



**PRELIMINARY DECISION**  
**Ergon Energy determination**  
**2015–16 to 2019–20**

**Attachment 14 – Control**  
**mechanisms**

April 2015

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## Note

This attachment forms part of the AER's preliminary decision on Ergon Energy's 2015–20 distribution determination. It should be read with all other parts of the preliminary decision.

The preliminary decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

Attachment 7 – Operating expenditure

Attachment 8 – Corporate income tax

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Demand management incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanism

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

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## Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	Expenditure Forecast Assessment Guideline for electricity distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PPI	partial performance indicators

Shortened form	Extended form
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

# 14 Control mechanisms for standard control services

The control mechanism imposes limits over the prices of direct control services, and/or the revenue from these services. For standard control services, the National Electricity Rules (NER) state that the control mechanism must be of the prospective CPI-X form (or some incentive-based variant).<sup>1</sup>

This attachment sets out the formulae for Ergon Energy's control mechanism, the revenue cap, for the 2015–20 regulatory control period. It discusses:

- how we will apply the revenue cap
- how we will determine compliance with the price controls<sup>2</sup>
- the mechanism through which Ergon Energy will recover distribution use of system (DUoS) charges—including adjustments for revenue under or over recovery—in the 2015–20 regulatory control period<sup>3</sup>
- how Ergon Energy must report to us on its recovery of designated pricing proposal charges and jurisdictional scheme amounts<sup>4</sup>
- the procedures Ergon Energy must apply for assigning or reassigning retail customers to tariff classes.<sup>5</sup>

## 14.1 Preliminary decision

Our preliminary decision for Ergon Energy is as follows:

- the control mechanism for standard control services provided by Ergon Energy is a revenue cap.<sup>6</sup>
- section 14.5.3 contains the formula that gives effect to the control mechanism for standard control services.<sup>7</sup> The revenue cap for any given regulatory year is the total annual revenue (TAR) (for distribution services) for that regulatory year (calculated using the formula in Figure 14.1) plus any adjustment required to move the DUoS under/over account to zero.
- the side constraints applying to the price movements of each Ergon Energy tariff class must be consistent with the formula in Figure 14.2.

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<sup>1</sup> NER, cl 6.2.6(a).

<sup>2</sup> NER, cl 6.12.1(13).

<sup>3</sup> NER, cl 6.12.1(11).

<sup>4</sup> NER, cl 6.12.1(19) and 6.12.1(20).

<sup>5</sup> NER, cl 6.12.1(17).

<sup>6</sup> AER, *Final framework and approach for Energex and Ergon Energy: Regulatory control period commencing 1 July 2015*, April 2014, p. 52; Ergon Energy, *Regulatory proposal 2015-20*, 31 October 2014, p. 32.

<sup>7</sup> NER, cl 6.12.1(11).

- Ergon Energy must demonstrate compliance with the control mechanism for standard control services in accordance with appendix A of this attachment.
- Ergon Energy must submit as part of its annual pricing proposal, a record of the amount of revenue recovered from designated pricing proposal charges and associated payments in accordance with appendix B of this attachment.<sup>8</sup>
- Ergon Energy must report to us its jurisdiction scheme amounts recovery in accordance with appendix C of this attachment.
- appendix D of this attachment specifies the procedures Ergon Energy must apply for assigning retail customers to tariff classes or reassigning retail customers from one tariff class to another.

## 14.2 Ergon Energy's proposal

Ergon Energy noted we will apply a revenue cap for standard control services in the 2015–20 regulatory control period.<sup>9</sup> Ergon Energy accepted our high level control mechanism for standard control services. Ergon Energy also described its assumptions regarding the control mechanism, including the formula.<sup>10</sup>

## 14.3 AER's assessment approach

In our final framework and approach (F&A) we decided the control mechanism for standard control services would be a revenue cap. The basis must be of the prospective CPI–X form (or some incentive-based variant).<sup>11</sup> We also stated we would finalise certain aspects of the control mechanism during the distribution determination process.<sup>12</sup>

In determining the control mechanism for standard control services, we considered the factors in clause 6.2.5(c) of the NER for each revenue adjustment mechanism and its application. This approach:

- satisfies the requirements of the NER
- confirms our decision in the final F&A decision to apply a revenue cap for Ergon Energy's standard control services in the 2015–20 regulatory control period.

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<sup>8</sup> We referred to this as the 'TUoS unders and overs account' in previous distribution determinations. In this preliminary decision, we use the term 'designated pricing proposal charges' to reflect the wording of the NER (cl 6.12.1(19)).

<sup>9</sup> Ergon Energy, *Regulatory proposal 2015–20*, 31 October 2014, p. 32.

<sup>10</sup> Ergon Energy, *Regulatory proposal 2015–20*, 31 October 2014, pp. 32–34.

<sup>11</sup> AER, *Final framework and approach for Energex and Ergon Energy: Regulatory control period commencing 1 July 2015*, April 2014, pp. 13 and 54.

<sup>12</sup> AER, *Final framework and approach for Energex and Ergon Energy: Regulatory control period commencing 1 July 2015*, April 2014, pp. 63–64.



## 14.4 Reasons for preliminary decision

In our final F&A we set out a generic formula to give effect to the control mechanism for standard control services.<sup>13</sup> The NER requires our final F&A to include a formula for the control mechanism.<sup>14</sup> The control formula requires parameters that we would complete in our final distribution determination. This preliminary decision clarifies our position regarding the control formula and its respective parameters.

## 14.5 Application of the revenue cap

### Total annual revenue

The revenue cap for any given regulatory year is the total annual revenue (TAR) for distribution services.<sup>15</sup> Figure 14.1 contains the formula that gives effect to the revenue cap.<sup>16</sup>

### Incentive Adjustment

Ergon Energy proposed to close off the demand management incentive scheme applying in the 2010–15 regulatory control period through the I-factor:

Under the current DMIS, the AER will calculate a total carryover amount to account for any amount of allowance unspent or not approved over the current regulatory control period and the time value of money accrued/lost as a result of the expenditure profile selected by Ergon Energy. The final carryover amount will be deducted from/added to allowed revenue in 2016-17.<sup>17</sup>

We agree with Ergon Energy and have incorporated the final carryover amount in the control mechanism and side constraint formulas (see Figure 14.1 and Figure 14.2).

### S-factor

Ergon Energy accepted our decision to apply an annual adjustment to revenue from distribution services due to the operation of an incentive scheme. As discussed in the service standards attachment, we will apply a Service Target Performance Incentive Scheme (S-factor) to Ergon Energy in the 2015–20 regulatory control period.

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<sup>13</sup> AER, *Framework and approach paper*, April 2014, p. 63.

<sup>14</sup> NER, cl 6.8.1(b)(2)(ii).

<sup>15</sup> The final F&A included the term 'total revenue' (TR) in the revenue cap formula. In the NER, the term 'total revenue' generally refers to revenue for an entire regulatory control period. To avoid confusion, this preliminary decision uses 'total annual revenue'.

<sup>16</sup> NER, cl 6.12.1(11).

<sup>17</sup> Ergon Energy, *Regulatory proposal 2015-20: Attachment 04.01.00: Compliance with Control Mechanisms*, 31 October 2014, p. 8;

## Intra-period adjustment to WACC

We consider that changes to revenue resulting from the annual return on debt update should be implemented through revising the X-factors.

The attachment on the cost of capital discusses the WACC annual adjustment. The revenue attachment details issues relating to 'X-factors'.

## Annual adjustment (B-factor)

Ergon Energy submitted that the B-factor will encompass:

- Any under or over-recoveries relating to capital contributions and shared assets from 2013–2014 and 2014–2015.
- The DUoS under and over-recovery adjustments approved to be passed through in the relevant pricing year.<sup>18</sup>

We agree with Ergon Energy because applying under or over-recoveries relating to capital contributions and shared assets was an obligation under the transitional rules.<sup>19</sup> Ergon Energy's proposal will close off the transitional rules.

We removed DUoS under and over-recovery adjustments from the definition of the B-factor to be consistent with the approach we adopted in the 2010–15 regulatory control period.<sup>20</sup> Ergon Energy must still account for the DUoS unders and overs account when demonstrating compliance with the control mechanism for standard control services (see section 14.5.3).

## Annual adjustment (C-factor)

Ergon Energy will recover approved pass through amounts via the C-factor during the 2015–20 regulatory control period. Ergon Energy will also recover feed-in tariff cost pass through amounts relating to the 2013–14 and 2014–15 regulatory years.

The generic formulaic expression in our final F&A includes a factor to adjust for approved pass through amounts. At that time we envisaged that any approved pass through amounts would be adjusted for as part of the C-factor.<sup>21</sup>

Ergon Energy stated the C-factor should include adjustments associated with:

- Feed-in-Tariff cost pass through amounts relating to 2013–14 and 2014–15
- Amounts relating to the occurrence of any of the prescribed and nominated cost pass through events

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<sup>18</sup> Ergon Energy, *Regulatory proposal 2015–20*, October 2014, p. 34.

<sup>19</sup> Ergon Energy, *Regulatory proposal 2015-20: Attachment 04.01.00: Compliance with Control Mechanisms*, 31 October 2014, pp. 8, 19–20; NER, cl 11.16.10 and 11.16.3.

<sup>20</sup> AER, *Final decision: Queensland distribution determination 2010–11 to 2014–15*, May 2010, pp. 26–27.

<sup>21</sup> AER, *Framework and approach paper*, April 2014, p. 64.

- Other one-off revenue adjustments approved by the AER. This would be used in limited circumstances, and only to the extent that such adjustments are unable to be accounted for within other parameters of the revenue cap formula.<sup>22</sup>

We agree with the inclusion of the feed-in tariff amounts relating to the 2013–14 and 2014–15 regulatory years. The final F&A stated the C-factor should represent the sum of adjustments likely to include (but not limited to) pass through events and feed-in tariff payments that are not made under jurisdictional schemes.<sup>23</sup> As we discuss in section 14.5.1, Ergon Energy recovered feed-in tariff amounts as cost pass through amounts in the 2010–15 regulatory control period. However, Ergon Energy will recover feed-in tariff amounts as jurisdictional scheme amounts in the 2015–20 regulatory control period. Hence, inclusion of the feed-in tariff amounts in the C-factor closes out the arrangement in the 2010–15 regulatory control period.

We do not agree with the inclusion of 'other one-off revenue adjustments approved by the AER' in the definition of the C-factor. The NER requires us to decide on the formula that gives effect to the control mechanism, and to decide on how a distributor is to demonstrate compliance with the control mechanism. We consider including a general 'catch-all' definition of the kind proposed in the control mechanism formula is not consistent with incentive regulation. A distributor should manage one-off events as part of its normal business practice, unless they come within the pass-through regime which is used for more exceptional cases. Incentive regulation is not intended to account for all events that may occur during a regulatory control period. In addition, including such a catch-all definition increases uncertainty and administration costs in annual pricing proposals. It would require us to revisit what the C-factor should include, before we could determine whether or not the distributor's pricing proposal should be approved.<sup>24</sup>

## Under and over recovery mechanism for DUoS

Under a revenue cap, Ergon Energy's revenues are adjusted annually to clear any under or over recovery of actual revenue collected through DUoS charges. Ergon Energy currently reports to the AER annually in their Pricing Proposal on the recovery of DUoS from our network tariffs. This includes adjustments for over or under recovery of those charges in accordance with the DUoS unders and overs account set out in the Distribution Determination 2010-15.<sup>25</sup> Appendix A details the operation of this method.

To minimise price volatility between regulatory years, Ergon Energy proposed to apply tolerance limits to the clearing of DUoS under and over recoveries. Under this

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<sup>22</sup> Ergon Energy, *Regulatory proposal 2015-20: Attachment 04.01.00: Compliance with Control Mechanisms*, 31 October 2014, p. 9.

<sup>23</sup> AER, *Framework and approach paper*, April 2014, p. 64.

<sup>24</sup> Under cl. 6.18.8(a) of the NER, the AER must approve a pricing proposal if it is satisfied that the proposal complies with any applicable distribution determination, Part I of Chapter 6 and any relevant clauses of Chapter 11 of the NER; and all forecasts associated with the proposal are reasonable.

<sup>25</sup> Ergon Energy, *Regulatory proposal 2015–20*, October 2014, p. 35.

proposal, Ergon Energy can spread the under or over recovery over multiple regulatory years when tolerance limits are triggered.

We discuss tolerance limits below.

## Future tolerance limits

We will not apply tolerance limits to the DUoS unders and over accounts in the 2015–20 regulatory control period. We consider the risks of applying tolerance limits (delayed price shocks, and reduced cost reflectivity in prices) outweigh the benefits of potentially smoothing prices.

Applying tolerance limits potentially smooths price shocks that may occur as a result of volume risk under a revenue cap. Tolerance limits may also offer flexibility to attain price stability. Ergon Energy proposed to apply a principles-based approach in the next regulatory control period which seeks to:

- balance the need to reduce the amount of under or over recoveries over time
- minimise volatility for prices in the short or longer term so as not to exacerbate future under or over recoveries.<sup>26</sup>

In practice, however, tolerance limits may result in under or over recoveries accumulating during the regulatory control period. This would leave a large end-of-period adjustment to eliminate or reduce the account balance accumulated during previous years. As a result, price shocks are merely delayed, not eliminated. This occurred in Queensland where consistent under-recovery in the 2010–15 regulatory control period led to an accumulated \$500 million in the account balance. The Queensland distributors proposed recovering this amount over the next regulatory control period.<sup>27</sup>

Accumulating over or under recoveries that persist for multiple years may also distort the cost reflectiveness of tariffs and thus price signals to customers. For example, instead of tariffs falling for a particular customer class in a given year, they rise as the distributor draws down on its accumulated balance. This is not consistent with the network pricing objective: the tariffs a distributor charges a retail customer should reflect the efficient costs of providing those services.<sup>28</sup> It is also not consistent with the requirement that tariffs minimise distortions to price signals for efficient usage.<sup>29</sup>

The Independent Pricing and Regulatory Tribunal (IPART) and more recently the ACCC experienced similar issues of delayed cost reflectivity in their determinations for the State Water Corporation of NSW. In past determinations, IPART set price caps for

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<sup>26</sup> Ergon Energy, *Regulatory proposal 2015-20: Attachment 04.01.00: Compliance with Control Mechanisms*, 31 October 2014, p. 11.

<sup>27</sup> Ergon Energy, *Regulatory proposal 2015 to 2020*, October 2014, p. 25.

<sup>28</sup> NER, cl 6.18.5(a).

<sup>29</sup> NER, cl 6.18.5(g)(3).

certain valleys having regard to the severe customer impact of full cost recovery (because of high prices in those valleys).<sup>30</sup> This resulted in prices for those valleys not recovering the revenue requirement in past years (although the NSW Government funded the shortfall through direct budgetary subsidies).<sup>31</sup> The issue of under recovery continued when the ACCC assumed regulation of State Water's Murray-Darling Basin Valleys for the 2014–17 period.<sup>32</sup> We note the different characteristics of the water and electricity sectors influence their regulatory regimes. For example, the ACCC must consider price stability in its annual tariff process for State Water.<sup>33</sup> As we noted above, the NER emphasise that electricity distributors' tariffs should reflect efficient costs.<sup>34</sup> Nevertheless, this example demonstrates the potential to delay cost reflective pricing when under (or over) recoveries of costs are allowed to accumulate.

Eliminating tolerance limits removes distortions to cost reflectivity that we discussed above. The move to cost reflective tariffs is now underway following the AEMC change to the distribution pricing rules in 2014.<sup>35</sup>

A drawback of not applying tolerance limits is the possibility of price shocks when the variance between the total annual revenue and actual revenue is large. However, in-built smoothing mechanisms from some sources of error can mitigate the variability in revenue stemming from a revenue cap. For example:

- under the STPIS, distributors can bank revenue adjustments resulting from the S-factor. Thus, there is no good reason for the S-factor payment to find their way into a tolerance limits account balance.
- consumption forecasts are a potential source of error. We can mitigate such errors by approving reasonable forecasts during the distribution determination and pricing proposal process. This process, along with requirements for greater consultation, put the onus on distributors to produce reasonable volume forecasts at the outset.

While this was not a major factor in our decision, tolerance limits also increase administration costs for the regulator and distributors. Both parties must keep records annually to track its operation over the regulatory control period. Administration costs may become particularly high where distributors proposed discretion for recovering revenue associated with the tolerance limits.<sup>36</sup> This may require negotiation between regulator and distributor during the pricing approval process. There is also the added

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<sup>30</sup> IPART, *Review of bulk water charges for State Water Corporation from 1 July 2010 to 30 June 2014: Water: Final report*, June 2010, pp. 18, 150–151.

<sup>31</sup> IPART, *Review of bulk water charges for State Water Corporation from 1 July 2010 to 30 June 2014: Water: Final report*, June 2010, pp. 110, 149–150.

<sup>32</sup> ACCC, *Final decision on State Water pricing application: 2014–15 — 2016–17*, June 2014, pp. 11–13.

<sup>33</sup> Water Charge (Infrastructure) Rules 2010, rule 37(2)

<sup>34</sup> NER, cl 6.18.5(e) to 6.18.5(g).

<sup>35</sup> See: <http://www.aemc.gov.au/Rule-Changes/Distribution-Network-Pricing-Arrangements> (accessed 18 February 2015).

<sup>36</sup> Ergon Energy proposed an approach that allows for flexibility if future over and under recoveries can be reasonably foreseen. For more details, see Ergon Energy, *Regulatory proposal 2015-20: Attachment 04.04.01: Compliance*, 20 January 2015, p. 8.

complexity and confusion, and associated costs, of different distributors proposing different mechanisms to recover such revenue. Eliminating tolerance limits also avoids these administration costs and potential confusion for customers.

## **Under and over recovery mechanism for designated pricing proposal charges**

We will apply an under and over recovery mechanism for designated pricing proposal charges to smooth the impact of over and under recovery into tariffs year on year. Our reasons are the same for the DUoS under and over recovery as set out above and is consistent with the requirements of the NER.<sup>37</sup>

We based the unders and overs account for designated pricing proposal charges on the approach we used in the 2010–15 regulatory control period. See appendix B for a more detailed discussion.

### ***Chumvale and Powerlink lines***

Ergon Energy will also recover, as part of designated pricing proposal charges, charges levied on it for the use of the Chumvale and Powerlink lines, which are transmission-related charges.

Under rule 11.39 of the NER, those charges are treated as 'designated pricing proposal charges' in the 2010–15 regulatory control period. In the 2015–20 regulatory control period, rule 11.39 will no longer apply. As a result of this, Ergon Energy proposed the charges levied on it be included as operating expenditures.<sup>38</sup>

We found those charges should not be included in opex as this would be inconsistent with the NER (see the opex attachment 7). As we discuss below, we consider they are designated pricing proposal charges.

The NER defines 'prescribed transmission services' as including:

connection services that are provided by a Transmission Network Service Provider to another Network Service Provider to connect their networks where neither of the Network Service Providers is a Market Network Service Provider<sup>39</sup>

We consider this definition applies to the charges levied on Ergon Energy for the use of the Chumvale and Powerlink lines. In particular, we consider the use of these lines to be 'prescribed exit services', because they constitute 'exit services provided to a [distributor]'. Further, chapter 10 of the NER includes 'prescribed exit services' in its definition of 'designated pricing proposal services'. Hence, we consider Ergon Energy should recover these charges as designated pricing proposal charges.

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<sup>37</sup> NER, cl 6.12.1(19) and 6.18.7.

<sup>38</sup> Ergon Energy, *Regulatory proposal 2015–20*, October 2014, p. 37.

<sup>39</sup> NER, chapter 10.

Ergon Energy stated Powerlink is considering applying to have the non-prescribed connection services it offers Ergon classified as prescribed services.<sup>40</sup> However, referring to the NER's definition of prescribed transmission services, it appears those connection services are already prescribed.

### 14.5.1 Reporting on jurisdictional scheme amounts

In Queensland, the Solar Bonus Scheme will apply as a jurisdictional scheme in the next regulatory control period.<sup>41</sup> We must decide how Ergon Energy will report on the recovery of jurisdictional scheme amounts for each year of the 2010–15 regulatory control period.<sup>42</sup> Appendix C sets out the unders and overs mechanism for jurisdictional scheme amounts.

Ergon Energy proposed to recover jurisdictional scheme amounts following a two-year lag. Under this method, Ergon Energy would earn zero revenues from jurisdictional amounts in the year it incurs those amounts. It would then pass on the full amount after two years.<sup>43</sup> Ergon Energy proposed to adjust these amounts for the time cost of money by applying the relevant WACC for the two years of the lag between when it incurs the cost and when it recovers those costs from its customers.<sup>44</sup>

Ergon Energy proposed this method to prevent 'doubling up' in recovering jurisdictional scheme amounts in 2015–16 and 2016–17. Ergon Energy expected to also recover Solar Bonus Scheme amounts as nominated cost pass throughs under the 2010–15 distribution determination.<sup>45</sup> Cost pass through amounts relating to the Solar Bonus Scheme were substantial as uptake of solar PV installations were greater than forecast during the 2010–15 distribution determination. For example, we approved for Ergon Energy to pass through \$84 million in Solar Bonus Scheme amounts in the 2014–15 regulatory year.<sup>46</sup>

We do not approve Ergon Energy's proposed method of reporting on jurisdictional scheme amounts. We consider Ergon Energy's proposed method is a significant departure from the national approach to the recovery of jurisdictional scheme amounts (such as the approach in appendix C). The two-year delay in recovering jurisdictional scheme amounts is also not consistent with the NER's emphasis on cost reflective pricing (see discussion in the 'future tolerance limits' section above). We consider the method described in appendix C is in accordance with clause 6.18.7A(c) of the NER. We also note this method is similar to the reporting method for the DUoS and TUoS

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<sup>40</sup> Ergon Energy, *Regulatory proposal: Attachment 04.01.01: Designated pricing proposal charges*, October 2014, p. 3.

<sup>41</sup> NER, cl 6.18.7A(e)(iii); Ergon Energy, *Regulatory proposal 2015 to 2020*, 31 October 2014, p. 37.

<sup>42</sup> NER, cl. 6.12.1 (20).

<sup>43</sup> Ergon Energy, *Regulatory proposal: Attachment 04.01.02 – Jurisdictional schemes*, October 2014, p. 6.

<sup>44</sup> Ergon Energy, *Regulatory proposal: Attachment 04.01.02 – Jurisdictional schemes*, October 2014, p. 7.

<sup>45</sup> Ergon Energy, *Regulatory proposal: Attachment 04.01.02 – Jurisdictional schemes*, October 2014, p. 4.

<sup>46</sup> Ergon Energy, *Regulatory proposal: Attachment 04.01.02 – Jurisdictional schemes*, October 2014, p. 3.

unders and overs accounts for the 2010–15 regulatory control period.<sup>47</sup> As we detail in appendices A and B, we are continuing with this approach for DUoS and designated pricing proposal charges in the 2015–20 regulatory control period.

Regarding Ergon Energy's \$84 million cost pass through example, Ergon Energy stated it represented a 5 per cent increase in its annual revenue requirement for that year.<sup>48</sup> However, this would translate to lower percentage increases in retail prices. In addition, the Queensland Government's uniform tariff policy reduces the effect of such pass throughs on electricity retail prices. Under this policy, retail electricity customers in Ergon Energy's distribution area pay a uniform tariff based on the network costs of Energex in the state's southeast corner. For example, the decision to approve the \$84 million pass through would not directly affect customers in Ergon Energy's distribution area.<sup>49</sup>

We note the costs of the feed-in tariff paid under the Solar Bonus Scheme were treated as opex for the current regulatory control period. The differences between the forecast feed-in tariff payments and actual payments were a nominated pass through event. Once we approved the cost pass through amounts, we adjusted Ergon Energy's annual revenue allowances to pass through these amounts to customers via DUoS charges. Ergon Energy will not continue with this method in the 2015–20 regulatory control period, except to close off the previous arrangement through the C-factor (see section 14.5).

The Queensland Farmers' Federation stated the Queensland Government must remove the ongoing cost of the Solar Bonus Scheme from electricity consumers.<sup>50</sup> The removal of the Solar Bonus Scheme is a matter for the Queensland Government. Under the NER, Ergon Energy (and Energex) can recover costs associated with the scheme from customers.<sup>51</sup>

### 14.5.2 Side constraints

Ergon Energy submitted the operation of side constraints will need to be further considered by the AER as part of the 2015–20 distribution determination.<sup>52</sup> Figure 14.2 contains the formula for side constraints, including the definition of parameters.

We consider the application of the unders and overs in the side constraint formula provides for the appropriate treatment of these revenue adjustments consistent with the NER.<sup>53</sup>

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<sup>47</sup> AER, *Final decision: Queensland distribution determination 2010–11 to 2014–15*, May 2010, pp. 393–396.

<sup>48</sup> Ergon Energy, *Regulatory proposal: Attachment 04.01.02 – Jurisdictional schemes*, October 2014, p. 3.

<sup>49</sup> AER, <http://www.aer.gov.au/node/22730> (accessed 25 March 2015).

<sup>50</sup> Queensland Farmers' Federation, *Submission to Australian Energy Regulator (AER) on the Ergon Energy and Energex regulatory proposals for 2015–2020*, 30 January 2015, p. 4.

<sup>51</sup> NER, cl 6.18.7A(e)(iii).

<sup>52</sup> Ergon Energy, *Regulatory proposal 2015-20: Attachment 04.01.00: Compliance with Control Mechanisms*, 31 October 2014, p. 14.

<sup>53</sup> NER, cl 6.18.6(d).



For each year after the first year of each regulatory period, side constraints will apply to the weighted average revenue to be raised from each tariff class. In accordance with the NER, the permissible percentage increase is the greater of CPI–X plus 2 per cent or CPI plus 2 per cent. Recovery of certain revenues such as those to accommodate cost pass throughs is disregarded in deciding whether the permissible percentage has been exceeded.<sup>54</sup>

### 14.5.3 Control mechanism formulas

#### Prescribed (Distribution) services

Ergon Energy's pricing proposals must submit to the AER proposed tariffs and charging parameters. Ergon Energy's revenues must be consistent with the total annual revenue formula set out below plus any unders and overs adjustment needed to move the balance of its DUoS unders and overs account to zero.

#### Figure 14.1 Revenue cap formula

1.  $AR_t = AR_{t-1}(1 + \Delta CPI_t)(1 - X_t)(1 + S_t)$

2. 
$$TAR_t \geq \sum_{i=1}^n \sum_{j=1}^m p_t^{ij} q_t^{ij}$$

$$i=1, \dots, n \text{ and } j=1, \dots, m \text{ and } t=1, \dots, 5$$

3.  $TAR_t = AR_t \pm I_t \pm B_t \pm C_t$

Where:

$AR_t$  is the annual smoothed expected revenue for regulatory year t. For the first year of the 2015–20 regulatory control period, this amount will be equal to the smoothed revenue requirement for 2015–16 set out in the PTRM.

$\Delta CPI_t$  is the annual percentage change in the ABS CPI All Groups, Weighted Average of Eight Capital Cities from December in year t-2 to December in year t-1. For example, for the 2015–16 year, t-2 is December 2013 and t-1 is December 2014 and in the 2016–17 year, t-2 is December 2014 and t-1 is December 2015 and so on.

$X_t$  is the X-factor for each year of the 2015–20 regulatory control period as determined in the PTRM, and annually revised for the return on debt update in accordance with the formula specified in the return on debt appendix I calculated for the relevant year.

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<sup>54</sup> NER, cl 6.18.6(d).

$S_t$  is the STPIS factor sum of the raw s-factors for all reliability of supply and customer service parameters (as applicable) to be applied in year t.<sup>55</sup>

$TAR_t$  is the total annual revenue in year t.

$p_t^{ij}$  is the price of component i of tariff j in year t.

$q_t^{ij}$  is the forecast quantity of component i of tariff j in year t.

$I_t$  is the final carryover amount from the application of the DMIS from the 2010–15 distribution determination. This amount will be deducted from/added to allowed revenue in the 2016-17 pricing proposal.

$B_t$  is any under or over-recoveries relating to capital contributions and shared assets from 2013–14 and 2014–15

$C_t$  is the sum of adjustments related to:

- feed-in tariff cost pass through amounts relating to 2013–14 and 2014–15
- amounts relating to the occurrence of any of the prescribed and nominated cost pass through events.

## Side constraints

Ergon Energy must demonstrate in its pricing proposal that proposed DUoS prices for the next year (t) will meet the side constraints formula in Figure 14.2 for each tariff class.<sup>56</sup>

**Figure 14.2 Side constraints**

$$\frac{\left(\sum_{j=1}^m d_t^j q_t^j\right)}{\left(\sum_{j=1}^m d_{t-1}^j q_t^j\right)} \leq (1 + \Delta CPI_t)(1 - X_t)(1 + 2\%)(1 + S_t) \pm I_t \pm B_t \pm C_t \pm DUoS_t$$

where each tariff class has up to 'm' components, and where:

$d_t^j$  is the proposed price for component 'j' of the tariff class for year t

<sup>55</sup> In the formulas in the STPIS attachment, the  $AR_{t+1}$  is equivalent to  $AR_t$  in this formula. Calculations of the S factor adjustment are to be made accordingly.

<sup>56</sup> NER, cl 6.18.6.

$d_{t-1}^j$  is the price for component 'j' of the tariff class in year t-1

$q_t^j$  is the forecast quantity of component 'j' of the tariff class in year t

$\Delta CPI_t$  is the annual percentage change in the Australian Bureau of Statistics (ABS) CPI All Groups, Weighted Average of Eight Capital Cities from December in year t-2 to December in year t-1.

$X_t$  the smoothing factor determined in accordance with the PTRM as approved in the AER's final decision, and annually revised for the return on debt update in accordance with the formula specified in the return on debt appendix I calculated for the relevant year. If  $X > 0$ , then X will be set equal to zero for the purposes of the side constraint formula

$S_t$  is the STPIS factor sum of the raw s-factors for all reliability of supply and customer service parameters (as applicable) to be applied in year t.<sup>57</sup>

$I_t$  is the final carryover amount from the application of the DMIS from the 2010–15 distribution determination. This amount will be deducted from/added to allowed revenue in the 2016-17 pricing proposal.

$B_t$  is any under or over-recoveries relating to capital contributions and shared assets from 2013-2014 and 2014-2015

$C_t$  is the sum of adjustments related to:

- feed-in tariff cost pass through amounts relating to 2013-2014 and 2014-2015
- amounts relating to the occurrence of any of the prescribed and nominated cost pass through events.

$DUoS_t$  is an annual adjustment factor related to the balance of the DUoS unders and overs account with respect to regulatory year t

With the exception of the CPI and X factors, the percentage for each of the other factors above can be calculated by dividing the incremental revenues (as used in the total annual revenue formula) for each factor by the expected revenues for regulatory year t-1 (based on the prices in year t-1 multiplied by the forecast quantities for year t).

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<sup>57</sup> In the formulas in the STPIS attachment, the  $AR_{t+1}$  is equivalent to  $AR_t$  in this formula. Calculations of the S factor adjustment are to be made accordingly.

## A DUoS unders and overs account

To demonstrate compliance with its distribution determination in the 2015–20 regulatory control period, Ergon Energy must maintain a DUoS unders and overs account in its annual pricing proposal under clause 6.18.2(b)(7) of the NER.

Ergon Energy must provide the amounts for the following entries in their DUoS unders and overs account for the most recently completed regulatory year (t–2) and the next regulatory year (t):

1. opening balance for year t–2 and year t
2. an interest charge for two years on the opening balance in year t–2. This adjustment should be calculated using the approved nominal weighted average cost of capital (WACC). No such charge applies to the opening balance for year t
3. the amount of revenue recovered from DUoS charges in respect of that year, less any under/over adjustment approved by the regulator for year t–2 (in relation to year t–4), less the total annual revenue for the year in question
4. an interest charge for two years related to the net amount in item 3 for year t–2. This adjustment should be calculated using the approved nominal WACC. No such charge applies to the net amount in item 2 for year t
5. the total of items 1–4 to derive the closing balance for each year.

Ergon Energy must provide details of calculations in the format set out in Table 14.1. Amounts provided for the most recently completed regulatory year (t–2) must be audited. Amounts for the next regulatory year (t) will be regarded as a forecast.

In proposing variations to the amount and structure of DUoS charges, Ergon Energy is to achieve an expected zero balance on its DUoS unders and overs accounts at the end of each regulatory year in the next regulatory control period.

The proposed prices for year t are based on the sum of the total annual revenue for year t plus any adjustment for DUoS under or over recoveries.

**Table 14.1 Example calculation of DUoS unders and overs account (\$000, nominal)**

	Year t–2 (actual)	Year t (forecast)
Revenue from DUoS charges	1,332,656	1,838,309
Less TAR for the relevant year	1,366,900	1,750,770
Allowed revenues (AR <sub>t</sub> )	1,362,301	1,573,963
Incentive scheme adjustments(I <sub>t</sub> )	(13,528)	31,479

	Year t-2 (actual)	Year t (forecast)
DUOS under/over adjustment approved by the regulator for year t-2 (Bt)	49,358	61,308
Transitional under/over adjustments (capital contributions and shared assets) (Bt)	21,043	n/a
Approved pass throughs and other adjustments (Ct)	(52,274)	84,020
Actual under/over recovery year t-2 (proposed under/over adjustment in year t)	(34,244)	87,539
<b>DUOS Unders and Overs Account</b>		
Nominal WACC for year t-2	9.72%	
Nominal WACC for year t-1	9.72%	
Opening balance	(91,033)	(141,106)
Interest on opening balance for 1 regulatory year	(8,848)	na
Actual under/over recovery in year t-2 (proposed under/over adjustment in year t)	(34,244)	87,539
Interest on under/over recovery for 2 regulatory years	(6,981)	Na
<b>Closing Balance</b>	<b>(141,106)</b>	<b>(53,567)</b>

## B Unders and over account for designated pricing proposal charges

To demonstrate compliance with its distribution determination in the 2015–20 regulatory control period, Ergon Energy must maintain an unders and overs account for designated pricing proposal charges in its annual pricing proposal under clause 6.18.2(b)(6).

Ergon Energy must provide the amounts for the following entries in its unders and overs account for designated pricing proposal charges for the most recently completed regulatory year (t–2) and the next regulatory year (t):

1. the opening balance for each year. The opening balance for year t–2 should be zero
2. the amount of revenue recovered from designated pricing proposal charges applied in respect of that year, less any under/over adjustment approved by the regulator for year t–2 (in relation to year t–4), less the amounts of all transmission related payments made by Ergon Energy.
3. an interest charge for two years related to the net amount in item 2 for year t–2. This adjustment should be calculated using the approved nominal weighted average cost of capital (WACC). No such adjustment applies to the net amount in item 2 for year t.
4. the total of items 1–3 to derive the closing balance for each year.

Ergon Energy must provide details of calculations in the format set out in Table 14.2 of this decision. Amounts provided for the most recently completed regulatory year (t–2) must be audited. Amounts for the next regulatory year (t) will be regarded as forecasts.

In proposing variations to the amount and structure of designated pricing proposal charges for a given regulatory year t, the Ergon Energy is to achieve a zero expected balance on its unders and overs account for designated pricing proposal charges at the end of each of the forecast years in the 2015–20 regulatory control period.

**Table 14.2 Example calculation of unders and overs account for designated pricing proposal charges (\$000, nominal)**

	Year t–2 (actual)	Year t (forecast)
Revenue from designated pricing proposal charges	296,021	337,688
Less under/over adjustment approved by the regulator for year t-2	(3,717) <sup>a</sup>	n/a
Less total transmission related payments	304,685	331,732

	Year t-2 (actual)	Year t (forecast)
Transmission charges to be paid to TNSPs	298,764	322,768
Payment to other DNSPs	2,692	4,749
<b>Under/over recovery for the regulatory year</b>	<b>(4,947)</b>	<b>5,956</b>
<b>Unders and Overs Account</b>		
Nominal WACC for year t-2	9.72%	n/a
Nominal WACC for year t-1	9.72%	n/a
Opening balance	0	(5,956)
Under/over recovery in year t-2	(4,947)	5,956
Interest on under/over recovery for year t-2	(1,009)	n/a
<b>Closing Balance</b>	<b>(5,956)</b>	<b>0</b>

- (a) In this example, the regulator agreed that the distributor could under recover its revenues by \$3.7 million in year t-2 due to over recoveries in year t-4.

## C Reporting on recovery of jurisdictional schemes

To demonstrate compliance with its distribution determination in the 2015–20 regulatory control period, Ergon Energy must maintain a jurisdictional scheme unders and overs account in its annual pricing proposal under clause 6.18.2(b)(6A) of the NER.

Ergon Energy must provide the amounts for the following entries in their jurisdictional schemes unders and overs account for the most recently completed regulatory year (t–2) and the next regulatory year (t):

1. opening balance for year t–2 and year t
2. an interest charge for two years on the opening balance in year t–2. This adjustment should be calculated using the approved nominal weighted average cost of capital (WACC). No such charge applies to the opening balance for year t
3. the amount of revenue recovered from jurisdictional charges in respect of that year, less the amounts of all jurisdictional scheme related payments made by Ergon Energy in respect of that year
4. an interest charge for two years related to the net amount in item 3 for year t–2. This adjustment should be calculated using the approved nominal WACC. No such charge applies to the net amount in item 3 for year t
5. the total of items 1–4 to derive the closing balance for each year.

Ergon Energy must provide details of calculations in the format set out in Table 14.3. Amounts provided for the most recently completed regulatory year (t–2) must be audited. Amounts for the next regulatory year (t) will be regarded as a forecast.

In proposing variations to the amount and structure of jurisdictional schemes charges for a given regulatory year t, Ergon Energy is to achieve an expected zero balance on its jurisdictional schemes unders and overs accounts at the end of each regulatory year in the next regulatory control period.

**Table 14.3 Example calculation of jurisdictional schemes unders and overs account (\$000, nominal)**

	Year t–2 (actual)	Year t (forecast)
Revenue from Jurisdictional charges	296,021	337,688
Less under/over adjustment approved by the regulator for year t-2	(3,717) <sup>a</sup>	n/a
Less total jurisdictional related payments	304,685	331,732
Under/over recovery for the regulatory year	(4,947)	5,956



	Year t-2 (actual)	Year t (forecast)
<b>Jurisdictional Schemes Unders and Overs Account</b>		
Nominal WACC for year t-2	9.72%	n/a
Nominal WACC for year t-1	9.72%	n/a
Opening balance	0	(5,956)
Interest on opening balance	0	n/a
Under/over recovery in year t-2	(4,947)	5,956
Interest on under/over recovery for year t-2	(1,009)	n/a
<b>Closing Balance</b>	<b>(5,956)</b>	<b>0</b>

- (a) In this example, the regulator agreed that the distributor could under recover its revenues by \$3.7 million in year t-2 due to over recoveries in year t-4.

## D Assigning retail customers to tariff classes

We are required to decide on the principles governing assignment or reassignment of retail customers to or between tariff classes.<sup>58</sup> There is no requirement on Ergon Energy to propose such procedures and consequently we must develop the required procedure.

### D.1 AER's approach

We apply the principles set out in clause 6.18.4(a) of the NER when formulating the provisions which Ergon Energy must apply with assignment or re-assigning retail customers to tariff classes. A distributor's decision to assign a retail customer to a particular tariff class or to re-assign a retail customer from one tariff class to another should be subject to an effective system of assessment and review.<sup>59</sup>

### D.2 Reasons for preliminary decision

The following procedures governing assignment or reassignment of retail customers to tariff classes will apply for Ergon Energy. Its regulatory proposal did contain an effective system of assessment and review<sup>60</sup> when it decides to assign a customer to a particular tariff class, or to re-assign a customer from one tariff class to another.<sup>61</sup> However, Ergon Energy's network tariff guide for standard control services does not contain complete procedures governing assignment or reassignment of retail customers to or between tariff classes.<sup>62</sup>

We consider that an effective internal review system should clearly set out the process of escalation, and the review system should be visible and transparent to users. A well-documented and transparent system is necessary for an effective system of review.

An effective system of assessment and review under clause 6.18.4(a)(4) may, apart from providing for internal review, also include an effective external system of review as the next step in the process of escalation. The assignment or reassignment of a customer to a tariff class has a direct impact on the price the customer will be charged for direct control services. Customers dissatisfied by a decision of the internal review process should have access to an external review body. In our last decision for

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<sup>58</sup> NER, cl 6.12.1(17).

<sup>59</sup> NER, cl 6.18.4(a)(4)

<sup>60</sup> In accordance with NER, clause 6.18.4(a)(4)

<sup>61</sup> Ergon Energy, *Regulatory proposal 2015–20*, October 2014, p. 36; Ergon Energy, *Information guide for standard control services pricing 2014–15*, June 2014.

<sup>62</sup> It does not contain an external review body, the Queensland Water and Energy Ombudsman, for small retail customers in the event of a dispute; [https://www.ergon.com.au/\\_\\_data/assets/pdf\\_file/0005/209606/Network-tariff-guide-for-SCS.pdf](https://www.ergon.com.au/__data/assets/pdf_file/0005/209606/Network-tariff-guide-for-SCS.pdf).

Queensland distribution determinations we recognised the Queensland Water and Energy Ombudsman as the external review body for small retail customers.<sup>63</sup>

In the event of a dispute between a distributor and a customer about assignment or reassignment of a customer to a tariff class, the dispute may be able to be referred us in accordance with Part 10 of the NEL and clause 6.22.1 of the NER.<sup>64</sup> We have included in Ergon Energy’s procedure for assigning customers to tariff classes a requirement that the distributor must inform customers of the availability of the dispute resolution mechanism under Part 10 of the NEL.

### **D.3 Procedures for assigning or reassigning retail customers to tariff classes**

The procedures outlined in this section apply to all direct control services.

#### **Assignment of existing retail customers to tariff classes at the commencement of the forthcoming regulatory control period**

1. Ergon Energy’s retail customers will be taken to be “assigned” to the tariff class which Ergon Energy was charging that retail customer immediately prior to 1 July 2015 if:
  - they were an Ergon Energy retail customer prior to 1 July 2015; and
  - they continue to be a retail customer of Ergon Energy as at 1 July 2015.

#### **Assignment of new retail customers to a tariff class during the forthcoming regulatory control period**

2. If, after 1 July 2015, Ergon Energy becomes aware that a person will become a retail customer of Ergon Energy, then Ergon Energy must determine the tariff class to which the new retail customer will be assigned.
3. In determining the tariff class to which a retail customer or potential retail customer will be assigned, or reassigned, in accordance with paragraphs 2 or 5 of this section, Ergon Energy must take into account one or more of the following factors:<sup>65</sup>
  - a. the nature and extent of the retail customer’s usage

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<sup>63</sup> AER, *Final decision: Queensland distribution determination 2010–11 to 2014–15*, May 2010, p. 389.

<sup>64</sup> Under Part 10 of the NEL, the AER has the function of resolving an access dispute between a network service user or prospective network user and a network service provider. An access dispute is a dispute about an aspect of access to an electricity network service that is specified under the NER to be an aspect about which the dispute resolution provisions in Part 10 of the NEL apply. Clause 6.22.1 in the NER relevantly provides that an access dispute for the purposes of Part 10 of the NEL includes a dispute between a DNSP and a Service Applicant about the terms and conditions of access to a direct control service.

<sup>65</sup> NER, Clause 6.18.4(a)(i).

- b. the nature of the retail customer's connection to the network<sup>66</sup>
  - c. whether remotely-read interval metering or other similar metering technology has been installed at the retail customer's premises as a result of a regulatory obligation or requirement.
4. In addition to the requirements of paragraph 3 above, Ergon Energy, when assigning or reassigning a retail customer to a tariff class, must ensure:
    - a. retail customers with similar connection and usage profiles are treated equally<sup>67</sup>
    - b. retail customers who have micro-generation facilities are not treated less favourably than retail customers with similar load profiles without such facilities.<sup>68</sup>

### **Reassignment of existing retail customers to another existing or a new tariff during the next regulatory control period**

5. Ergon Energy may reassign a retail customer to another tariff class if the existing retail customer's load characteristics or connection characteristics (or both) have changed such that it is no longer appropriate for that retail customer to be assigned to the tariff class to which the retail customer is currently assigned or a retail customer no longer has the same or materially similar load or connection characteristics as other retail customers on the retail customer's existing tariff class, then it may reassign that retail customer to another tariff class. In determining the tariff class to which a retail customer will be reassigned, Ergon Energy must take into account paragraphs 3 and 4 above.

### **Objections to proposed assignments and reassignments**

6. Ergon Energy must notify a customer's retailer in writing of the tariff class to which the customer's retailer has been assigned or reassigned, prior to the assignment or reassignment occurring.
7. A notice under paragraph 6 above must include advice informing the customer's retailer that they may request further information from Ergon Energy and that the customer's retailer may object to the proposed reassignment. This notice must specifically include:
  - a. a written document describing Ergon Energy's internal procedures for reviewing objections, if the customer's retailer provides express consent, a soft copy of such information may be provided via email
  - b. that if the objection is not resolved to the satisfaction of the customer's retailer under Ergon Energy's internal review system within a reasonable timeframe, then, to the extent resolution of such disputes are within the jurisdiction of the

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<sup>66</sup> The AER interprets 'nature' to include the installation of any technology capable of supporting time based tariffs.

<sup>67</sup> NER, cl 6.18.4(2).

<sup>68</sup> NER, cl 6.18.4(3).

Energy and Water Ombudsman or like officer, the customer's retailer is entitled to escalate the matter to such a body

- c. that if the objection is not resolved to the satisfaction of the customer's retailer under Ergon Energy's internal review system and the body noted in clause 7.b. above, then the customer's retailer is entitled to seek a decision of the AER via the dispute resolution process available under Part 10 of the NEL.
8. If, in response to a notice issued in accordance with paragraph 7 above, Ergon Energy receives a request for further information from a customer's retailer, then it must provide such information within a reasonable timeframe. If Ergon Energy reasonably claims confidentiality over any of the information requested by the customer's retailer, then it is not required to provide that information to the customer's retailer. If the customer's retailer disagrees with such confidentiality claims, he or she may have resort to the dispute resolution procedures referred to in section 7 above, (as modified for a confidentiality dispute).
9. If, in response to a notice issued in accordance with paragraph 7 above, a customer's retailer makes an objection to Ergon Energy about the proposed assignment or reassignment, Ergon Energy must reconsider the proposed assignment or reassignment. In doing so Ergon Energy must take into consideration the factors in paragraphs 3 and 4 above, and notify the customer's retailer in writing of its decision and the reasons for that decision.
10. If a customer's retailer's objection to a tariff class assignment or reassignment is upheld by the relevant body noted in paragraph 7 b and c above, then any adjustment which needs to be made to tariffs will be done by Ergon Energy as part of the next annual review of prices.
11. If a customer's retailer objects to Ergon Energy's tariff class assignment Ergon Energy must provide the information set out in paragraph 7 above and adopt and comply with the arrangements set out in paragraphs 8, 9 and 10 above in respect of requests for further information by the customer's retailer and resolution of the objection.

## **System of assessment and review of the basis on which a retail customer is charged**

12. Where the charging parameters for a particular tariff result in a basis of charge varies according to the retail customer's usage or load profile, Ergon Energy must set out in its annual pricing proposal a method by which it will review and assess the basis on which a retail customer is charged.