FINAL DECISION

AusNet Services, CitiPower, Jemena, Powercor and United Energy
Six-month extension - variation decision

Attachment A – Control mechanism formulae

October 2020

AUSTRALIAN ENERGY REGULATOR

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: 1300 585 165
Email: VIC2021-26@aer.gov.au

Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to for the six-month extension period to the 2016–20 regulatory control period. It should be read with all other parts of the final decision.

This final decision includes the following attachments:

AusNet Services, CitiPower, Jemena, Powercor and United Energy - Final variation decision

Attachment A – Control mechanism formulae

Attachment B – Rate of Return (Confidential)

Contents

A Control mechanism formulae

Control mechanisms impose limits over the prices of direct control services (standard and alternative control services) and/or the revenues that a distribution network service provider can recover from customers for these services. Our 2016–20 final decision set out both the form of the control mechanisms to apply to different services, and the formulae to give effect to these control mechanisms.

As set out in the Final variation decision document for each distributor, our decision is to maintain these forms of control into the six-month extension period.

Our decision for the six-month extension period is to alter the control mechanism formulae (including simplification of the formulae) to apply to the six-month extension period.

A.1 Final decision

For revenue-capped services (standard control services and type 5 and 6 (incl. smart metering) services), our decision is to set the revenue requirements with no further adjustments to be made in the annual pricing process. The side-constraints mechanisms to apply will be adjusted to reflect these simplifications.

For price-capped alternative control services, our decision is to make some adjustments to simplify the control mechanism formulae where relevant. The approach for each type of service is detailed below.

This approach was developed in consultation with the Victorian distributors and reflects a pragmatic approach to the control mechanism formulae and how they will be applied for the six-month extension. See Section 2.12 of the Final variation decision for each distributor.

A.1.1 Revenue-capped services

Our decision is to set the revenue requirements for the six-month extension period for both standard control services and type 5 and 6 (incl. smart metering) services with no further adjustments to be made in the annual pricing process. That is, no adjustments for incentive schemes (e.g. service target performance incentive scheme), prior year under or over-recoveries or cost pass-throughs.

Figure 1 sets out the revenue cap for standard control services, and Figure 2 sets out the revenue cap for type 5 and 6 (incl. smart metering) services.

Figure 1 Standard control services revenue cap formula

1. $$TAR_t \geq \sum_{i=1}^{n} \sum_{j=1}^{m} p_t^{ij} q_t^{ij}$$ i = 1,…,n and j = 1,…,m and t = 6

2. $TAR_t = AR_t$ t = 6

where:

TAR_t is the total allowable revenue in year t.

p_t^{ij} is the price of component 'j' of tariff 'i' in year t.

q_t^{ij} is the forecast quantity of component 'j' of tariff 'i' in year t.

t is the regulatory year. For the 6-month extension period, the regulatory year t=6 is the period 1 January to 30 June 2021.

AR_t is the annual smoothed revenue requirement in the Post Tax Revenue Model (PTRM) for year t=6, being the 6-month extension period.

Figure 2 Type 5 and 6 (incl. smart metering) services revenue cap formulae

1. $TARM_t \geq \sum_{i=1}^{n} \sum_{j=1}^{m} p_t^{ij} q_t^{ij}$ i = 1,…,n and j = 1,…,m and t = 6

2. $TARM_t = AR_t$ t = 6

where:

$TARM_t$ is the total allowable revenue for metering in year t.

p_t^{ij} is the price of component 'j' of tariff 'i' in year t.

q_t^{ij} is the forecast quantity of component 'j' of tariff 'i' in year t.

t is the regulatory year. For the 6-month extension period, the regulatory year t=6 is the period 1 January to 30 June 2021.

AR_t is the annual smoothed revenue requirement for metering in the Metering PTRM for year t=6 (the 6-month extension period).

The side constraints mechanism (which operates to limit movements in tariffs) will be adjusted to reflect these simplifications, while retaining the CPI-X plus 2 per cent

structure in accordance with the National Electricity Rules (NER).[1] Figure 3 sets out the adjusted side constraints formula to apply to both standard control services and type 5 and 6 (incl. smart metering) services.[2]

Figure 3 Side constraints formula

$$\frac{\left(\sum_{i=1}^{n}\sum_{j=1}^{m} p_t^{ij} q_t^{ij}\right)}{\left(\sum_{i=1}^{n}\sum_{j=1}^{m} p_{t-1}^{ij} q_t^{ij}\right)} \leq (1 + \Delta CPI_t) \times (1 + 2\%)$$

t = 6

where each tariff class has "n" tariffs, with each up to "m" components, and where:

p_t^{ij} is the proposed price for component ‘j’ of tariff 'i' for year t.

p_{t-1}^{ij} is the price charged for component ‘j’ of tariff 'i' in year t–1.

q_t^{ij} is the forecast quantity of component ‘j’ of tariff 'i' in year t.

ΔCPI_t is the annual percentage change in the Australian Bureau of Statistics (ABS) Consumer price index (CPI) All Groups, Weighted Average of Eight Capital Cities[3] from the June quarter in year t–2 to the June quarter in year t–1, calculated using the following method:

The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the June quarter in regulatory year t–1

divided by

The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the June quarter in regulatory year t–2

minus one.

For example, for the 2021 6-month extension period, year t–2 is the June quarter 2019 and year t–1 is the June quarter 2020.

A.1.2 Price-capped services

1 NER, cl. 6.18.6(c).

2 For type 5 and 6 (incl. smart metering) services, tariff classes do not apply like in standard control services. Therefore the movement in revenues of each individual price will be measured against the permissible percentage for compliance against the side constraint mechanism.

3 If the ABS does not or ceases to publish the index, then CPI will mean an index which the AER considers is the best available alternative index.

Our decision is to simplify some of the price control formulae for price-capped alternative control services relative to our 2016–20 determination. Reasoning for our approach to each price-capped service is provided in Section A.1.2.2 below.

A.1.2.1 Formulae

Figure 4, Figure 5, and Figure 6 set out the price control formulae for calculating price caps for specific alternative control services.

Figure 4 Metering exit fees and public lighting services price cap formula

$$\bar{p}_t^i \leq \bar{p}_{t-1}^i \qquad t = 6$$

where:

$\bar{p}_t^i$ is the cap on the price of service i in year t.

$\bar{p}_{t-1}^i$ is the cap on the price of service i in year t–1.

t is the regulatory year. For the six-month extension period, the regulatory year t=6 is the period 1 January to 30 June 2021.

Figure 5 Ancillary network services price cap formula

$$\bar{p}_t^i \leq \bar{p}_{t-1}^i(1 + \Delta CPI_t)(1 - X_t) \qquad t = 6$$

where:

$\bar{p}_t^i$ is the cap on the price of service i in year t.

$\bar{p}_{t-1}^i$ is the cap on the price of service i in year t–1.

t is the regulatory year. For the six-month extension period, the regulatory year t=6 is the period 1 January to 30 June 2021.

ΔCPI_t is the annual percentage change in the ABS CPI All Groups, Weighted Average of Eight Capital Cities[4] from the June quarter in year t–2 to the June quarter in year t–1, calculated using the following method:

The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the June quarter in regulatory year t–1

[4] If the ABS does not or ceases to publish the index, then CPI will mean an index which the AER considers is the best available alternative index.

divided by

The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the June quarter in regulatory year t–2

minus one.

For example, for the 2021 six-month extension period, year t–2 is the June quarter 2019 and year t–1 is the June quarter 2020.

X_t^i is the X-factor for service i in year t. The value of this factor the 6-month extension period, regulatory year t=6, is as specified in Section A.1.2.2 below.

Figure 6 Type 7 metering services price cap formula

$$\bar{p}_t^i \leq \bar{p}_{t-1}^i(1 + \Delta CPI_t) \qquad t = 6$$

where:

$\bar{p}_t^i$ is the cap on the price of service i in year t.

$\bar{p}_{t-1}^i$ is the cap on the price of service i in year t–1.

t is the regulatory year. For the 6-month extension period, the regulatory year t=6 is the period 1 January to 30 June 2021.

ΔCPI_t is the annual percentage change in the ABS CPI All Groups, Weighted Average of Eight Capital Cities[5] from the June quarter in year t–2 to the June quarter in year t–1, calculated using the following method:

The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the June quarter in regulatory year t–1

divided by

The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the June quarter in regulatory year t–2

minus one.

For example, for the 2021 six-month extension, year t–2 is the June quarter 2019 and year t–1 is the June quarter 2020.

A.1.2.2 Reasons for our decision

[5] If the ABS does not or ceases to publish the index, then CPI will mean an index which the AER considers is the best available alternative index.

Our proposed price cap control mechanism formulae for the six-month extension period were provided to the Victorian distributors in December 2019. The distributors have broadly accepted the proposed approach and we have not had stakeholder submissions suggesting changes to the approach for price-capped alternative control services. In August 2020 we published a document setting out the indicative control mechanism formulae, along with letters to the distributors setting out our position on the distribution determinations for the six-month period.[6]

The simplified price cap control mechanism formulae were arrived at through an assessment of the likely movements in key parameters (for instance, cost of capital and inflation outcomes). As is usual with forecasts, the actual figures have differed from the assumptions. In particular, the COVID-19 pandemic and its economic effects have led to some larger divergences from these assumptions.

In considering whether we should retain the approach set out in December 2019, we had regard to various factors, including: the materiality of the expected impact of a change in approach on the price of these services; the burden that a revised approach would likely place on distributors; and the absence of suggestions from stakeholders that we should alter the proposed approach.

We considered that a change in approach would likely have a non-material impact on the price of services. More generally, while the divergence between forecasts and actual outcomes had different effects on different services, we expect that the impact of adjusting our proposed approach to likely alternatives approaches would have broadly balanced impacts between consumers and the Victorian distributors. We also considered that a change in approach at the late stage at which the relevant data became available would likely place additional regulatory burden on distributors that, in the absence of stakeholder concerns, and noting the likely materiality, was difficult to justify. As such, we considered that maintaining the proposed control mechanism formulae was the appropriate course of action.

Metering exit fees and public lighting charges include capital components. The capital components of these charges are influenced by the weighted average cost of capital (WACC). When developing the proposed control mechanisms for these services we considered that the reduction in the WACC resulting from the adoption of the 2018 rate of return instrument would be generally offset by the escalation for inflation. We therefore removed the CPI and X-factor adjustments from the price control formulae for metering exit fees for simplicity in this final decision.

For ancillary network services, we generally escalate price caps by CPI and an X-factor that reflects forecast real labour cost growth. We consider that this approach remains appropriate for the 6-month extension period.

---

[6] These documents are available the 'AER position' and 'Updates' pages on the AER's website relating to each distributor's 2021-26 determination.

Our 2019 advice proposed that the X-factor applied to ancillary network services for the six-month extension period would be calculated in line with the approach to calculating labour escalation forecasts for our draft decision for the new regulatory control period. We further noted that the X-factor calculation should reflect half of the forecast yearly change in the State utilities sector real wages for Victoria for 2021–22. We consider that the reference to 2021–22 represents an error, and should have referred to the 2020–21 year. However, we found that to correct this error would result in an immaterial difference, and have retained the position in our advice for simplicity. Therefore the X-factor to apply for ancillary network services for the six-month extension period is -0.1193 per cent. This X-factor has been calculated in line with the approach taken to calculating X-factors in our draft decision for the 2021–26 regulatory control period.[7] The X-factor applicable to the six-month extension period (regulatory year t=6) reflects a six-month adjustment, rather than the 12-month adjustment typically applied to a 12-month regulatory year.

For type 7 metering services, we have maintained the CPI escalation that would usually be applied. Type 7 metering services do not include any X-factor escalation.

We have removed the general adjustment factor from all price-capped services, as we do not consider any pass-throughs or other adjustments should apply for the six-month extension period. Any pass-throughs or other adjustments that may arise for the six–month extension period will be delayed until the 2021–26 period for simplicity.

The price caps to apply to these alternative control services will be set in the annual pricing process for the six-month extension period.

[7] Consistent with the approach taken in our 2021-26 draft decision, these labour growth forecasts have been adjusted to account for the legislated increase in the superannuation guarantee. For more details, see Attachment 6 of our 2021-26 draft decision.

Shortened forms

Shortened form	Extended form
ABS	Australian Bureau of Statistics
AER	Australian Energy Regulator
CPI	consumer price index
distributor	distribution network service provider
F&A	framework and approach
NER	National Electricity Rules
WACC	weighted average cost of capital