifting of power lines along transport routes to enable high load vehicles to pass. Coverage of low voltage mains involves the attaching of synthetic tubes over power lines for identification purposes in order to provide safety to parties working in close proximity.

63 Energex submission, p. 13.

noted that in Energex's operating region both elements are unregulated. It considered that both elements of high load escorts and tiger tails should be unregulated.[64]

**AER considerations**

High load escorts and tiger tails are provided by means of or in connection with a distribution system and therefore are distribution services.

*High load escorts*
The AER acknowledges that, as submitted by Energex, the QCA's list of excluded services does not include high load escorts and these services are currently unregulated. Energex informed the AER that currently there are 50 road transport operators who have permission to transport loads up to five meters and that the accreditation of the service provider is overseen by the Queensland Electrical Safety Office.[65] The AER's position paper noted that it will maintain consistency with the current regulatory approach unless a departure is clearly more appropriate. Therefore, in the absence of a reason that justifies a departure this service provided by Energex will be unclassified (unregulated).

The QCA's list of Ergon's excluded services only includes the high load escort service element relating to lifting or disconnecting and reconnecting mains. Ergon submitted that both elements of high load escorts can be undertaken by other parties. It advised the AER that it has authorised one service provider to lift mains and service lines, it has a standard process for making authorisations and if requested it would, authorise other service providers in the future.[66] Consistent with its stated position, in the absence of sufficient information justifying a departure from the current regulatory approach the AER will maintain consistency and classify the element of this service that is currently regulated as an alternative control service. This classification is intended to allow competition to develop and if a competitive market can be sufficiently demonstrated then this service could be unclassified in the future. The element of this service that is currently unregulated will be unclassified.

*Coverage of low voltage mains*
Although Energex and Ergon submitted that there are other parties providing tiger tails and therefore this service should be unregulated, neither DNSP has provided any information demonstrating the depth of competition in the relevant market.

In the absence of any information supporting the existence of a competitive market the AER will, consistent with its position paper, classify the coverage of low voltage mains as an alternative control service.

**Conclusion**

The AER has not classified high load escort services provided by Energex. The aspect of high load escorts provided by Ergon currently regulated by the QCA will be classified as an alternative control service and the currently unregulated element will be unclassified.

64 Ergon submission, p. 24.

65 Energex, response to information request, confidential, submitted 15 August 2008.

66 Ergon, response to information request, confidential, submitted 15 August 2008.

The coverage of low voltage mains provided by both Energex and Ergon will be classified as an alternative control service.

The provision of high load escorts and the coverage of low voltage mains will be included in the quoted services group.

## 2.5 AER decision

### 2.5.1 Classification of services applicable to Energex

Pursuant to clause 6.8.1 and in accordance with Part B of the NER, the AER has determined its likely approach for the classification of distribution services applicable to Energex for the forthcoming distribution determination.

The AER will apply the following service classifications to the nominated distribution service groups, as set out in table 2.4.

**Table 2.4: AER's service classification for Energex**

| Distribution service group | AER service classification |
|---|---|
| Network services | Standard control services |
| Connection services | Standard control services |
| Metering services | Standard control services |
| Street lighting services | Alternative control services |
| Quoted services | Alternative control services |
| Fee based services | Alternative control services |
| Unregulated | Unclassified |

### 2.5.2 Classification of services applicable to Ergon

Pursuant to clause 6.8.1 and in accordance with Part B of the NER, the AER has determined its likely approach for the classification of distribution services applicable to Ergon for the forthcoming distribution determination.

The AER will apply the following service classifications to the nominated distribution service groups, as set out in table 2.5.

**Table 2.5: AER's service classification for Ergon**

| Distribution service group | AER service classification |
|---|---|
| Network services | Standard control services |
| Connection services | Standard control services |
| Metering services | Standard control services |
| Street lighting services | Alternative control services |
| Quoted services | Alternative control services |
| Fee based services | Alternative control services |
| Unregulated | Unclassified |

# 3 Form of control mechanism

## 3.1 Introduction

This chapter sets out the AER's decision on the control mechanisms to be applied to Energex's and Ergon's direct control services for the 1 July 2010 to 30 June 2015 regulatory control period. It does not deal with the form of control to be applied to negotiated distribution services, which are regulated under the negotiate-arbitrate framework set out in Part D of chapter 6 of the NER.

### 3.1.1 Requirements of the National Electricity Rules

Under the NER a distribution determination is to impose controls over the prices of direct control services or the revenue to be derived from direct control services or both.[67] The AER's framework and approach paper must state the form or forms of control to be applied in the distribution determination, as well as the reasons for deciding on each control mechanism.[68]

Unlike other elements of the framework and approach paper, the AER's statement of the form or forms of control in the framework and approach paper is binding on the AER and the DNSP for the relevant distribution determination.[69]

Clauses 6.2.5(b) and 6.2.6 of the NER set out the control mechanisms and the basis of control mechanisms applicable to direct control services. The AER must have regard to the factors outlined in clause 6.2.5(c) and 6.2.5(d) when deciding on the control mechanism to apply to standard and alternative control services respectively. These factors, the available control mechanisms and the basis of the control mechanisms are set out in appendix A.

### 3.1.2 Current arrangements

**Prescribed services**

The QCA's 2000 *Determination of Prescribed Services* declared all of Energex's and Ergon's distribution services to be prescribed services.[70] In selecting the control mechanism to apply in the 2005–10 regulatory period, the QCA considered there was insufficient information to judge the performance of the DNSPs under the arrangements established in 2001, or to determine whether a change in the form of control was warranted.[71] The QCA therefore considered it appropriate to retain the fixed revenue cap form of control and apply it to Energex's and Ergon's prescribed services in its 2005 distribution determination.[72]

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67 NER, clause 6.2.5(a).

68 NER, clause 6.8.1(c).

69 NER, clause 6.12.3(c).

70 A DNSP or any interested party could apply to the QCA to have a particular service treated as an excluded service if it could demonstrate that there was potential for competition in the market for that service. QCA, *Electricity Distribution: Determination of Prescribed Services*, September 2000, p. 8.

71 QCA, *Form of Regulation of Electricity Distribution to commence from 1 July 2005*, Final Decision, June 2003, p. 4.

72 At the time of making its 2005 distribution determination the QCA and the DNSPs considered the inclusion of non-DUOS services within the fixed revenue caps would not unduly affect DUOS tariffs as

Each fixed revenue cap used a building block approach and was of the consumer price index (CPI) minus X (CPI – X) form. X factors were applied as a means of smoothing revenues over the regulatory period to reduce volatility in annual revenues and thereby minimise year to year price shocks.

**Excluded services**

Full retail competition (FRC) was introduced into Queensland retail electricity and gas markets on 1 July 2007. To facilitate competition in the retail electricity market the Queensland Government sold Energex's and Ergon's retail electricity businesses.[73]

Energex and Ergon anticipated that the introduction of FRC combined with the sale of their retail businesses would lead to a significant increase in the volume of non-DUOS services, resulting in a significant increase in the revenue earned from the provision of these services. Under the fixed revenue cap, the higher level of non-DUOS revenue would artificially lower DUOS prices, effectively non-DUOS services would be subsidising DUOS services. The QCA considered this was an unintended and undesirable outcome of the fixed revenue cap form of control and the introduction of FRC.[74] The QCA amended its *Determination of Prescribed Services* in August 2007 and in December 2007 reclassified all of Energex's and Ergon's non-DUOS services as excluded services and removed the forecast revenue associated with those services from each of the fixed revenue caps.

Excluded services are categorised as either standard or non-standard excluded services. A standard excluded service is where the service has a maximum capped price—fee for service. A non-standard excluded service is where the price for the service is variable also known as a quoted or price on application service.

The QCA approves the maximum price to be charged for each excluded service.[75] The current form of control is effectively a price cap, where the approved price is the maximum to be charged for a particular service. However, nothing under this arrangement prevents Energex or Ergon from charging below the capped price.

### 3.1.3 Proposals

Clause 11.16.6 of the NER permitted Energex and Ergon to submit proposals to the AER in relation to the classification of services and the control mechanisms to apply for the 1 July 2010 to 30 June 2015 regulatory control period. The AER received proposals from Energex and Ergon on 31 March 2008.[76]

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the demand for non-DUOS service had been relatively stable.
QCA, *Electricity Distribution: Review of Excluded Services*, Final Decision, December 2007, p. 5.

73 Ergon continues to provide retail services to a number of non-market and excluded customers.

74 QCA, *Electricity Distribution: Review of Excluded Services*, Final Decision, December 2007, p. 5.

75 QCA, *Guidelines for the Regulation of Excluded Distribution Service Provided by Energex and Ergon Energy*, February 2008, p. 2.

76 Energex, *Service Classification and Control Mechanisms for Distribution Services Proposal to the Australian Energy Regulator under clause 11.16.6 of the National Electricity Rule*, March 2008
Ergon, *Proposal: Service Classification and Control Mechanism*, March 2008.

**Energex proposal**

Energex proposed ten groups of standard control services, table 2.1 sets out each of these groups. It also proposed a hybrid control mechanism for standard control services, consisting of:[77]

- a fixed revenue cap—covering network services (Group 1)[78]
- a weighted average price cap (WAPC)—covering connection and customer services (Groups 2 and 3)[79]
- a WAPC—covering all remaining standard control services (Groups 4 to 10).

Energex proposed that subtransmission connection services to be classified as a negotiated distribution service and therefore did not propose a control mechanism to apply to these services as they are regulated under Part D of the NER.

**Ergon proposal**

Ergon proposed the same ten groups of standard control services as Energex, these groups are set out in table 2.2. It also proposed the same combination of control mechanisms for standard control services as Energex. However, Ergon did not propose any negotiated distribution services.

## 3.2 AER proposed positions

In its framework and approach paper the AER must state the form of the control mechanism or mechanisms that will apply to direct control services during the 2010–15 regulatory control period. In making this assessment the AER must have regard to the factors outlined in clause 6.2.5(c) and 6.2.5(d) when deciding on the control mechanism to apply to standard and alternative control services respectively, these factors are set out in appendix A.

For the first round of distribution determinations the AER's assessment of the factors in clause 6.2.5(c) and 6.2.5(d) is aimed at determining whether it is more appropriate to move away from the current form of control.

### Standard control services

The AER proposed to classify Energex's and Ergon's network, connection and metering service groups as standard control services.

Energex and Ergon proposed separate control mechanisms to apply to different groups of standard control services, a fixed revenue cap applied to network services and a WAPC applied to connection and metering services (collectively referred to it as a hybrid form of control).

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77 Energex proposal, p. 74.

78 The AER considers a fixed revenue cap control mechanism is permitted under the NER as it constitutes caps on the revenue to be derived from a particular combination of services under clause 6.2.5(b)(3).

79 The AER considers a weighted average price cap control mechanism is permitted under the NER as it constitutes a tariff basket price control under clause 6.2.5(b)(4).

The AER's assessment of the factors in the NER was aimed at determining whether it was more appropriate to adopt two separate control mechanisms as proposed by the DNSP's—that is, move away from the current fixed revenue cap approach. The AER's assessment of clause 6.2.5(c) indicated that:[80]

- 6.2.5(c)(1)—a separate WAPC was not warranted for connection and metering services on the basis that it may result in more efficient tariffs but rather that it was appropriate to apply a fixed revenue cap

- 6.2.5(c)(2)—the implementation of a single fixed revenue cap control mechanism would involve significantly lower administrative costs for the DNSP, users and the AER than the imposition of a separate fixed revenue cap and a WAPC

- 6.2.5(c)(3)—a fixed revenue cap form of control is currently applied to Energex and Ergon's prescribed services[81]

- 6.2.5(c)(4)—the pursuit of consistent control mechanisms between jurisdictions should not be a key consideration in the selection of a control mechanism to apply to standard control services for the first round of distribution determinations

- 6.2.5(c)(5)—Energex's and Ergon's improved operating procedures and forecasting methodologies should reduce the likelihood of volume risk.

Overall, the AER did not consider that a separate WAPC form of control was warranted for connection and metering services. Therefore, in addition to network services, it proposed that connection and metering services should be included under a fixed revenue cap. That is, that a fixed revenue cap form of control be applied to all of Energex's and Ergon's standard control services maintaining the current regulatory approach.

**Basis of a control mechanism for standard control services**

For standard control services the AER must implement a control mechanism that is of the prospective CPI – X form made in accordance with Part C of the NER—using the building block approach.[82] Where the AER must determine a DNSPs annual revenue requirement (ARR) for standard control services based on clause 6.4.3 of the NER.

The AER proposed that the basis of the control mechanism to apply to standard control services will be of the CPI – X form incorporating any revenue increment or decrement associated with any applicable service target performance incentive scheme (STPIS) and demand management incentive scheme (DMIS).[83]

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80 AER position paper, pp. 42–47.

81 The current application of a fixed revenue cap control mechanism is set out in section 3.1.2.

82 NER, clause 6.2.6(a).

83 The AER's preliminary position on the application of a STPIS, an EBSS and a DMIS to Energex and Ergon is set out in a separate framework and approach paper.
AER, *Framework and approach paper—application of schemes Energex and Ergon Energy 2010–15 Preliminary positions*, 30 June 2008.

**Proposed control mechanism for standard control services**

The AER proposed to apply a fixed revenue cap form of control to Energex's and Ergon's standard control services for the 2010–15 regulatory control period.

The control mechanism will be of the CPI – X form and will include adjustments to incorporate any revenue increment or decrement associated with the application of any STPIS and DMIS.

## Alternative control services

In its positions paper the AER proposed to classify Energex's and Ergon's quoted and compensable services as alternative control services.

Energex and Ergon proposed to classify service groups 4 to 10 as standard control services regulated via a WAPC control mechanism. However, the AER recognised that a WAPC control mechanism can be applied to alternative control services.

The AER's assessment of the factors in the NER was aimed at determining whether continuation of the current price cap form of control was appropriate. The AER's assessment of clause 6.2.5(c) indicated that:

- 6.2.5(d)(1)—a WAPC could adversely affect the potential for the development of competition
- 6.2.5(d)(2)—the continuation of the price cap form of control would not entail higher administrative costs on the DNSP, users and the AER than the imposition of a WAPC form of control
- 6.2.5(d)(3)—a price cap form of control is currently applied to Energex and Ergon's excluded services[84]
- 6.2.5(d)(4)—the pursuit of consistent control mechanisms between jurisdictions should not be a key consideration in the selection of a control mechanism to apply to standard control services for the first round of distribution determinations
- 6.2.5(d)(5)—no other relevant factors were identified.

Overall, the AER did not consider there to be any substantive reasons why the current price cap form of control should not continue to apply to Energex's and Ergon's alternative control services in the 2010–15 regulatory control period.[85]

**Basis of a control mechanism for alternative control services**

The AER is able to apply a control mechanism to a DNSP's alternative control services using Part C of the NER—the building block approach, but may elect to only apply certain elements of the building block approach—a limited building block approach. Alternatively, the AER may elect to implement a control mechanism that does not use the building block approach.

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84 The current application of a fixed revenue cap control mechanism is set out in section 3.1.2.

85 The AER considers that a price cap control mechanism is permitted under the NER as it constitutes caps on the prices of individual services under clause 6.2.5(b)(2).

The AER proposed to separate Energex's and Ergon's alternative control services into two groups:

- street lighting services
- all remaining alternative control services.

The AER proposed to retain the existing price cap form of control to regulate alternative control services for the 2010–15 regulatory control period, where:

- a price cap is established in the first year of the regulatory control period
- a price path is established for the remaining years of the regulatory control period.

Energex and Ergon will be required to submit annual pricing proposal for all alternative control services as part of the distribution pricing rules set out in Part I of the NER.

**Proposed control mechanism for alternative control services**

The AER proposed to apply a price cap form of control to Energex's and Ergon's alternative control services in the 2010–15 regulatory control period.

The AER proposed to apply a price cap via limited building block approach to determine the efficient costs of providing street lighting services for the first year of the regulatory control period and establish a price path for remaining years of the period.

For all of Energex's and Ergon's remaining alternative control services, the AER proposed to apply a price cap to determine capped prices in the first year of the regulatory control period and establish a price path for remaining years of the period. The approved price is the maximum price Energex and Ergon are permitted to charge for a particular service.

## 3.3 Submissions

The AER received submissions commenting on its position paper from the following interested parties: the Electrical and Communication Association, Energex, Ergon, the Local Government Association of Queensland, Robin Russell and Associates, SPA Consulting, the Urban Development Institute of Australia (Queensland) and Vision Energy.

The main issues raised in submissions were in relation to:

- the control mechanism to apply to standard control services
- the control mechanism to apply to alternative control services
- the application of a limited building block approach
- the treatment of the regulatory asset base (RAB).

## 3.4 Issues and AER considerations

### 3.4.1 Application of a fixed revenue cap to standard control services

**AER proposed position**

The AER proposed to apply a fixed revenue cap form of control to Energex's and Ergon's standard control services for the 2010–15 regulatory control period.[86]

**Submissions**

Energex and Ergon supported the application of a fixed revenue cap control mechanism to services classified as standard control services.[87]

**AER considerations**

In section 2.5 the AER classified Energex's and Ergon's network services, connection services and metering services as standard control services. The AER will apply a fixed revenue cap control mechanism to these services in the 2010–15 regulatory control period.

The application of a fixed revenue cap control mechanism to Energex and Ergon's standard control services is consistent with the form of control currently applied by the QCA to the DNSP's prescribed services. The QCA included a mechanism that allows for the under or over recovery of revenue in a regulatory year to be recovered from or returned to users in subsequent years.[88] The AER considers it appropriate to include an unders and overs mechanism for each fixed revenue cap in the 2010–15 regulatory control period.

For standard control services the AER must implement a control mechanism that is of the prospective CPI – X form made in accordance with Part C of the NER—using the building block approach.[89] Clause 6.4.3 outlines the calculation of the ARR using the building block approach for each regulatory year of a regulatory control period.[90]

The AER noted in its position paper that the basis of each fixed revenue cap would be of the CPI – X form and would include adjustments to incorporate any revenue increment or decrement associated with a STPIS and a DMIS. The AER has provided further detail on the treatment of any applicable STPIS, efficiency benefits sharing scheme (EBSS) or DMIS.

As outlined in section 1.2, due to transitional arrangements applicable to Energex and Ergon the framework and approach paper for the DNSP's is in two stages. The AER must publish a separate framework and approach paper in relation to application of schemes by 30 November 2008. In that paper the AER will set out its likely approach to the application of a STPIS, an EBSS and a DMIS.

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86 AER position paper, p. 52.

87 Energex submission, p. 14.
Ergon submission, p. 5.

88 QCA, *Regulation of Electricity Distribution*, Final Determination, April 2005, pp. 39–46.

89 NER, clause 6.2.6(a).

90 NER, clause 6.4.3(a).

The following section sets out how the AER will incorporate the revenue increment or decrement associated with any applicable STPIS, EBSS and DMIS:

- Should the AER decide to apply a STPIS to either Energex or Ergon in the 2010–15 regulatory control period any revenue increment of decrement associated with the operation of that scheme in a regulatory year will be applied to the smoothed ARR that applies two regulatory years after the regulatory year in which the service performance was measured.[91]

- Should the AER decide to apply an EBSS to either Energex or Ergon in the 2010–15 regulatory control period any applicable EBSS revenue increment or decrement will be added to opex. The AER will apply both positive and negative carryovers as part of the opex building block element in the calculation of a DNSP's ARR for the regulatory control period following the regulatory control period in which the EBSS applied.

- Should the AER decide to apply a DMIS to either Energex or Ergon in the 2010–15 regulatory control period any DMIS allowance will be provided as an amount in addition to the approved efficient operating and maintenance expenditure (opex). At the end of the 2010–15 regulatory control period, the AER will calculate a carryover amount to be deducted from or added to the allowed revenues in year two of the following regulatory control period or as specified in the applicable scheme.

**Conclusion**

The AER will apply a fixed revenue cap control mechanism to those services classified by the AER as standard control services in the 2010–15 regulatory control period. Each fixed revenue cap will be of the CPI – X form and will be made in accordance with Part C of the NER—using the building block approach.

### 3.4.2 Control mechanism to apply to alternative control services

**AER proposed position**

The AER stated that for the first round of distribution determinations that its assessment of the factors in clause 6.2.5(d) was aimed at determining whether it was more appropriate to move away from the current control mechanism.

The AER's assessment of the factors under clause 6.2.5(d) indicated there was not sufficient reason to adopt an alternate control mechanism. Accordingly, the AER proposed to continue to apply a price cap form of control to Energex's and Ergon's alternative control services for the 2010–15 regulatory control period.[92] Further discussion on the AER's assessment of clause 6.2.5(d) is set out in section 3.2.

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91 The revenue increment or decrement associated with the operation of a STPIS is expressed as a percentage of revenue at risk.
AER, *Electricity distribution service providers—Service target performance incentive scheme*, June 2008, clause 2.5, pp. 6–7.

92 AER position paper, pp. 52–53.

**Submissions**

Energex did not support the application of a price cap form of control for alternative control services. It considered that the application of separate control mechanisms was appropriate:[93]

- a WAPC—covering street lighting services
- a formula based WAPC—covering fee based services
- a formula based WAPC—covering quoted services.[94]

Ergon also did not support the application of a price cap control mechanism to alternative control services. It considered the application of two separate control mechanisms was appropriate:[95]

- a WAPC—covering fee based services
- a formula based approach to be applied to quoted services.

Ergon did not propose a control mechanism to apply to street lighting services because it proposed that these services should not be unregulated.

**AER considerations**

Energex and Ergon proposed separate control mechanisms to apply to different groups of alternative control services. The AER considered in its position paper that the application of separate control mechanisms to different groups of direct control services was permitted under the NER.[96]

In its positions paper, the AER considered the most important factor in the first round of distribution determinations was the current regulatory arrangements applicable to the DNSP, clause 6.2.5(d)(3), and specifically whether the continuation of the current price cap form of control was appropriate having considered the factors under clause 6.2.5(d).

The AER proposed to apply a price cap form of control to alternative control services after making its assessment of the factors in clause 6.2.5(d).

Energex and Ergon raised a number of issues in response to the AER's position paper in support of applying a WAPC to different groups of alternative controls services. These issues and the AER's response to each issue are discussed below.

***A WAPC caters for different price calculations and new services***

Energex stated that a formula based WAPC can cater for different price calculation methods and the emergence of new and altered services that are driven by external

93 Energex submission, p. 15.

94 Energex clarified the control mechanisms it considered should be applied to alternative control services. Energex, response to information request, confidential, submitted 4 August 2008.

95 Ergon submission, pp. 21–22.

96 NER, clause 6.5.9(b)(3)(ii).

factors.[97] Energex considered a formula based WAPC should be applied to quoted services and fee based services.

The AER accepts that a WAPC can allow for different price calculation methods. However, different price calculation methods can equally be incorporated into a price cap form of control. As part of their respective regulatory proposals, Energex and Ergon can propose an individual formula to calculate the tariff (the capped price) of each individual quoted and fee based service, where different formulas can be used to derive the tariff for different services.

Further, the AER considers that irrespective of the control mechanism that is to apply to a group of direct control services a new or altered service can be included in a DNSPs pricing proposal for the regulatory year in which that new or altered service is be provided. The AER must assess the DNSP's pricing proposal according to clause 6.18.8 of the NER.

The AER considers that a price cap form of control can incorporate different price calculations and the addition of new and altered services in the same manner as a WAPC and this is not a persuasive reason to move away from the current regulatory approach.

***Variability in alternative control services***

Ergon stated that there is still considerable uncertainty associated with accurately forecasting the services that the AER proposed to classify as alternative control services and this was a key reason why the QCA permitted these services to be regulated as excluded services.[98] Further discussion on the current treatment of excluded services is set out in section 3.1.2 above.

A WAPC allows a DNSP to recover revenues commensurate with outturn volumes. The AER considers that a price cap also allows a DNSP to recover revenues commensurate with outturn volumes. Under a price cap control mechanism the capped price is the maximum price a DNSP is permitted to charge for a particular service. The maximum revenue a DNSP can earn from the provision of an individual alternative control service is equal to the capped price multiplied by the outturn volume of that service. Therefore, the AER does not consider this to be a substantive reason to move away from the current regulatory approach.

***A WAPC provides protection to users and allows for the full recovery of the costs associated with providing services***

Ergon stated that a WAPC provides protection to users while providing it with flexibility to recover the full costs of the services over time and enabling it to manage variations in demand for individual services.[99]

As mentioned above, the AER considers a price cap allows a DNSP to recover revenues commensurate with the outturn volume of each individual alternative control service.

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97 Energex submission, p. 15.

98 Ergon submission, p. 21.

99 ibid., p. 21.

Under a price cap, the tariff for each individual service is capped, where the capped tariff (price) is the maximum a DNSP is permitted to charge for that service in a given regulatory year. Under a WAPC, each individual services forms part of a tariff basket, where the tariff basket is subject to an overall constraint (such as CPI – X) and individual tariffs can be rebalanced each regulatory year subject to the overall constraint. The AER does not consider a WAPC provides users greater protection than a price cap form of control.

The AER notes that irrespective of the control mechanism that is to apply to alternative control services, the tariffs that are to apply to those services are reviewed after the publication of the distribution determination, and each regulatory year thereafter, in accordance with the distribution pricing rules in Part I of the NER. Clause 6.18.5 of the NER sets out the distribution pricing principles, including the recovery of costs associated with the provision of direct control services through tariffs that are to apply to a tariff class. A DNSPs pricing proposal must demonstrate compliance with these pricing principles.[100]

The AER considers that a price cap control mechanism will not prevent Ergon or Energex from recovering the efficient cost of providing each individual alternative control service and this is not a substantive reason to move away from the current regulatory approach.

***A WAPC is applied to similar services in NSW***

Ergon stated that a WAPC is applied to these types of services in other jurisdictions, such as NSW, and that there is nothing unique to NSW or Queensland that renders a WAPC a suitable control mechanism in NSW and not in Queensland.[101]

The AER acknowledges that some similar types of services are currently regulated under a WAPC in NSW. However, as noted in its position paper, the AER considered that consistency in regulatory arrangements are desirable but the pursuit of consistent control mechanisms is not a driving consideration in the selection of a control mechanism to apply to Energex's and Ergon's alternative control services for the first round of distribution determinations.[102]

Therefore, even though a WAPC is applied to similar services in another jurisdiction the AER does not consider that to be a sufficient reason by itself to move away from the current form of control.

***Formula based approach to quoted services***

Ergon stated that it does not support the application of a price cap (in the traditional sense) to quoted services as it is not possible to set a fixed price for these services without a full understanding of the detailed requirements of each individual service.[103] Ergon proposed that the AER amend its framework and approach paper to enable a formula based approach to be applied to these services.[104]

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100 NER, clause 6.18.2(b)(7).

101 Ergon submission, p. 21.

102 AER position paper, p. 50.

103 Ergon submission, p. 21.

104 ibid., p. 21.

The AER acknowledges that it is not possible to set a fixed price for services that are provided on a quoted or price on application basis (where the scale and scope of the each individual service is initially unknown).

In its position paper, the AER considered it was appropriate to retain the QCA's current approach to derive prices for each individual alternative control service.[105] Under this approach the AER considers that a DNSP can propose an individual formula to calculate the tariff of each individual quoted and fee based service, where different formulas can be used to derive the tariff for different services.

**Conclusion**

After reviewing the issues raised in submissions the AER is satisfied there are no substantive reasons to depart from the control mechanism proposed in its position paper.

The AER will apply separate price cap control mechanisms to Energex's and Ergon's street lighting services, quoted services and fee based services.

### 3.4.3 Application of a limited building block approach to street lighting services

**AER proposed position**

The AER proposed to classify Energex's and Ergon's street lighting services as alternative control services and to apply a price cap control mechanism to these services in the 2010–15 regulatory control period. In its position paper the AER proposed to assess the efficient costs of providing street lighting services under a price cap control mechanism using a limited building block approach.

The AER proposed to cap prices in the first year of the regulatory control period and establish a price path for the remaining years of the regulatory control period.

**Submissions**

Energex sought further information on the details of the simplified building block approach proposed by the AER.[106]

**AER considerations**

In section 3.4.2 the AER set out its considerations relating to the appropriate control mechanism to apply to alternative control services. The AER considered it appropriate to maintain its proposed position, that is, assess the efficient costs of providing street lighting services under a price cap form of control implemented using a limited building block approach.

***Simplified building block assumptions***

The AER's position paper set out a number of simplifications to the building block approach. On the basis of Energex's submission, the AER has provided further guidance on these simplifications, specifically that:

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105 AER position paper, p. 51.

106 Energex submission, p. 15.

- Energex and Ergon will not be required to provide a separate proposal on the weighted average cost of capital (WACC) for alternative control services. The AER proposes to apply to the same WACC to street lighting services that is applied to standard control services.
- Energex and Ergon may propose reasonable simplifying assumptions within the limited building block model. In particular, the AER will accept the current depreciation assumptions.
- Energex and Ergon may base their opening asset valuation for street lighting services on the existing asset valuation, adjusted for capex and depreciation incurred in the current regulatory period. If either DNSP proposes to retain the current treatment of the RAB as permitted under clause 11.16.3 of the NER the AER considers the opening asset valuation for street lighting services should be derived consistent with that method.

***Price path escalators***

The AER considers that any price path escalators should be set out and justified in the DNSP's regulatory proposal. Price path escalators need not be of the CPI – X form. Any proposed escalators should be based on the cost information provided by the simplified building block assumptions, and the DNSP should demonstrate the relationship between any proposed escalators and these assumptions.

***Information that should form part of the regulatory proposal***

The NER sets out the information that must be provided as part of a DNSP's regulatory proposal for alternative control services, which includes:[107]

- a demonstration of the application of the control mechanism set out in the framework and approach paper
- the necessary supporting information.

The AER considers the following information should be provided to support the proposed control mechanism:

- an overview of the street lighting services provided by the DNSP
- cost information, including:
  - the historic capex and opex, including replacement costs
  - the proposed capex and opex including replacement costs over the next regulatory control period
  - a justification for any material differences between historic and proposed costs.
- asset valuation information, including:

[107] NER, clause 6.8.2(c).

- a proposed opening asset valuation for street lighting services at 30 June 2010 and a detailed description of how it has been calculated.

- pricing information, including:
  - a capped price for the first year of the regulatory control period
  - a proposed price path
  - indicative prices for each year of the regulatory control period.

**Conclusion**

As part of its distribution determination, the AER will apply a price cap in the first year of the regulatory control period and a price path based on the efficient costs for providing street lighting services in the remaining years of the regulatory period.

### 3.4.4 Treatment of the regulatory asset base

**AER proposed position**

In its position paper, the AER highlighted the NER requirements relating to the RAB, specifically, that a DNSP's RAB is the value of assets used by the DNSP to provide standard control services, but only to the extent that those assets are used to provide such services.[108] The AER also noted that the value of the RAB may be added to or reduced to incorporate assets that now or are no longer classified as standard control services.[109]

The AER stated that in accordance with the NER requirements Energex's and Ergon's respective building block proposal will need to propose a RAB value that includes those assets or a proportion of those assets that are used to provide standard control services.

**Submissions**

Ergon stated the AER's position paper did not have appropriate regard for the transitional arrangements in the NER, in particular clause 11.16.3. Clause 11.16.3 permits Energex and Ergon to maintain the approach allowed in the 2005 distribution determination in relation to the treatment of standard control services and other services in the RAB.[110] On that basis, Ergon considered that it should not be required to split its RAB. Ergon requested that the AER amend its framework and approach paper to acknowledge, and apply, clause 11.16.3 with respect to the treatment of the RAB.[111]

**AER considerations**

The AER acknowledges that clause 11.16.3 permits Energex and Ergon to retain the approach allowed in the QCA's 2005 distribution determination to the treatment of the standard control services and other services in the RAB in the next regulatory

108 NER, clause 6.5.1(a).

109 NER, schedule 6.2, clause S6.2.1(e)(7) and S6.2.1(e)(8).

110 Ergon submission, p. 15.

111 ibid., p. 15.

control period. The AER understands that Ergon's asset base consists of assets that currently provide prescribed, excluded and unregulated services. Energex indicated that its asset base contains assets that currently provide prescribed and excluded services.[112] Rather than separating the asset base, the QCA elected to make offsetting adjustments to the total revenues calculated using this asset base.[113] Each DNSP sets its prices in order to recover this adjusted revenue.

As part of their respective regulatory proposals, if either Energex or Ergon propose to retain the treatment of their asset base as is permitted under clause 11.16.3 of the NER the AER will accept that approach if it is consistent with the approach allowed in the QCA's 2005 distribution determination.

**Conclusion**

Although schedule 6.2 requires that a DNSP's RAB only consists of assets that provide standard control services, the AER acknowledges that the transitional arrangements for Queensland allow Energex and Ergon to retain the current approach to the treatment of their asset base by the QCA.

## 3.5 AER decision

### 3.5.1 Control mechanisms applicable to Energex

**Standard control services**

The AER will apply a fixed revenue cap control mechanism to Energex's standard control services in the 2010–15 regulatory control period.

The control mechanism will be of the CPI – X form and will include adjustments to incorporate any revenue increment or decrement associated with any applicable STPIS and DMIS.

**Alternative control services**

The AER will apply a price cap form of control to Energex's alternative control services in the 2010–15 regulatory control period.

The AER will apply a limited building block approach to determine the efficient costs of providing street lighting services under the price cap control mechanism in the first year of the regulatory control period and establish a price path for remaining years of the period.

The AER will apply a formula based approach (a non-building block approach) to determine the efficient costs of providing quoted services under a price cap form of control in the first year of the regulatory control period and establish a price path for remaining years of the period.

The AER will apply a formula based approach (a non-building block approach) to determine the efficient costs of providing fee based services under a price cap form of

112 Energex, response to information request, confidential, submitted 21 August 2008.

113 QCA, *Regulation of Electricity Distribution*, Final Determination, April 2005, pp. 169–171.

control in the first year of the regulatory control period and establish a price path for remaining years of the period.[114]

For all alternative control services the approved price is the maximum price Energex is permitted to charge for a particular service.

### 3.5.2 Control mechanisms applicable to Ergon

**Standard control services**

The AER will apply a fixed revenue cap control mechanism to Ergon's standard control services in the 2010–15 regulatory control period.

The control mechanism will be of the CPI – X form and will include adjustments to incorporate any revenue increment or decrement associated with any applicable STPIS and DMIS.

**Alternative control services**

The AER will apply a price cap form of control to Ergon's alternative control services in the 2010–15 regulatory control period.

The AER will apply a limited building block approach to determine the efficient costs of providing street lighting services under the price cap control mechanism in the first year of the regulatory control period and establish a price path for remaining years of the period.

The AER will apply a formula based approach (a non-building block approach) to determine the efficient costs of providing quoted services under a price cap form of control in the first year of the regulatory control period and establish a price path for remaining years of the period.

The AER will apply a formula based approach (a non-building block approach) to determine the efficient costs of providing fee based services under a price cap form of control in the first year of the regulatory control period and establish a price path for remaining years of the period.[115]

For all alternative control services the approved price is the maximum price Ergon is permitted to charge for a particular service.

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114 For quoted services the formula based approach may contain variable components whereas for fee based services the components for each formula are fixed.

115 ibid.

# Appendix A: Requirements of the National Electricity Rules

This appendix sets out the requirements of the National Electricity Rules (NER) the AER must have regard for when classifying distribution services and deciding on the control mechanisms to apply to direct control services.

## Classification of services

A distribution determination made by the AER must include a decision on the classification of the services to be provided by the DNSP during the course of the relevant regulatory control period.[116] In its framework and approach paper, the AER must set out its likely approach to the classification of distribution services in a DNSP's forthcoming distribution determination, and its reasons for that approach.[117]

The classification of services in the distribution determination must be consistent with the framework and approach paper unless the AER considers that, in light of the DNSP's regulatory proposal and submissions received, there are good reasons for departing from the classifications.[118]

Where the NER require that a particular classification be assigned to a specified kind of distribution service, the service is to be classified in accordance with that requirement.[119] In classifying services that have previously been subject to regulation under the present or earlier legislation, the AER must act on the basis that:

- if the services have been previously classified, there should be no departure from a previous classification; and
- if there has been no classification, the classification should be consistent with the previously applicable regulatory approach, unless a different approach is clearly more appropriate.[120]

The distribution service classifications available under the NER are illustrated in the figure below.

116 NER, clause 6.12.1(1).

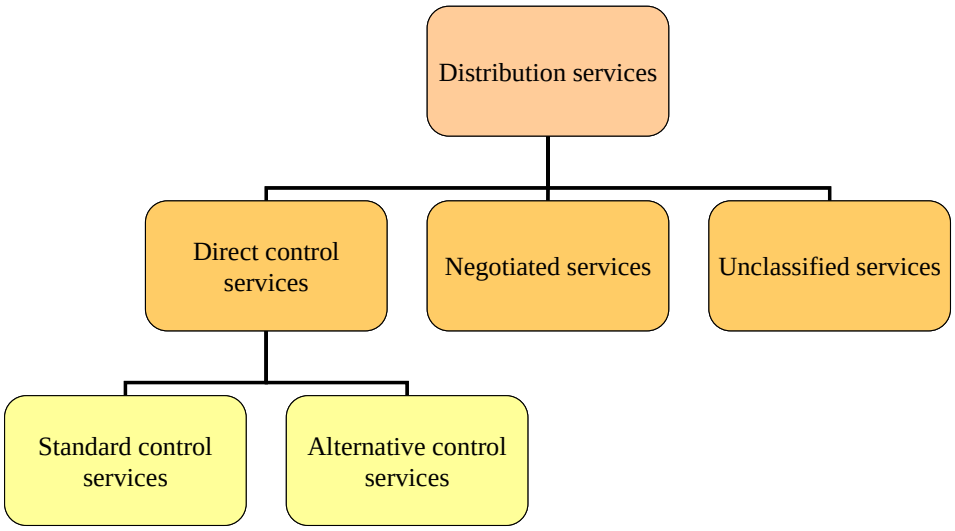
117 NER, clause 6.8.1(b)(1).

118 NER, clause 6.12.3(b).

119 NER, clause 6.2.1(e) and 6.2.2(e).

120 NER, clause 6.2.1(d).

**Figure A1: Distribution service classifications**




**Division of distribution services in to direct control, negotiated and unregulated services**

Distribution services are defined in the NER, as services provided by means of, or in connection with, a distribution network, together with the connection assets associated with the distribution network, which are connected to another transmission or distribution system. Distribution services include services provided by means of, or in connection with, the apparatus, equipment, plant and buildings used to convey, and control the conveyance of, electricity to customers (whether wholesale or retail), excluding such services provided over a transmission network.[121]

The AER may classify a distribution service as either:

- a direct control service; or
- a negotiated distribution service.[122]

If the AER decides against classifying a distribution service the service is not regulated under the NER.[123]

The AER may group distribution services together for the purpose of classification and a single classification made to the group applies to each service in the group.[124]

When classifying a distribution service as either a direct control service or negotiated service, the AER must have regard to:

- the form of regulation factors[125]

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121 The definition of distribution services in this section paraphrases that contained in chapter 10 of the NER. In the case of any inconsistency between the definition in this section and that in the NER, the definition in the NER prevails.

122 NER, clause 6.2.1(a).

123 NER, clause 6.2.1.

124 NER, clause 6.2.1(b).

125 NEL, section 2F.

- the form of regulation (if any) previously applicable to the relevant service or services and, in particular, any previous classification under the present system of classification or under the present regulatory system (as the case requires)
- the desirability of consistency in the form of regulation for similar services (both within and beyond the relevant jurisdiction); and
- any other relevant factor.[126]

**Division of direct control services into standard and alternative control services**

The AER must further classify each direct control service as either:

- a standard control service; and
- an alternative control service.[127]

In classifying a direct control service as either a standard control service or an alternative control service, the AER must have regard to:

- the potential for development of competition in the relevant market and how the classification might influence that potential
- the possible effects of the classification on administrative costs of the AER, the DNSP and users or potential users
- the regulatory approach (if any) applicable to the relevant service immediately before the commencement of the distribution determination for which the classification is made
- the desirability of a consistent regulatory approach to similar services (both within and beyond the relevant jurisdiction)
- the extent that costs of providing the relevant service are directly attributable to the customer to whom the service is provided; and
- any other relevant factor.[128]

## Form of control mechanism

Under the NER a distribution determination is to impose controls over the prices of direct control services or the revenue to be derived from direct control services or both.[129] The AER's framework and approach paper must state the form or forms of control to be applied in the distribution determination, as well as the reasons for deciding on each control mechanism.[130]

126 NER, clause 6.2.1(c).

127 NER, clause 6.2.2(a).

128 NER, clause 6.2.2(c).

129 NER, clause 6.2.5(a).

130 NER, clause 6.8.1(c).

Unlike other elements of the framework and approach paper, the AER's statement of the form or forms of control in the framework and approach paper is binding on the AER and the DNSP for the relevant distribution determination.[131]

The NER allow the AER to group direct control services together for the purpose of classification. The AER can apply a control mechanism to either an individual or a group of direct control services.

**Available control mechanisms**

The NER provides that the control mechanism to be applied to direct control services may consist of:

- a schedule of fixed prices
- caps on the prices of individual services (i.e. a price cap)
- caps on the revenue to be derived from a particular combination of services (i.e. a fixed revenue cap)
- tariff basket price control (i.e. a weighted average price cap)
- revenue yield control (i.e. an average revenue cap); or
- a combination of any of the above (i.e. a hybrid control mechanism).[132]

**Deciding on control mechanisms**

The AER decision on the control mechanism to apply to direct control services consists of two parts:

- the form of control mechanism[133]
- the basis of the control mechanism.[134]

**Standard control services**

In deciding on a control mechanism for standard control services, the AER must have regard to the following factors:

- the need for efficient tariff structures
- the possible effects of the control mechanism on administrative costs of the AER, the DNSP and users or potential users
- the regulatory arrangements (if any) applicable to the relevant service immediately before the commencement of the distribution determination

131 NER, clause 6.12.3(c).

132 NER, clause 6.2.5(b).

133 NER, clause 6.2.5(b).

134 NER, clause 6.2.6(a).

- the desirability of consistency between regulatory arrangements for similar services (both within and beyond the relevant jurisdiction); and
- any other relevant factor.[135]

The basis of the control mechanism to be applied to standard control services must be made according to Part C of the chapter 6 of the NER—using the building block approach and must be of the prospective consumer price index (CPI) minus X (CPI – X) form or an incentive based variant of that form.[136]

**Alternative control services**

In deciding on a control mechanism for standard control services, the AER must have regard to the following factors:

- the potential for development of competition in the relevant market and how the control mechanism might influence that potential
- the possible effects of the control mechanism on administrative costs of the AER, the DNSP and users or potential users
- the regulatory arrangements (if any) applicable to the relevant service immediately before the commencement of the distribution determination
- the desirability of consistency between regulatory arrangements for similar services (both within and beyond the relevant jurisdiction); and
- any other relevant factor.[137]

The basis of the control mechanism to be applied to alternative control services can be either:

- the building block approach
- certain elements of the building block approach, that is, a limited building block approach; or[138]
- may not be based on the building block approach.[139]

The control mechanism must have a basis stated in the distribution determination and may, but is not required to, be of the CPI – X form or a variant of that form.[140]

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135 NER, clause 6.2.5(c).

136 NER, clause 6.2.6(a).

137 NER, clause 6.2.5(c).

138 The building block approach determines an annual revenue requirement based on the elements under clause 6.4.3(a). A limited building block approach may not include one or more of these elements.

139 NER, clause 6.2.6(c).

140 NER, clause 6.2.6(b).

# Appendix B: AER service groups and classification

Table B1 of this appendix sets out the AER's distribution service groups and the applicable classifications and the current QCA classifications. For guidance, the Table includes general descriptions of the type of activity that fall within each service group. It is not a complete listing of the underlying services provided by Energex and Ergon.

**Table B1: AER's service groups and classifications**

| AER service group | QCA current classification | AER classification | Activities included in service group |
|---|---|---|---|
| **Network services** | Prescribed service | Standard control service | Constructing the network<br>Maintaining the network<br>Operating the network for DNSP purposes<br>Planning the network<br>Designing the network<br>Emergency response<br>Administrative support |
| **Connection services** | Prescribed service | Standard control service | Commissioning of connection assets<br>Service connections for small customers<br>Installation inspection<br>Operating and maintaining connection assets |
| | | | Commissioning of metering and load control equipment |

| | | | |
|---|---|---|---|
| **Metering services** | Prescribed service | Standard control service | Type 5–7 metering<br>Scheduled meter reading<br>Unscheduled meter reading – non-chargeable<br>Metering investigation<br>Maintaining and repairing meters and load control equipment |
| **Street lighting services** | Prescribed service | Alternative control service | Provision, construction and maintenance of street lighting |
| **Quoted services** | Excluded service | Alternative control service | Rearrangement of network assets<br>Covering of low voltage mains<br>Non standard data services (type 5–7 metering)<br>Ancillary metering services (type 5–7 metering)<br>Supply enhancement<br>Metering enhancement<br>Temporary disconnect / reconnect services<br>After hours provision of any service<br>Emergency recoverable works<br>Large customer connections[a]<br>Auditing of design and construction |

| | | | |
|---|---|---|---|
| **Fee based services** | Excluded service | Alternative control service | Specification and design enquiry fees<br>De-energisation and re-energisation<br>Re-test<br>Supply abolishment<br>Temporary supply services<br>Fault response—not DNSP fault<br>Wasted attendance |
| **Unregulated services** | Unregulated | Unclassified | Non distribution services<br>Distribution services provided in a competitive market:<br>▪ High Load escorts[b]<br>▪ Watchman lights<br>▪ Type 1–4 metering |

(a) Service connections for large customers are currently classified by the QCA as a prescribed service.
(b) The following aspects of high load escorts that are unclassified for Ergon: accrediting contractors, scoping the route, and travelling with the high load.