ACTEWAGL DISTRIBUTION

RESPONSE TO PRELIMINARY FRAMEWORK AND APPROACH

Regulatory Control Period commencing 1 July 2019

Submission to the Australian Energy Regulator

ActewAGL for you

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1 Background and overview

ActewAGL Distribution, equally owned by Icon Water Limited and Jemena Limited via subsidiary companies, is the Distribution Network Service Provider (**DNSP**) for the Australian Capital Territory (**ACT**) electricity distribution network.

Prices for network services provided by and in connection with electricity distribution networks are subject to the regulation of the Australian Energy Regulator (**AER**) under the National Electricity Law and National Electricity Rules (**Rules**). A new five year regulatory control period for the ACT electricity distribution network will begin on 1 July 2019 (**next period**). As the first part of the process for making a regulatory distribution determination for the next period, the AER must by the end of July 2017 publish a framework and approach paper (**F&A paper**) in respect of certain matters set out in the Rules.[1]

On 10 March 2017, the AER published its preliminary positions on the F&A (**preliminary F&A**) for the 2019-24 regulatory period.[2] This submission by ActewAGL Distribution responds to issues raised by the AER in the preliminary F&A.

1.1 Scope of the framework and approach

For some matters, the AER's decision in the F&A paper applies to the distribution determination to be published in April 2019. These are:

- the form (or forms) of the control mechanisms applying to prices or revenues; and
- whether or not electricity transmission services provided by the DNSP should be priced under the rules that apply to transmission.

For other matters, the F&A paper sets out the AER's proposed approach in the forthcoming distribution determination. These matters are:[3]

- the regulatory classification of distribution services;
- the formulae that give effect to the control mechanisms;
- the application to the DNSP of any or all of several regulatory incentive schemes;
- the application to the DNSP of the AER’s Expenditure Forecast Assessment Guidelines; and
- whether depreciation for establishing the regulatory asset base (**RAB**) of the distribution system as at the commencement of the following regulatory control period is to be based on actual or forecast capital expenditure (**capex**).

[1] Specifically, National Electricity Rules, clause 6.8.1, sets out the matters that are subject to the framework and approach.
[2] AER 2017, *Preliminary framework and approach, ActewAGL,* Regulatory control period commencing 1 July 2019. March
[3] For the first two of this latter group (classification of services and control formulae), a change of approach from the F&A paper to the final determination requires there to have been “unforeseen circumstances”.

In late October 2016, ActewAGL Distribution, as required under the Rules, provided a submission to the AER (**request to make an F&A paper**) setting out which F&A matters for the current 2014–19 regulatory period (**current period**) it wished to have revised for the next period, and the reason for making such a request. Following review of the submission, the AER determined in December 2016 that, given the broad extent of changes to the regulatory environment, it was prudent to review all F&A matters.

ActewAGL Distribution seeks further consultation with the AER on the relevant matters before the F&A paper is finalised.

As noted by the AER, its approach to some of the F&A matters could be impacted by the outcomes of reviews into previous determinations currently before the Federal Court where the timing and nature of changes is uncertain. There are several other institutional processes in train with effect on one or more F&A matters. These include implementation of the AER's new ring fencing guidelines, proposed and finalised Rule changes, and pending reviews of schemes and guidelines under the Rules.

Table 1 summarises ActewAGL Distribution's views on the AER's preliminary F&A approaches. The remaining sections of the submission discuss these matters in more detail.

Table 1: ActewAGL Distribution's comments on the AER's preliminary F&A approaches

F&A matter	*ActewAGL Distribution comments*
Classification of distribution services	• At a high level, the AER's proposed classifications of ActewAGL Distribution's network services are consistent with our assessment. • ActewAGL Distribution seeks greater clarity in the explicit definition of the *ancillary services* grouping. • At this stage, ActewAGL distribution is uncertain as to the precise extent of unregulated distribution services it will be offering in the next period. These will be subject to review in the context of our implementation plan for ring fencing to be presented to the AER in the near future.
Control mechanisms	• ActewAGL Distribution does not oppose implementation of a revenue cap control mechanism for standard control services subject to greater clarity around transition from the current average revenue cap form of control and other elements of the control formula. • ActewAGL supports continuation of caps on the prices for individual services as the control mechanism for alternative control services.
Formulae for control mechanisms	• ActewAGL Distribution notes that relevant detail is lacking around the operation of the adjustments in the formula for the revenue cap for standard control services. While the preliminary F&A notes that the details of the formulae will be decided in the distribution determination, we consider explanation could be provided for greater clarity on several practical elements of their operation.

F&A matter	*ActewAGL Distribution comments*
	• The AER's proposed price setting formula for alternative control services is as currently used and is consistent with ActewAGL Distribution's expectations.
Service Target Performance Incentive Scheme	Given the current circumstances and effects of dramatically reduced operating expenditure in the current period, ActewAGL Distribution could not support proceeding on the basis that the existing STPIS will apply without significant changes to STPIS parameters being implemented in the determination.
Efficiency Benefit Sharing Scheme	ActewAGL Distribution agrees with the AER preliminary F&A that an EBSS should apply in the next period where opex is forecast based on a revealed cost approach.
Capital Expenditure Sharing Scheme	ActewAGL Distribution accepts a Capital Expenditure Sharing Scheme as an element of balanced incentives to increase DNSP efficiency, but maintains that in the case of ActewAGL Distribution, the inclusion of customer initiated capex in the scheme can create perverse incentives.
Demand Management Incentive Scheme	• ActewAGL Distribution supports in principle the application of a Demand Management Incentive Scheme and allowance mechanism that provides rewards for implementing non-network options and net cost savings to electricity consumers. • ActewAGL Distribution considers that the scope of eligible projects should be interpreted as broadly as possible.
Expenditure forecast assessment guideline	ActewAGL Distribution offers several comments in response to the AER's invitation to make explicit specific concerns regarding the application of the EFA Guideline.
Depreciation	ActewAGL Distribution supports the AER's preliminary position to use forecast depreciation to establish the RAB at the commencement of the 2024-29 regulatory control period.
Dual function assets	• ActewAGL Distribution welcomes the AER's recognition in the preliminary F&A that the assets characterised as dual function assets in 2012 conform to the Rules definition. • We have provided further information as requested by the AER that we believe explains the increase in the value of the dual function assets.

1.2 Customer engagement

ActewAGL Distribution has established an extensive consumer engagement strategy to engage with and gather feedback from consumers, as part of preparing the 2019-24 regulatory proposal. Our approach to consumer engagement aims to ensure that consumer feedback is reflected in its development.[4]

An important component of the strategy is to keep the Energy Consumer Reference Council (ECRC)[5] informed about the progress and issues arising in preparing the proposal. This consultation with the ECRC commenced in August 2016 with a presentation containing information about the F&A. This consultation was further developed at subsequent ECRC meetings in October 2016, December 2016, February 2017 and April 2017.[6]

[4] An outline of the consumer engagement strategy is available on the ActewAGL Distribution website at http://www.actewagl.com.au/Networks/About-our-network/Initiatives/Consumer-engagement.aspx

[5] The ActewAGL Distribution Energy Consumer Reference Council (ECRC) is an independent forum providing representatives of the ACT community with an opportunity to provide considered input into operations and long term planning of ActewAGL Distribution.

[6] Copies of the ECRC meeting presentations containing the Regulatory Proposal content are available at http://www.actewagl.com.au/Networks/About-our-network/Initiatives/Consumer-engagement/ECRC-details/ECRC-meetings.aspx

2 Classification of distribution services

2.1 Overview

Service classification determines the extent of regulatory control to be exercised by the AER over services provided by a DNSP and ultimately how the DNSP can set prices to recover the cost of services.

In its request to make an F&A paper, ActewAGL Distribution noted that:

> *It is possible that changes could be required to service classifications for direct control services as the result of Rule changes and the commencement of metering competition for small customers in December 2017. Some such changes were included in the distribution determination for ActewAGL for the current period made by the AER in April 2015.*

Direct control services are those over which the AER determines in advance of the regulatory period the price that can be charged or the revenue that can be raised for provision of a service or group of services. Direct control services are further divided into **standard control services**, which are provided as part of a customer's electricity bill and **alternative control services**, which are services usually separate from basic services provided by the network in that they are requested with an identifiable beneficiary.

2.2 AER preliminary F&A

For ActewAGL Distribution, the AER's preliminary view is to continue to classify common distribution services (previously called *network services*) and connection services, which include connection to and augmentation of the network, as standard control services. In addition, the AER is proposing to include as standard control services:[7]

- Emergency recoverable costs (currently unclassified); and
- Type 7 metering services (covering the calculation of costs for small, unmetered loads including public lighting connections).

The AER proposes to classify as alternative control services those which it groups as ancillary services as well as certain metering services. The metering services that would be alternative control services are those which are currently supplied by ActewAGL Distribution (related to types 5 and 6 meters), but which from 1 December 2017 will no longer meet requirements in new and replacement applications.

The changes from 1 December 2017 are in connection with the Australian Energy Market Commission's (**AEMC's**) *Power of Choice* reforms. These reforms will see ACT consumers gain the ability to choose their meters through their electricity retailers or other metering providers. The meters will be remotely read ("smart") meters, also known as Types 1 to 4 meters.

ActewAGL Distribution has two current arrangements for its types 5 and 6 metering fleet:

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[7] Both of these are alternative control services in the current period.

- For those installed before 1 July 2015, ActewAGL Distribution will continue to recover the capital costs of the meter on an ongoing basis; and
- For those installed on or after 1 July 2015, capital costs are paid upfront by the customer.

The AER classifies as **negotiated services** those which it considers require a less prescriptive regulatory approach where DNSPs and customers are able to negotiate prices according to a framework established by the DNSP. The AER classified none of ActewAGL Distribution's services as negotiated services. ActewAGL Distribution has no such services in the current period and is not proposing to introduce negotiated services in the next period.

The AER defines as **unclassified services** in its preliminary F&A "services that are not distribution services [provided by means of, or in connection with, a distribution system] or services that are contestable".[8] It nominates in this category:

- Types 1 to 4 metering services (further described in Appendix B to the preliminary F&A[9] as "Type 1 to 4 meters and supporting services [that] are competitively available"); and
- Unregulated distribution services: Such services nominated by the AER in Appendix B to the preliminary F&A[10] are:
  - Distribution asset rental—rental of assets to third parties (for example, office space rental, pole and duct rental etc); and
  - Contestable metering support roles—includes metering coordinator, metering data provider and metering provider for meters installed or replaced after 1 December 2017.

2.3 ActewAGL Distribution response

At a high level, the AER's proposed classifications of ActewAGL Distribution services are consistent with our assessment.

In general, we concur with the AER's proposed approach of:[11]

> *… classifying distribution services in groupings rather than individually … obviat[ing] the need to classify services one-by-one and instead defin[ing] a service cluster, that where a service is similar in nature it would require the same regulatory treatment.*

However, we observe in this regard that the AER's detailed table of its preliminary classification of ACT distribution services (in Appendix B of the Preliminary F&A) lacks an overarching statement of the general nature of *Ancillary services* of the type provided in the same table for *Common services*. An example of such a statement based on the definition of common services in the text of the preliminary F&A[12] is as follows:

[8] AER 2017, p11
[9] AER 2017, p84
[10] AER 2017, p88
[11] AER 2017, p17
[12] AER 2017, p28

> *Ancillary services involve work on, or in relation to parts of ActewAGL's distribution network. Therefore similar to common distribution services, only ActewAGL may perform these services in its distribution area. Ancillary services share the common characteristic of being services provided to individual customers on an 'as needs' basis (eg meter testing and reading at the customer's request, moving mains, temporary supply).*

In the absence of such a statement, the definitive Appendix B lacks an anchor for ancillary services that would allow ActewAGL Distribution include services in its pricing schedule with the confidence they would be accepted as ancillary services, and thus as alternative control services.

As recognised by the AER, the impact of the AER's new ring fencing guideline, currently under implementation, provides an additional complication in relation to classification. The AER states in the preliminary F&A that:[13]

> *Developing a comprehensive list of unregulated distribution services will be challenging as this service group will capture all distribution services that are contestable services.*

At this stage, ActewAGL Distribution is uncertain as to what unregulated distribution services it will offer in the next period. As the AER is aware, these will be subject to assessment in the context of ActewAGL Distribution's implementation plan for ring fencing which will presented to the AER in the near future.

[13] AER 2017, p31

3 Control mechanisms

3.1 Overview

The AER's F&A paper will determine the form control mechanisms that the AER will apply to ActewAGL Distribution's direct control services. There needs to be separate mechanisms applying to standard control and alternative control services. The decision made at that stage will be binding on the determination.

In its request to make an F&A paper, ActewAGL Distribution noted in respect of standard control services that:

> *Whether the form of regulation applying in the current period to ActewAGL Distribution's standard control services should continue to be an average revenue cap into the Forthcoming Period needs to be considered in the overall context of the changing business environment for electricity distribution and the potential volatility of electricity consumption forecasts.*
>
> *ActewAGL Distribution seeks amendment or replacement of the form of control mechanism to ensure it retains a fair opportunity to recover its determined revenue requirement over the Forthcoming Period in order to be able to provide services in the long term interests of customers.*

ActewAGL Distribution did not request the AER to amend the F&A with regard to the control mechanism or formula for giving effect to the control mechanism for alternative control services.

3.2 AER preliminary F&A

The AER's preliminary view on the control mechanisms for ActewAGL Distribution is as follows:

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

The AER notes that the transition to a revenue cap for standard control services would ensure consistent regulatory arrangements across all electricity distributors subject to economic regulation under the Rules. It also considers that a revenue cap will result in benefits to consumers through a higher likelihood of revenue recovery at efficient costs and will provide a better incentive for demand side management than ActewAGL Distribution existing average revenue cap for standard control services.[14]

The AER notes also that the continuation of caps on the prices of individual services for alternative control services would ensure consistency across regulatory control periods and jurisdictions.

[14] AER 2017, p12

3.3 ActewAGL Distribution response

ActewAGL Distribution does not oppose implementation of a revenue cap control mechanism for standard control services subject to greater clarity around transition from the current average revenue cap form of control and other elements of the control formula. This matter is discussed under the formulae for control mechanisms section below.

ActewAGL supports continuation of caps on the prices for individual services as the control mechanism for alternative control services.

4 Formulae for control mechanisms

4.1 Overview

The AER is required to set out its proposed approach to the formulae that give effect to the control mechanisms for direct control services discussed in the previous section.

In its request to make an F&A paper, ActewAGL Distribution noted that:

> *If the form of control for standard control services were to change for the forthcoming period, the formulae used to give effect to the form of control would also need to be revisited. The formulae used currently vary, for example, according to circumstances in the particular jurisdiction across National Electricity Market jurisdictions, even where the same form of control is applied. ActewAGL Distribution seeks to ensure that appropriate formulae are applied to give effect to its control mechanism.*

ActewAGL Distribution did not request the AER to amend the F&A with regard to the control mechanism or formula for giving effect to the control mechanism for alternative control services.

4.2 AER preliminary F&A

Given that the AER has stated an intention to change the control mechanism for standard control mechanism to a revenue cap from the current average revenue cap, it has proposed a formula to give effect to a revenue cap. The revenue cap formula is as set out in Figure 2.1 of the AER's preliminary F&A.[15]

4.3 ActewAGL Distribution response

ActewAGL Distribution agrees that the set of formulae published in the preliminary F&A in relation to standard control services gives effect to a revenue cap. We note that relevant detail is lacking around the operation of the adjustments in equation 2, which includes the interaction with the unders and overs account. While the preliminary F&A notes that the details of the formulae will be decided in the distribution determination, we consider explanation could be provided on the following:

- the application of incentive amounts is unclear. We seek clarity on the treatment of EBSS, DMIS and CESS in the revenue recovery, while assuming that the STPIS is excluded from the general incentive factor since there is a separate S factor for STPIS in the formula;
- there is a lack of clarity in the annual adjustment factors. The AER notes that it includes unders and overs account adjustments. We assume that the mentioned factor equals a dollar amount and not a percentage;
- it is unclear to ActewAGL Distribution how the timing of unders and overs will operate in the transition to a revenue cap. In addition, the formulae do not explicitly include the balance of the unders and overs account;

[15] AER 2017, pp43-44

- the term "TAR_{t}" is calculated using forecast energy for year t although forecasts are less critical for revenue recovery under a revenue cap. It is unclear what forecasting arrangements would apply to ActewAGL Distribution; and
- AER's proposed formula for the consumer price index (**CPI**) adjustment relies on only two data points. Averaging four quarterly indices provides a better reflection of inflationary impacts throughout the year and is likely to be more stable.

The AER's proposed price setting formula for alternative control services is as currently used and is consistent with ActewAGL Distribution's expectations.

5 Service Target Performance Incentive Scheme

5.1 Overview

The national distribution Service Target Performance Incentive Scheme (**STPIS**) provides a financial incentive to DNSPs to maintain and improve service performance. The STPIS adjusts ActewAGL Distribution prices each year to reward or penalise network reliability and call centre performance relative to a target established in the determination. Elements of the STPIS that can be varied across businesses include:

- the service performance parameters to apply
- the level of revenue at risk
- incentive rates (levels of rewards/penalties), including the value of customer reliability (**VCR**)
- performance targets
- the major event day (**MED**) boundary
- the AER guaranteed service level (**GSL**) scheme

In its request to make an F&A paper, ActewAGL Distribution noted that:

> *ActewAGL Distribution supports in principle the application of an STPIS. We do not propose changes to the existing scheme but seek consultation on the specific parameters of the STPIS to apply to ActewAGL Distribution during the regulatory review process. We also seek consultation on other elements of the STPIS such as the manner of calculation of performance targets and the revenue at risk.*

Subsequent to this submission, the AER has separately commenced a review of the STPIS as it applies to all businesses, with an issues paper published in January 2017. The AER's final STPIS is scheduled for publication in October/November 2017.

These two reviews of STPIS applying to ActewAGL Distribution will take place in parallel. This raises questions about how and when the impact of the broader STPIS review will feed into the determination.

5.2 AER preliminary F&A

The AER's preliminary position is to apply the national STPIS to ActewAGL Distribution in the next regulatory period as it currently applies.

5.3 ActewAGL Distribution response

One of the points of contention with the AER during the 2015-19 determination process and subsequent appeal to the Australian Competition Tribunal was the extent to which operating expenditure (**opex**) affects reliability. The AER argued that reliability was largely driven by sunk capex and that opex is not the major determinant of ActewAGL Distribution's ability to meet performance targets. ActewAGL Distribution agreed that opex was not the only driver of reliability, but nonetheless it was a significant driver.

ActewAGL Distribution is observing that under the current reduced levels of opex unplanned system average interruption duration index (**uSAIDI**) has started to increase relative to unplanned system average interruption frequency index (**uSAIFI**) potentially as a result of the reduced number of crews available to respond on days with multiple supply interruptions.

The STPIS currently applying to ActewAGL Distribution set the level of revenue risk at 2.5 per cent each year. The default level is 5 per cent. ActewAGL Distribution proposed the lower level in its revised regulatory proposal to mitigate the risks posed by the dramatic reduction in forecast opex in the AER draft decision. It is argued that a 5 per cent level would effectively be asymmetric because the reliability levels corresponding to the lower bound would be technically infeasible.

Given the circumstances set out above, ActewAGL Distribution could not support the F&A process proceeding on the basis that the existing STPIS will apply or without significant changes to STPIS parameters being pursued in the determination.

6 Efficiency Benefit Sharing Scheme

6.1 Overview

An efficiency benefit sharing scheme (EBSS) is a mechanism intended to provide a DNSP with a continuous incentive to reduce opex by allowing the DNSP to retain savings on approved opex for five years before passing the benefit of lower costs to consumers.

ActewAGL Distribution supports in principle the application of an EBSS. We note, however, that a consistent and effective implementation of the EBSS depends on the application of a revealed cost approach to forecasting operating expenditure requirements.

In its request to make an F&A paper, ActewAGL Distribution asked the AER, in the context of its intention to review the current Expenditure Forecast Assessment Guideline[16] and of the pending decision of the Federal Court on the 2015–19 ActewAGL distribution determination, to clarify its intentions on the application of revealed cost approach versus other methodologies.

6.2 AER preliminary F&A

The AER has indicated in the preliminary F&A an intention to apply an EBSS to ActewAGL Distribution for the 2019–24 regulatory period and that AER's Distribution Determination for 2019–24 will specify if and how the AER applies an EBSS.[17]

The AER also notes that the EBSS does not apply in the current (2015–19) regulatory period. Having made their 2015-19 determination outside the framework of revealed costs, the AER was uncertain whether, and to what extent, it was likely to rely on revealed costs in the 2015-19 period to forecast opex in the 2019-24 period. This provided, it argues, a strong reason not to apply the EBSS in the 2015-19 period.[18] The AER states that a decision whether to apply an EBSS will depend on whether the AER will use ActewAGL Distribution's revealed costs in the 2019–24 regulatory control period to forecast opex in the 2024–29 regulatory control period.

The AER is strongly of the view that any EBSS must provide a 'fair' sharing of efficiency gains and losses between the distributor and consumers. Both the distributor and consumers are to receive a benefit when ongoing reductions in opex are achieved; similarly both share ongoing increases in opex.

The AER is cognisant of incentives DNSPs may have to capitalise expenditure. Where opex incentives are balanced with capex incentives, a DNSP does not have an incentive to favour opex over capex, or vice versa. Since the CESS is a symmetric capex scheme with a 30 per cent incentive power, this is consistent with the incentive power for opex when we use an unadjusted base year approach in combination with an EBSS. Since the AER is also proposing a CESS in its preliminary F&A, any perverse incentives to ActewAGL Distribution relating to a possible opex-capex trade-off are likely to be avoided.

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[16] AER 2016, *Statement of intent 2016-17*, p6
[17] AER 2017, pp56-57
[18] AER 2017, p57

6.3 ActewAGL Distribution response

ActewAGL Distribution agrees with the AER preliminary F&A that an EBSS should apply in the next period where opex is forecast based on a revealed cost approach.

The current litigation in the Federal Court and the absence of an undisputed final decision for the current regulatory control period presents ActewAGL Distribution with uncertainty regarding the means by which it should forecast next period opex. The retrospectivity and severity of the AER's determined opex cuts left ActewAGL Distribution no choice but to immediately pair back activities to minimise business risk. The consequences of the cuts include a lack of clarity around efficient base year expenditure and the need to identify and estimate the cost of underperformed maintenance. Preliminary evidence shows that service levels have been adversely affected. Should the AER be unsuccessful in its judicial review appeal of the Tribunal decision on the 2015-19 final decision, ActewAGL Distribution's preliminary view is that the AER should revert to a revealed cost approach in remaking the decision.

7 Capital Expenditure Sharing Scheme

7.1 Overview

The AER's Capital Expenditure Sharing Scheme (**CESS**) aims to provide incentives for DNSPs to undertake efficient levels of capex throughout a regulatory period by rewarding underspending and penalising overspending against approved capex.

In its request to make an F&A paper, ActewAGL Distribution noted its in-principle support for the application of a CESS, while indicating concern that the application to us of some aspects of the current scheme, particularly the inclusion in the scheme of capex for customer initiated works, is not appropriate.

7.2 AER preliminary F&A

The AER's preliminary F&A view is to apply the CESS to ActewAGL Distribution as per the capex incentive guideline. The AER points to principle of ensuring uniformity of application of incentives across all categories of capex.

7.3 ActewAGL Distribution response

The Rules require that a CESS must be consistent with the capex incentive objective, which is to ensure that:[19]

> *… the only capital expenditure that is included in an adjustment that increases the regulatory asset base is capital expenditure that reasonably reflects the capital expenditure criteria.*

The capital expenditure criteria are as follows:[20]

- *The **efficient costs** of achieving the capital expenditure objectives;*
- *The costs that a prudent operator would require to achieve the capital expenditure objectives; and*
- *A **realistic expectation** of the demand forecast and cost inputs required to achieve the capital expenditure objectives.*

The CESS currently applies to ActewAGL Distribution in the 2015–19 regulatory control period. We note that there a significant divergence between the incentives targeted by the CESS and actual incentives due to the presence of customer initiated capex. This capex category comprises a considerable proportion of ActewAGL Distribution's capex allowance, which arises from the fact that ActewAGL Distribution operates in the ACT, which has a non-contestable connection service regime.

As the costs of customer initiated works are outside the control of ActewAGL Distribution, timing differences account for a large if not overriding cause of differences between forecast and actual capex. For example, ActewAGL Distribution will be submitting its capex forecasts in January 2018, inclusive of customer initiated capex, for the 2019-24 period

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[19] NER Clause 6.4A(a), Clause 6A.5A(a).
[20] NER Clause 6.5.6(c), Clause 6A.6.7(c).

based on external information on new developments and land releases. When new developments are announced or land released, the actual customer requirements can change considerably. Hence, there is acute uncertainty inherent in forecasting such capex.

Any CESS penalty or reward arising from overspending or underspending in this capex category will not reflect improvement or reductions in cost efficiency. While ActewAGL Distribution notes that there are both upside and downside risks to service providers from uncontrollable events, overspending in customer initiated works could lead to perverse incentives for ActewAGL Distribution to underspend on capital projects elsewhere in its capex program to avoid facing a CESS penalty in the next regulatory period.

The result is a situation that is contrary to the capex criteria and the capital expenditure objective, where the application of the CESS often has no connection to:

- the efficient costs of achieving the capital expenditure objective; or
- capex based on a realistic expectation of demand or cost inputs.

Further, while we accept that in many cases a service provider can strive to control the resulting costs, ActewAGL Distribution is in a particularly low capacity to do so compared to other DNSPs due to the relatively large proportion of capex that is customer initiated.[21]

[21] Considerably higher than NSW DNSPs

8 Demand Management Incentive Scheme

8.1 Overview

ActewAGL Distribution acknowledges that the AER is currently engaging with stakeholders in developing a new demand management incentive scheme (**DMIS**) and innovation allowance mechanism. The AER is scheduled to release a draft DMIS and allowance mechanism for consultation in May 2017, and a final version in September 2017.

ActewAGL Distribution notes the objective of the new DMIS is to encourage the implementation of efficient non-network options to manage demand. ActewAGL Distribution understands that the objective of the new allowance mechanism is to provide distribution businesses with funding for research and development in demand management projects that have the potential to reduce long term network costs.

8.2 AER preliminary F&A

The AER's preliminary position is to apply the new Scheme and Allowance Mechanism to ActewAGL Distribution in the next regulatory period.

8.3 ActewAGL Distribution response

Clause 6.12.1(9) of the Rules provides that one of the constituent decisions of the AER for the distribution determination is predicated on how a Scheme and Allowance Mechanism would apply to a DNSP. We understand that while the new DMIS and allowance mechanism will apply across the National Electricity Market, the AER will be able to tailor it to different distribution businesses.

ActewAGL Distribution supports in principle the application of a DMIS and allowance mechanism that provides rewards for implementing non-network options and net cost savings to electricity consumers. ActewAGL Distribution considers that the scope of eligible projects should be interpreted as broadly as possible.

9 Expenditure forecast assessment guideline

9.1 Overview

The Expenditure Forecast Assessment Guideline (**EFA Guideline**) sets out how the AER intends to assess DNSPs' proposed expenditure and is, in turn, an important determinant on how a DNSP will prepare and present its expenditure proposal. In its request to make an F&A paper, ActewAGL Distribution noted that the AER has foreshadowed amendments to the EFA Guideline[22] and requested that:

> *If the new [EFA] Guideline is not published prior to the making or amendment of the new F&A Paper then, given issues in relation to the way this Guideline was applied in the last regulatory determination process, we seek consultation on changes to the F&A Paper to address concerns with the application of the existing Guideline in the Forthcoming Period*

9.2 AER preliminary F&A

The AER states in the preliminary F&A that "ActewAGL has not made explicit any specific concerns regarding the application of the EFA guideline [referencing ActewAGL Distribution's request to make an F&A paper]." and that, "Accordingly," the AER "propose[s] to apply the existing EFA guideline in the forthcoming regulatory period."[23]

The AER further states in this regard that it "would welcome ActewAGL's and stakeholders' submissions to this preliminary F&A in which they can raise their concerns with the application of the current EFA guideline."[24]

9.3 ActewAGL Distribution response

In response to the AER's invitation to make explicit specific concerns regarding the application of the EFA Guideline, ActewAGL Distribution offers the following comments.

Since the first Annual Benchmarking Report was issued by the AER in 2014, there has been considerable debate and disagreement regarding the appropriate model specification, data inputs and adjustments that should applied to the AER's approach. Following lack of resolution on these issues, ActewAGL Distribution appealed the AER's approach and use of benchmarking during the 2015-19 distribution determination process. The Australian Competition Tribunal (Tribunal) considered that the Regulatory Information Notice (RIN) and overseas data used by the AER was not fit for purpose and concluded that there were serious deficiencies in the AER's model. The AER is currently appealing the Tribunal's decision to the Federal Court on judicial review grounds.[25]

[22] AER 2016, *Statement of intent 2016-17*, p6
[23] AER 2017, p70
[24] AER 2017, p70
[25] Nothing in this response should be taken to prejudice our submissions in these proceedings.

ActewAGL Distribution refers to and repeats its contentions before the AER and subsequently the Tribunal in respect of the AER's economic benchmarking analysis.[26] We do not accept that the AER’s benchmarking models can be considered the most robust measures of overall efficiency available. From a statistical basis, there are clearly superior models available, some of which were presented to the AER during the last regulatory determination. Further, benchmarking only allows comparisons of DNSP performance if the comparisons are valid. Biases in the AER’s model specification mean that the results of its benchmarking analysis cannot be considered a true reflection of the absolute or relative productivity performance of DNSPs.

While ActewAGL Distribution appreciates the AER's reasons for maintaining its existing approach to economic benchmarking, pending the outcome of its appeal before the Federal Court, we maintain that, in the event that the Court affirms the Tribunal’s decision concerning opex, it will not be open to the AER to apply the analysis and conclusions reached in that Report in making ActewAGL Distribution's 2019-24 distribution determination.

With respect to the data used by the AER, ActewAGL Distribution encourages the AER to work with the industry to investigate how to better normalise the RIN data before conducting the various analyses.

If the AER is committed to improving its benchmarking technique in the future then it needs to go beyond simply refining its benchmarking tools.[27] It must be open to considering alternative approaches, engage genuinely with industry and experts on the concerns that have been raised and, in particular, investigate the reasons why:

- the multilateral total factor productivity (MTFP) model results in the same set of firms performing as “most” or “least” productive over time, in particular, to what extent do model specification issues bias the results because the MTFP does not account for differences in network design or operating differences;
- it would require completely unrealistic expectations of opex to move one of the “least” productive DNSPs to the position of one of the “most” productive under the AER’s MTFP model. For example, to be in the top four performers in terms of opex, ActewAGL Distribution estimates that its annual opex would need to be reduced by a further 50 per cent over and above the 36 per cent decrease already generated from the 2015-19 distribution determination;

[26] ActewAGL Distribution’s concerns with the AER’s approach to benchmarking are detailed in its submission to the AER’s 2014 Draft Benchmarking Report dated 3 September 2014, ActewAGL Distribution’s Revised Regulatory Proposal of 20 January 2015, and its merits and judicial review applications, primary and reply submissions, and oral submissions. As a result, we do not repeat these concerns here.

[27] The improvements required to the AER’s benchmarking approach go well beyond an improvement to data systems as foreshadowed in the AER’s *Statement of Intent 2016-17*, p16

- the AER recognises the need to adjust the stochastic frontier analysis for operating and environmental factors but makes no such adjustments to the MTFP analysis;[28] and
- the MTFP results are so sensitive to changes in specification and to what extent this limits the usefulness of the results for informing revenue determinations. For example, as ActewAGL Distribution has previously demonstrated, changes to the way in which cable lengths are measured and how high voltage assets are treated in the model have significant impacts on the relative productivity results.[29]

[28] ActewAGL Distribution maintains that the RIN data should be normalised as much as possible to account for differences between DNSPs, and ideally carried out before conducting the econometric analysis, thereby reducing the need for ad hoc, post modelling adjustments.

[29] ActewAGL Distribution 2014, Response to the AER's Draft Annual Benchmarking Report, pp9-10, September

10 Depreciation

10.1 Overview

To roll-forward the RAB to the start of the next regulatory control period, the RAB is updated for actual capex, actual inflation, actual disposals and depreciation. The AER determines the depreciation approach for rolling forward the RAB for the start of the 2024-29 regulatory control period as part of the framework and approach for the 2019-24 regulatory control period to provide sufficient incentive for ActewAGL to achieve capex efficiency gains over the 2019-24 regulatory period.

Schedule 6.2.1(e)(5) of the NER sets out how depreciation should be used to roll-forward the RAB:

> *The previous value of the regulatory asset base must be reduced by the amount of depreciation of the regulatory asset base during the previous regulatory control period, calculated in accordance with the distribution determination for that period.*

Depreciation can be based either on actual capex (actual depreciation) incurred during the regulatory period or the capex allowance forecast at the start of the regulatory period (forecast depreciation).

10.2 AER preliminary F&A

The AER's preliminary position is to use the forecast depreciation approach to establish the RAB at the commencement of the 2024-29 regulatory control period. The AER considers this approach will provide sufficient incentives for ActewAGL to achieve capex efficiency gains over the 2019-24 regulatory control period.

The AER's position is consistent with the capex incentive guidelines, which takes into account the relevant factors in the NER. In particular, the AER considers the incentive provided by the application of the CESS in combination with the use of forecast depreciation and other ex post capex measures should be sufficient to achieve the capex incentive objective.

The use of forecast depreciation to roll-forward the RAB is also consistent with the approach that will used to establish the RAB for the 2019-24 regulatory period.

10.3 Summary of proposed changes to the AER's preliminary position

ActewAGL Distribution supports the AER's preliminary position to use forecast depreciation to establish the RAB at the commencement of the 2024-29 regulatory control period. ActewAGL Distribution concurs with the AER that under most circumstances, this approach provides sufficient incentives for a NSP to achieve efficiency gains over the regulatory control period.

There would be a better case for actual depreciation if a NSP is not subject to a CESS or has persistently overspent or persistently incurred inefficient capex. In the absence of the CESS, the stronger efficiency mechanism from using actual depreciation provides the necessary incentives to ensure efficient capex.

11 Dual function assets

11.1 Overview

The Rules deem as a dual function asset:

> *… any part of a network owned, operated or controlled by a Distribution Network Service Provider which operates between 66 kV and 220 kV and which operates in parallel, and provides support, to the higher voltage transmission network …*

Parts of ActewAGL Distribution's 132 kilovolt (**kV**) sub-transmission network first satisfied this definition (and were therefore deemed to be a dual function asset) during the 2009-14 regulatory period when a second connection was made between the ActewAGL Distribution network and TransGrid's transmission network at Williamsdale. Part of the ActewAGL Distribution 132 kV network from that time ran parallel to the TransGrid transmission line between the existing Canberra transmission connection point (**TCP**) and the new Williamsdale TCP and allowed the ActewAGL Distribution network to provide support to TransGrid's transmission network to the Cooma region of southern New South Wales.

The AER's (binding) F&A decision as to whether transmission pricing will apply to dual function assets requires it to determine whether the value of the dual function assets comprises a sufficiently material proportion of the Distribution Network Service Provider's RAB.

11.2 AER preliminary F&A

When considering the materiality of ActewAGL Distribution's dual function assets, the AER notes in the Preliminary F&A that their value as a proportion of its RAB, at 19 per cent, as to 1 July 2016, has increased significantly from ActewAGL Distribution's corresponding estimate in the previous (2014-19) regulatory period.

This led the AER to conclude the following in the Preliminary F&A:

> *While our preliminary position is to apply transmission pricing rules to ActewAGL's dual function assets, our final position will be informed by further information requested from ActewAGL. … At this point, we are satisfied that the assets characterised as dual function assets in 2012 conform to the [National Electricity Rules] definition. We require further information from ActewAGL, including a rationale for the increase in the value for its dual function assets.*

11.3 Summary of proposed changes to the AER's preliminary position

In order to satisfy the AER's request for information on this matter, ActewAGL Distribution and AER officers have consulted on this matter before and since publication of the preliminary F&A. ActewAGL Distribution provided the AER with separate correspondence as a submission on this matter.[30]

[30] Devlin S 2017, Correspondence to AER, 20 April

The letter sets out that a substantial proportion of the growth in the value of dual function assets observed by the AER is explained by the level of the 2009 starting transmission value. This value was based on ActewAGL Distribution's initial assessment of the scope of the dual function assets, which did not adequately account for all relevant assets.

ActewAGL Distribution subsequently reviewed and improved its methodology for identifying dual function assets for consistency with industry practice, resulting in a higher estimate. We used this amended methodology in its regulatory proposals for the 2014–19 regulatory period when the initial regulated asset base (at 1 July 2009) was retrospectively split into distribution and transmission. This initial value of transmission assets was reviewed and accepted by the AER in its 2014 determination. A relatively large capex program allocated to dual function assets over the 2009–14 regulatory control period has also contributed to the growth in dual function assets over time. The nature of these asset additions was subject to AER review at that time.

The main drivers of the capex include augmentation expenditure relating to the Civic Zone Substation extension, construction of the new East Lake zone substation, and construction of the second point of electricity supply for the ACT. It should be noted that the zone substations, as transmission exit assets, is recovered from ACT electricity customers.

ActewAGL Distribution welcomes the AER's recognition in the preliminary F&A that the assets characterised as dual function assets in 2012 conform to the Rules definition. We have provided further information as requested by the AER that we believe explains the increase in the value of the dual function assets.

Abbreviations and acronyms

AAD	ActewAGL Distribution
ACT	Australian Capital Territory
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
capex	capital expenditure
CESS	Capital Expenditure Sharing Scheme
CPI	consumer price index
current period	2014-19 regulatory period
DMIS	Demand Management Incentive Scheme
DNSP	Distribution Network Service Provider
EBSS	Efficiency Benefit Sharing Scheme
EFA Guideline	Expenditure Forecast Assessment Guideline
F&A	Framework and Approach
F&A paper	Framework and Approach paper
GSL	Guaranteed Service Level
MED	Major Event Day
MTFP	Multilateral Total Factor Productivity
NEL	National Electricity Law
NER / Rules	National Electricity Rules
next period	Regulatory period commencing 1 July 2019
opex	operating expenditure
Preliminary F&A	AER'S preliminary positions on the F&A
RAB	Regulatory Asset Base
Request to make an F&A paper	AAD's submission to the AER of 28 October 2016

RIN	Regulatory Information Notice
STPIS	Service Target Performance Incentive Scheme
TCP	Transmission Connection Point
Tribunal	Australian Competition Tribunal
uSAIDI	Unplanned system average interruption duration index
uSAIFI	Unplanned system average interruption frequency index
VCR	Value of Customer Reliability