Matters relevant to distribution determinations for NSW and ACT DNSPs for 2009-2014

ActewAGL response to AER Issues Paper

Demand management incentive scheme
Control mechanism for alternative control services
Materiality for pass-through events

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1. Introduction

ActewAGL welcomes the opportunity to respond to the matters raised in the *Issues Paper*. In the limited time available before regulatory proposals for the ACT and NSW reviews must be submitted ActewAGL is keen to continue working with the Australian Energy Regulator (AER) to address all outstanding issues and clarify the AER's requirements.

Comments on each of the three matters covered in the *Issues Paper* – demand management incentives schemes, control mechanisms for alternative control services and materiality for pass-through – are set out in the following chapters of this submission. An overview is provided in the section below. In addition to the specific comments set out in the submission, we would like to make some general comments on the approach taken by the AER in developing these guidelines.

ActewAGL appreciates that the approach to the ACT and NSW guidelines is shaped very much by time constraints. With the new chapter 6 and transitional chapter 6 of the National Electricity Rules not expected to take effect until 1 January 2008, there is not sufficient time before the ACT and NSW businesses must submit their full regulatory proposals in June 2008 for a full review of the matters to be covered by the guidelines. The AER has indicated in the *Issues Paper* (p. 6) that, unless there is sufficient time to consider and implement changes to existing arrangements or clear reasons to change, it will generally consider maintaining the current approaches taken by the ICRC and IPART. ActewAGL supports this pragmatic approach.

A further implication of the late finalisation of the revised Rules is that the guidelines for the ACT and NSW reviews will be finalised before the general guidelines. The AER notes (p. 8) that if differences arise between the general guidelines and the transitional guidelines, then it is possible to amend the transitional guidelines after the general guidelines are finalised. ActewAGL appreciates that some flexibility to fine-tune the transitional arrangements is important. However, in the interests of providing as much certainty as possible for the ACT and NSW businesses, we urge that changes to the transitional guidelines be minimised and only made in consultation and agreement with the affected businesses.

Overview of ActewAGL's responses

Demand management incentive scheme

- ActewAGL agrees that a D-factor scheme, as currently in place in NSW, is not appropriate for the ACT given its form of regulation and should not be introduced in the ACT.
- ActewAGL supports the AER's proposal to further consider the appropriateness of introducing a new scheme based on an existing scheme, such as a learning-by-doing fund, to further encourage demand management initiatives.

- The approach to demand management incentive schemes will need to be reviewed as the policy framework evolves. For example, outcomes of the Australian Energy Market Commission (AEMC) review of demand side participation in the national electricity market will need to be addressed, as will the implications of any further policy initiatives to manage or constrain demand and energy use to address, say, climate change or other environmental concerns.

Control mechanism for alternative control services

- ActewAGL supports the AER's intention to consider continuing the existing form of regulation for alternative control (previously excluded) services in the ACT.
- We believe that the total revenue cap, escalated annually by CPI, is appropriate. The cap arrangement will also need to recognise the existing regulatory position whereby ActewAGL is allowed to recover the additional costs associated with meeting the requirement that interval meters be installed in the ACT whenever a new or replacement meter is provided or a customer requests an interval meter.
- The revenue cap should be set on the basis of a limited building block approach, taking as a starting point the metering assets identified by the ICRC in the 2004 determination.
- New requirements to install smart meters would significantly increase metering costs, although the magnitude of the costs cannot be determined until the requirements are finalised. ActewAGL therefore proposes that the AER's determination for alternative control services acknowledge that the additional costs, when known, would be fully recovered.

Materiality threshold for pass through events

- ActewAGL believes that the AER should consider 'no threshold' as one of its options.
- We recognise that there will be benefits from setting a threshold, including greater up-front certainty about what will be regarded as 'material', and avoiding small claims where the transaction costs may be higher than the value of the claim.
- However, setting the appropriate threshold is difficult, as the range of options and questions listed by the AER indicates, and there is a risk that an inappropriate threshold could create efficiency costs – for example by distorting the timing of expenditure, or by failing to allow the business to recover legitimate and efficient costs.
- We note that the transitional Rules (6.6.1(j)) contain checks against inefficient claims – for example by requiring the AER to take account of the efficiency of the provider's decisions and actions in relation to a positive change event. We therefore believe that there is not a strong need for a threshold to prevent a 'cost-plus' form a regulation (*Issues Paper* p. 34).
- If the AER decides that a materiality threshold is to apply, there are many possible approaches to the design, each with some advantages and shortcomings. ActewAGL suggests that the AER adopt a flexible approach. Instead of trying to define a single

threshold to apply to all types of pass through events and all DNSPs, it may be appropriate to have a number of possible thresholds. If at least one of the thresholds is met, then the claim can be considered material.

- This flexible approach of setting out alternate ways in which the materiality requirement may be satisfied is consistent with the purpose of guidelines, which is to provide guidance to DNSPs rather than provide a definitive and binding statement on the AER's approach.

2. Demand management incentive scheme

2.1 Current ACT arrangements

There is currently no demand management incentive scheme in the ACT. The ICRC concluded in its 2004 final determination (p. 108) that pricing remains the main tool by which ActewAGL is best able to manage demand on its network.

ActewAGL has voluntarily implemented a wide range of pricing and other demand management initiatives during the current regulatory period to respond to its commercial requirement to continually improve its management and operation of the network. Examples include:

- Introduction of demand tariffs based on the kVA (instead of kWh) which provide cost incentives for customers with poor power factor to improve power factor and/or to reduce demand;
- Removal of the demand limits for HV and LV demand tariffs for customers to qualify for the demand charges;
- Change in the balance between the energy component of the demand tariff and the demand component to provide stronger price signals in relation to demand;
- Load balancing of the zone substation transformers to reduce network losses;
- Removal of 185mm AL 11 kV PILC cables for the standard equipment resulting in reduction of network losses. Use of larger cables, resulting in loss reduction;
- Setting the power factor limit in the ActewAGL Service and Installation Rules at 0.9 (previously 0.8).

2.2 The AER's options and initial position for the ACT

The AER has raised three demand management incentive scheme options for the ACT:

- Introduce the same D-factor scheme as currently applies in NSW;
- Introduce a scheme based on an existing demand management model, such as a learning-by-doing fund;
- Not introduce a scheme.

While the AER does not consider a D-factor to be an appropriate model to apply in the ACT, it proposes to further consider the appropriateness of a learning-by-doing fund to encourage demand management in the ACT.

2.3 ActewAGL response

ActewAGL agrees with the AER's view that a D-factor scheme as applied in NSW should not be adopted for the ACT. As the AER notes, the different form of regulation in the ACT (which does not discourage shifting load away from peak periods), different network characteristics, and the use of price signals as demand management tools mean that the D-factor scheme as developed for NSW is neither warranted nor appropriate.

ActewAGL supports the AER's proposal to further examine the option of introducing a scheme based on an existing demand management model such as a learning-by-doing fund. In the limited time available to develop a scheme for the ACT (any new scheme must be published before 1 March 2008), an existing scheme is an appropriate starting point.

In basing a new scheme on an existing scheme, it is important to recognise that the existing schemes, in South Australia and Victoria, were developed to address specific constraints, issues and circumstances. Different issues and circumstances in the ACT should be reflected in the objectives and design of any scheme introduced for the ACT.

A learning-by-doing type scheme for the ACT would need to incorporate:

- a clear objective or set of objectives;
- guidelines for project eligibility – including an indication of whether the scheme covers both demand management and energy efficiency initiatives;
- a clear set of procedures and timelines for applications, assessment and approval – ensuring that there can be certainty about funding before a project begins;
- clear criteria for assessing applications – recognising that many projects will involve a flow of costs and benefits over the long term;
- funding linked to the life of eligible projects, not constrained by the length of the regulatory review period; and
- a process for reviewing performance of projects funded under the scheme.

While time constraints mean that a relatively simple scheme based on an existing model is the only reasonable option for consideration by the AER at this stage, ActewAGL believes that further incentive options may need to be considered in the future as the policy setting evolves. For example, outcomes of the AEMC review of the role of demand side participation in the national electricity market will need to be addressed, as will the implications of any further policy initiatives to manage or constrain load to address, say, climate change or other environmental concerns.

3. Control mechanisms for alternative control services

3.1 Current ACT arrangements

ActewAGL's services that were defined as *excluded services* under the ICRC's 2004 determination will be classified as alternative control services for the 2009-2014 determination. These services comprise the provision and servicing of meters for customers consuming fewer than 160 megawatt hours per annum (types 5-7 meters), including:

- Meter testing
- Meter reading
- Meter checking
- Processing meter data
- Provision of non-standard meters.

As the AER explains in the *Issues Paper*, excluded services in the ACT are currently subject to a total revenue cap which is escalated annually by CPI.

An additional element of the current mechanism for excluded services (not noted in the *Issues Paper*) is the treatment of the additional costs of interval meters installed to comply with the ICRC's 2005 decision on metrology procedures. ActewAGL recovers the additional cost of installing the interval meters in the previous calendar year in the metering charges for the next financial year.

3.2 The AER's considerations

The AER intends to consider continuing the existing form of regulation applied to excluded services in the ACT.

The AER explains (p. 26) that under such an approach ActewAGL would propose a revenue cap based on a limited building block analysis, with maximum allowable revenues to be escalated each year by CPI. Consistent with the approach taken in the current regulatory period, the revenue cap would be established based on the rolled-forward value of the relevant metering assets, and analysis of the build-up of costs associated with providing the services. ActewAGL's revenue cap proposal for these services would need to include some detail on the build-up of costs. In assessing the build-up of costs the AER would have regard to whether the proposed costs are efficient, and would allow a return on capital equal to that allowed for standard control services.

3.3 ActewAGL's response

ActewAGL believes that the current form of regulation applied to excluded services in the ACT should continue to apply. The AER's approach should recognise the regulatory risk associated with metering, and acknowledge that additional costs associated with any new requirements for "smart" meters or interval meters will be fully compensated in metering charges.

Responses to the AER's specific questions are as follows:

1. Should the AER apply a total revenue cap to alternative control services in the ACT? If so, are any modifications to the total revenue cap as applied by the ICRC appropriate?

Response: Yes, the total revenue cap is appropriate. It will need to be modified to address additional costs associated with any new metering requirements being proposed for the coming regulatory period. The annual escalation by the CPI will not be adequate to cater for the increased costs of the interval meters currently being installed. Also, it would not be appropriate where significant additional costs were imposed by requirements to introduce smart meters or to read installed interval meters as interval meters (see further discussion below).

ActewAGL notes that the pass through provisions in the transitional chapter 6 (and also the general chapter 6) do not appear to cover possible pass through for alternative control services. Clause 6.6.1(j)(2) refers to the need for the AER to take account of the increase in costs in the provision of *standard control services*. It does not refer to alternative control services. It is therefore important that the possible need to pass through additional costs associated with new metering requirements is addressed explicitly in the AER's approach to alternative control services.

2. In determining a revenue allowance for the next regulatory control period, should the AER:

a. escalate current allowances, or

b. undertake a building block analysis?

Response: A limited building block analysis is appropriate to establish the revenue cap for the start of the 2009-14 period.

3. If a building block analysis is undertaken, should the AER adopt the approach to the building block analysis outlined in section 3.4.1?

Response: Yes.

3.3.1 Further comments on metering costs

Metering costs are an area of continued uncertainty for ActewAGL. During the last regulatory round it was anticipated that all metering would become contestable. However, the rules were subsequently changed so that ActewAGL remained the sole provider of manually read meters (types 5 and 6).

Following that decision, the ICRC, as jurisdictional regulator, released a decision that required interval meters to be installed in all new premises, as replacement meters and where requested by consumers. The ICRC concluded that ActewAGL should not be financially disadvantaged as a result of its decision and allowed it to pass on the additional cost of implementing this program.

ActewAGL has so far been able to manage and limit the cost of interval meters for small consumers by reading the meters as time-of-use meters rather than an interval meters. If consumers or retailers choose to have their interval meters read as interval meters, the cost of metering for residential customers rises from $38.14 per annum to $192.72 per annum (including GST). For a non-residential customer, the cost of metering rises from $68.26 per annum to $702.63 per annum (including GST) when read as an interval meter. The main reason for the difference between residential and non-residential customers is that the data from residential customer meters are read and processed quarterly while non-residential meters are read and processed monthly.

The cost of interval meters is high because the data has to be downloaded and then processed. ActewAGL uses contractors to provide these meter reading and data processing services.

The Ministerial Council on Energy is proposing to change the metering rules and require the installation of meters with a capacity for two-way communications. It is anticipated that these “smart” meters will be required to be installed over a five year period. The “smart” meters are expected to add substantially to metering costs and, for this reason, are being subject to a detailed cost-benefit analysis.

4. Materiality for pass through events

4.1 Current ACT arrangements

The materiality test adopted by the ICRC in its 2004 determination (p. 138) is that the effect of the event:

> must be such that the annualised cost incurred, or forecast to be incurred, by ActewAGL as a result of the event occurring is at least $1.0 million (in 2002–03 dollar terms) in any one year above the costs reasonably foreseen by the commission and ActewAGL and incorporated in this final decision.
>
> The annualised cost in any year = the amount of additional operating expenditure incurred in that year + 15 per cent of the additional capital expenditure incurred in that year.

ActewAGL argued, in response to the 2003 draft determination, that it is not appropriate to set an explicit materiality threshold.

The ICRC acknowledged that regulators have found difficulty in defining a specific threshold, and noted that the selection of the threshold for materiality will always, to some extent, be arbitrary (p. 125). However, it retained the threshold of $1.0 million in any one year.

4.2 The AER's considerations

The AER explains in the *Issues Paper* that it considers it important to set an appropriate materiality threshold for pass through as the threshold represents a trade-off between ensuring that:

- It does not create a 'cost-plus' form of regulation; and
- It does not exclude events that have a serious impact on the DNSP's financial position.

The AER considers that the threshold should be clear in its application to both opex and capex. It then raises a range of issues and options for how the impact of the event should be measured and how the threshold should be set.

4.3 ActewAGL's response

ActewAGL agrees that it is important that the pass through mechanism does not create a cost-plus form of regulation, while at the same time ensuring that the DNSP is able to recover the efficient costs of meeting its obligations and delivering its services.

However, it does not necessarily follow that it is appropriate to specify an explicit materiality threshold. The transitional Rules, and the general chapter 6 Rules, contain checks against inefficient claims by DNSPs – for example by requiring the AER to take account of the efficiency of the provider's decisions and actions in relation to a positive change event (clause 6.6.1(j)). We therefore believe that there is not a strong need for a threshold to prevent a 'cost-plus' form a regulation.

On the other hand, there is a risk that a threshold set too high could potentially limit the ability of the DNSP to recover efficient and legitimate costs. Furthermore, the design of the threshold could distort the timing and level of expenditure – for example, if the threshold is based on annual costs, there may be an incentive to concentrate the expenditure in a short period to ensure that the annual threshold is met, even though it may be more efficient to stage the expenditure over several years.

ActewAGL acknowledges that there will be benefits from setting a materiality threshold, to the extent that it helps to provide up-front certainty about which claims will be considered material. There will also be benefits to the extent that the threshold eliminates small claims, where the transactions costs of lodging and assessing the claim may be greater than the value of the claim. However, it is not clear that these benefits necessarily justify the application of a specific threshold.

ActewAGL therefore believes that the AER should consider 'no threshold' as an option.

4.3.1 Design issues if a threshold is adopted

As the AER's list of options and questions indicates, there are many possible ways of designing a threshold. ActewAGL believes that there is no ideal model, and agrees with the ICRC's comment that any threshold will to some extent be arbitrary.

It is important that the approach taken is flexible enough to deal with the wide range of cost and revenue impacts associated with different types of pass through events. It should not, for example, result in a situation whereby a claim is rejected as immaterial simply because its costs are spread over 4 years, while a claim of similar total magnitude is assessed as material because its cost and revenue impacts are concentrated in 2 years.

This type of perverse outcome, where the conclusion on materiality depends on the timing of the costs, could arise if the threshold is based on the average annual cost or revenue impact (one of the AER's options). The average annual approach could also create a situation where an event has a material impact overall but the threshold is not met in some years so the pass through is not approved in those years.

To address these types of timing issues, the AER should consider a threshold that does not depend on the timing of the costs or revenue impacts. For example, the claim could be considered material if the total cost or revenue impact exceeds a certain percentage of the value of the Regulated Asset Base (RAB).

On the other hand, an average annual approach may be appropriate in cases where an event results in a relatively even spread of costs over the regulatory period, for example a tax change event.

As well as catering for different types of pass through events, with different impacts spread over time, the approach to materiality must be flexible enough to deal with different DNSPs. If a proportional approach is taken, this may seen to be inequitable to the extent that it implies that $x to a large DNSP is worth less than $x to a smaller DNSP. On the other hand, a uniform dollar threshold implies that the impact, or 'materiality', of an $x increase in costs is identical across all business, regardless of relative size.

Therefore ActewAGL suggests that, instead of trying to define a single threshold to apply to all types of pass through events and all DNSPs, it may be appropriate to apply a DNSP-specific threshold based on an assessment of 'materiality' to each specific business. Alternatively, the AER might consider a two stage materiality test that incorporates a "safety net" for larger DNSPs, whereby:

- The cost or revenue impact of the event must exceed x% of the value of the RAB; or
- The cost or revenue impact of the event must exceed an absolute dollar amount determined to be material for a larger DNSP.

ActewAGL notes that a flexible approach of defining a number of possible ways in which the materiality requirement may be satisfied is consistent with the purpose of guidelines, which is to provide guidance to DNSPs rather than provide a definitive and binding statement on the AER's approach.